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Islamic Capital Market Products: Developments and Challenges

Salman Syed Ali

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بسم الله الرحمن الرحيم

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LIST OF ABREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BBA	*Bay[Bi-saman Ajil*
BMA	Bahrain Monetary Agency
CMC	Central Bank *Musharakah* Certificate
DJIMI	Dow Jones Islamic Market Index
FTSE	Financial Times Stock Exchange Index
FTSE-GII	FTSE Global Islamic Index
GDR	Global Depository Receipt
GIC	Government Investment Certificates
GMC	Government *Musharakah* Certificate
IDB	Islamic Development Bank
IDR	Islamic Depository Receipts
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Markets
IIRA	International Islamic Rating Agency
IOSCO	International Organization of Securities Commissions
IRTI	Islamic Research and Training Institute
LMC	Liquidity Management Centre
MC	*Mudarabah* Certificate
MCo	*Mudarabah* Company
NBFI	Non-Bank Financial Institution
PTC	Participation Term Certificate
SEC	Securities and Exchange Commission
SECP	Securities and Exchange Commission of Pakistan
SFSC	Sudan Financial Services Company

FOREWORD

Capital markets and interest-free financial products are integral part of Islamic financial system and also important for the growth of other Islamic financial institutions. Islamic Research and Training Institute have therefore pursued an active research interest in this area. Previously the Institute has published studies on various aspects of Islamic financial instruments and markets.

Financial markets in a number of IDB-member countries are growing fast, while other member countries are also actively trying to develop vibrant capital markets. New products and Islamic *sukuk* have been offered both by the public and private corporate sectors in local and international markets. In this backdrop the Institute took the initiative for the present paper "Islamic Capital Market Products: Developments and Challenges" which is prepared by Salman Syed Ali. It is hoped that the paper will serve to increase the understanding in developments and challenges of the new products for Islamic financial markets. The ideas explored in it will help expand the size and depth of these markets.

Bashir Ali Khallat
Acting Director
Islamic Research and Training Institute

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The opinions expressed in the paper reflect the views of the author which does not necessarily reflect the opinion and views of IRTI or IDB.

EXECUTIVE SUMMARY

The development of Islamic capital markets is integral part of development of capital markets in general. Such markets are essential for efficient resource mobilization and allocation. It is more so in an Islamic economy because prohibition of interest implies greater reliance on equities and asset based financing.

The paper focuses on the state of equity and stable income products (*sukuk*) in Islamic capital markets. Taking Bahrain, Malaysia, Pakistan, and Sudan as sample it surveys the size of the markets for stocks and *ijarah sukuk* and highlights the issues in their development. [Excluded from the analysis are the other products, the regulatory issues, and the aspects of market micro-structure]. This is done with the purpose to understand how to enhance the proportion of Islamic products in the capital markets of the IDB-member countries. Availability of appropriate products will induce the firms to use the markets in the member countries for raising the funds and investing them there.

Proportion of *shari[ah* compliant stocks in total market capitalization considerably varies between countries: ranging from 6.4 per cent in Bahrain to 51 per cent in Pakistan. Malaysia uses a different criteria under which this proportion comes to 57.7 per cent. This small portion shows that more is needed to transform the market by inducing changes in the businesses and their capital structure. At the same time, the criteria for determining *shari[ah* compliance of stocks needs further refinement and unification across jurisdictions. The *shari[ah* admissible set of stocks constructed using the debt to capitalization ratio criteria is quite sensitive to market trend. It is a source of stability if the set of *shari[ah* compliant stocks is large but a source of instability if it is small.

Sukuk are another class of products in the capital markets which have gained acceptance. It has great potential as financing and risk management tool both for corporate and government sectors. During the past three and a half years (2001-2005) the market for sovereign *ijarah sukuk* has witnessed 18 issues amounting to USD5.6 billion; and that for corporate *ijarah sukuk* 10 issues amounting to USD1.599 billion. However, these are still very small as compared to market needs.

The primary market for *ijarah sukuk* is expected to grow further. However, its secondary market has not yet developed. Targeting *sukuk* towards more diversified group of investors can help create its secondary market due to variable and non-correlated liquidity needs of such investors.

There are some un-resolved *shari[ah* issues in the design of many *ijarah sukuk* such as the buy-back arrangement; terminal pricing on maturity; and assignment of maintenance costs of the underlying-asset. These issues need to be resolved quickly for the stability and continued investor confidence in *sukuk*.

The paper also proposes new *ijarah sukuk* structure based on IDB and member country joint asset pool for financing of projects in the IDB-member countries.

Presently, market for Islamic capital market instruments is segmented across countries and regions this reduces the effective available size and risk-return spanning possibilities for investors. A system of Islamic Depository Receipts is therefore proposed to expand the market for Islamic products.

Case studies on the evolution of various other Islamic products in Pakistan, Malaysia, and Sudan provide a number of lessons for product development. Successful product development requires: tax neutrality across products; managerial incentives; management of adverse selection (and favorable selection) of issuers of the new product; and timing with the state of economic and financial market conditions. Liquidity of the product is an important aspect which is adversely affected by non-standard or un-familiar terms and conditions. Therefore, simplicity of the product and investor education both are required. While care must be taken for all these in designing of the product, the ultimate test of the product as well as refinements come through market after its launch. It is therefore important that the issuer remain active in product refinement as well as in creating investor awareness and education.

The paper concludes with medium-term strategic issues and other longer-term issues to enhance share of Islamic capital market products.

INTRODUCTION

The issue of development of Islamic capital market is not separate from the issue of development of capital market in general. Capital market plays a vital role in attracting savings and channeling them for productive purposes. Both primary and secondary markets are important in this regard. While the primary market directly effects the supply of funds for investment, the secondary market does the same indirectly. The function of secondary market is multi-fold. It provides liquidity to the assets by providing early exit opportunity; prices the assets and their associated risks on continuous basis incorporating relevant new information as it arrives. The liquidity and efficient pricing of risk and return encourages small savers to save more, and entrepreneurs to invest more in efficient manner. This is achieved when market correctly rewards the performance of the entrepreneurs by appreciation (or depreciation) of stock value. The savers (investors) and the entrepreneurs, both groups, gain to the proportion of stocks they hold. Moreover, the individual instruments as well as the static and dynamic portfolios constructed from these instruments provide opportunities to diversify risk across the society and over time. These features are attractive both to the suppliers and users of capital. In short, the capital market provides long-term capital through a series of short-term contracts.

The importance of capital markets in Islamic financial system also stems from the fact that Islam prohibits interest and encourages trade. Therefore, even the banking sector would tend to rely to a greater extent on financial markets. The banks would be either intermediating between savers and entrepreneurs through the markets or they would be directly financing their clients through fixed return[1] or equity based instruments. Thus they would have a non-negligible equity based assets in their asset portfolio. These factors would put banks in direct competition with the markets (as market substitutes) to the extent they intermediate directly between savers and entrepreneurs. It will also put them into a complementary role with the market to the extent the banks intermediate through the market.

[1] *Murabaha*, *ijarah*, *istisna[*, *salam*, are examples of fixed return contracts.

Another dimension which has started to bring capital markets to prominence in many countries is the increasing role of private capital flows. The economic growth previously relied on domestic financial sources of funding or foreign aid. This has changed with time, now private capital flows from abroad have also become an important financial contributing factor.[2] The importance of capital markets in tapping domestic as well as foreign financial resources have therefore increased manifold. Businesses and governments needing to finance their operations through Islamic modes cannot remain aloof to this development. Providing public finance through market based instruments in Islamic system remains a challenge for which well performing capital markets would be crucial.

The subject of development of Islamic capital markets is very broad. It can include a variety of aspects such as: the state of regulatory system and possible approaches for further development; market micro-structure and practices; product range and product development; nature and preferences of market players; identification and development of support institutions; market performance evaluation; cost benefit analysis of market expansion and integration; designing of incentive and corporate governance system; evaluation of the nature and role of Islamic capital markets in the overall Islamic financial system; and many other dimensions. The present study attempts to discuss only a subset of these issues involved in development of Islamic capital markets. Its primary focus is on products and product development. More specifically, the equity and stable income products like *sukuk*; and their implications for the future of capital market. When further focus is needed we have relied on examples from four countries namely, Bahrain, Malaysia, Pakistan, and Sudan.

The second section gives the landscape of capital markets. The third section discusses at length the two types of capital market products, equities in subsection-3.1 and *sukuk* in subsection-3.2 evaluating their nature and market size. These subsections survey the existing state of the two kinds of products, analyze their risks and risk mitigating potentials, as well as suggest some new innovation possibilities. The subsection-3.3 discusses the issue of standardization of products and procedures and proposes issuance of Islamic Depository Receipts which can help in achieving the convergence across different jurisdictions. The fourth section

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[2] Just to give an example from Kruger (2003), the net capital inflows to emerging markets were under US$48 billion in 1990 (about 0.8 per cent of their GDP). These flows had reached US$212 billion by 1996 (i.e., about 3 per cent of their GDP).

provides short case studies of product innovations from Bahrain, Malaysia, Pakistan, and Sudan highlighting the successes and challenging issues. This section brings out some lessons in product development. The concluding section summarizes the paper with recommendations and directions for the future.

2: THE CAPITAL MARKETS—LANDSCAPE

Islamic capital markets are supposed to perform all the useful functions of conventional capital markets with justice and equitable distribution of benefits. The subjective nature of justice and equity are bound to involve social welfare judgments that could lead to unsettled debates in societies (particularly when financial dealings are involved). However, the guidance provided in the *Quran* and *Hadith* on the moral rules and behavior along with the well defined boundaries of prohibitions and compulsory obligations narrow down this debate and these are fundamental to the concept of justice and welfare in Islam. Prohibition of interest is one such boundary applicable in financial and economic matters. Allah has prohibited receiving and giving of interest[3]. He has also prohibited obtaining each others property by wrongful means. Therefore, an Islamic capital market is to function without interest and without malpractices tantamount to grabbing others' property by wrongful means.

Islam also prescribes a compulsory financial obligation which is *zakah:* a financial/wealth obligation to be taken from the rich and given to the poor. Among the many purposes of *zakah* (and *fay)* one that is described in *Quran* is 'so that the wealth does not circulate only among your rich folk.'[4] Therefore, if capital markets are not growing to allow for increase in wealth and economic growth or if the growth is skewed resulting in concentration of wealth, then it is an indication of some weakness which needs correction.

With this view when we survey capital markets in the OIC-member countries, we find various issues needing attention. In some countries these markets are quite young while in some others they have a long history. Irrespective of their age, all these markets have found new vigor and an emerging role since 1990s. This is out of the globalization and move towards financial liberalization in the world. However, many of these markets are not growing fast enough to achieve a critical mass; and those

[3] Ayat of Quran prohibiting riba are at following five set of instances in Quran. (i) al-Roum 30:39, (ii) al-Nissa' 4:160-162, (iii) Ale-Imran 3:130-136, (iv) al-Baqarah 2:275-277, and (v) al-Baqarah 2:278-281.

[4] al-Hashar 59:7.

that are growing are not contributing enough towards economic development and balanced distribution of wealth. A number of observations can be cited to back these claims. For example, (i) despite economic growth in some countries companies are not seeking listing at their domestic stock exchanges, and little capital is raised through these markets. This is an indication of lack of confidence in the market by the market players. (ii) A large number of companies that are listed are closely held which allow only limited free float. (iii) Investor base is very small and stagnant.[5] This is true even for those Muslim countries where the markets have witnessed bullish sentiments. (iv) Most of the exchanges are run by brokers or few dominant players for their own interest, creating a closed club mentality rather than promotion of social interest.[6] (v) The proportion of traded scrip out of the total listed scrip is very small, thus market liquidity depends on few stocks acting as volume leaders. (vi) The above factors leave investors vulnerable to different forms of market abuses. Thus allegations of price manipulation, front running, insider trading, and blank selling are heard more often. (vii) Regulatory rules exist in a number of markets but the enforcement is weak. To further add to the negation of Islamic objectives, practice of borrowing and lending on interest for carry over transactions past the settlement dates, short-selling, and trading of debt instruments are also prevalent in many markets.

These factors call for a review of capital markets with a focus to develop them with Islamic orientation and growth objectives. There are also some issues specific to efficient functioning of Islamic capital markets, which also need to be addressed. These current issues include: (i) product development to cover wider range of maturity structures and risk-return spanning possibilities by *shari[ah* compatible products, (ii) Product standardization and *fiqh* convergence, (iii) measures to decrease market segmentation and their consequences, (iv) contract enforcement and protection of investors, (v) designing capital market products for participation of Islamic financial institutions in the capital markets, (vi) designing of infrastructure institutions to support *shari[ah* compatible products and *shari[ah* confirming market practices. It is hoped that a capital market that will thus evolve will better cater to the investment

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[5] For example in Pakistan, less than 1 per cent of adult population owns shares traded in the domestic stock markets. (Reported in Securities and Exchange Commission Pakistan (2004)).

[6] This is now changing, for example stock markets in Malaysia has been integrated and demutualized and same is likely to happen in Bangladesh, Pakistan, and some other countries.

needs and wider circulation of wealth in society and it will directly contribute to economic growth.

Below we discuss in some detail few obstacles to overall growth of capital markets as well as the impediments to their Islamic orientation in context of a sample of markets in four selected countries. Namely, Bahrain, Malaysia, Pakistan, and Sudan each representing a different region while each is intending to transform its financial markets in Islamic direction.

2.1 Market Penetration:

To what extent the capital markets are relevant in the economies of our sample countries? This relevance is measured by various ratios. Market capitalization as percentage of GDP is one of them. This ratio serves as a proxy for stock market penetration in the economy when used along with other indicators. The ratio of market capitalization to GDP has been low for Pakistan and Sudan while it is close to international benchmark of above 100 percent for Bahrain and Malaysia. Table-1 below displays this ratio for the four countries over last few years.

The theoretical relation between market capitalization and economic growth is not simple and often not very clear. Market capitalization can increase by (i) increase in stock prices, (ii) increase in new capital formation (economic investment) through stock markets, and (iii) by increase in flow of financial capital towards stock markets (asset substitution, i.e., increase in savings held in the form of stocks). A common link between market capitalization and the GDP is corporate earnings. An increase in expected corporate earnings directly contribute to increase in GDP and at the same time increases market capitalization through increase in stock prices and increase in new capital formation. The ratio of market capitalization to GDP is also affected by structure of financial system and liquidity in the stock markets. A higher liquidity enables the investors to buy and sell stocks easily. A liquid stock market reduces investment risk thus attracting financial flows and hence increasing market capitalization. The difficulty, however, is that corporate earnings is only but one of the many factors that affect market liquidity. Therefore, ratio of market capitalization to GDP has to be supplemented with other indicators to measure stock market penetration in the economy.

Table-1
Market Size in terms of Market Capitalization

Panel-A: Main Sample

	Market Capitalization USD billion			Market Capitalization as per cent of GDP		
	(2002)	(2003)	(2004)	(2002)	(2003)	(2004)
Bahrain	7.58 a			98.7 a	120 b	122.2c
Malaysia (KLSE)	122.9	168.6	190	130.0	171.8	
Pakistan (KSE)	9.7	16.26	24.7	13.5	19.7	26.0
Sudan	0.593	0.734	1.4	4.0	4.3	

a. Calculation based on data from BSE Annual Report on Mkt Cap and IFS data for exchange rate and GDP.
b. Calculation based on the value of Mkt Cap reported in BMA Annual Report 2003 and GDP for 2003 (at constant prices) reported in MBA Islamic Finance Review, Jan 2005 issue 8.
c. Calculation based on value of Market Capitalization as of Sep. 2004 reported in Bahrain Stock Exchange 3rd Quarter Highlights 2004 and GDP at current prices (local currency) 2004 reported by IMF World Economic Outlook Database.
Data for Pakistan (KSE) is from State Bank of Pakistan (SBP) Financial Markets Report (2004), Chapter-4. Conversion into USD is made using Average Exchange Rates for each year given in SBP Annual Report 2004.

Table-1 (Continued)

Panel-B: Size Comparison with some other OIC countries and World

Country	**Market Capitalization**				**S&P/IFC Investable Index**	
	Million USD		% of GDP		% change in price index	
	1990	**2004**	**1990**	**2003**	**2003**	**2004**
Bangladesh	321	3,317	1.1	3.1	15.4	104.3
Egypt	1,760	38,576	4.1	32.8	79.3	126.4
Indonesia	8,080	73,251	7.1	26.2	69.7	39.3
IR Iran	34,300	34,444	--	25.1	--	--
Jordan	2,000	18,383	49.7	111.2	65.4	55.0
Kazakhstan	--	2,425	--	8.2	--	--
Kyrgyz Rep.	--	31	--	1.6	--	--
Lebanon	--	2,321	--	7.9	0.9	53.5
Morocco	966	25,064	3.7	30.1	44.0	18.3
Oman	1,060	6,325	9.4	19.7	47.0	25.2
Palestine	--	6,292	--	182.1	--	--
Saudi Arabia	48,200	306,248	36.7	73.2	49.5	83.6
Tunisia	533	2,641	4.3	9.8	14.9	4.2
Turkey	19,100	98,299	12.7	28.4	113.2	32.9
UAE	--	--	--	11.4	--	--
WORLD	*9,403,525*	*32,436,350*	*48.0*	*89.7*		
LIC	*46,543*	*319,611*	*10.5*	*37.3*		
MIC	*328,522*	*2,534,088*	*19.4*	*44.5*		
HIC	*9,028,460*	*29,582,653*	*51.6*	*100.1*		

LIC: Low Income Countries; **MIC**: Middle Income Countries; **HIC**: High Income Countries
Source: Complied from *World Development Indicators* (2005) Table 5.4 Stock Markets. World Bank.

2.2 Corporate Earnings:

The data on corporate earnings is not available in consistent format for all the sample markets. The fragmented data that we have indicates that corporate earning has increased in past three years.

Bahrain: Of the 32 companies only 6 did not pay cash dividend in the year 2004. In the same year the average cash dividend per company was 19.05 per cent; average dividend yield per company was 2.99 per cent; and average Price-to-Earning ratio was 16 per cent.

Pakistan: Profit after tax in the corporate sector has increased by 26.5 per cent in 2004 (Rs. 106.359 billion) as compared to that in year 2003 (Rs.84.048 billion). However, out of 661 listed companies in 2004, about 20 per cent (141 companies) had not paid any dividend for the last three consecutive years.

2.3 Market Liquidity:

A second complementary measure we report is the Turnover Ratio which is the ratio between number of securities transacted daily divided by total number of outstanding securities in each market. (It is same as Value of Transaction Volume divided by Market Capitalization). This is used as an indicator of market liquidity. For healthy growth the market liquidity should grow in conjunction with market capitalization to GDP ratio.

”Table-2

Trading Volume and Market Liquidity

Panel-A: Main Sample

	Trading Volume (No. of shares in millions)			**Trading Value (Value of Transactions)**			**Turnover Ratio (Percent)**		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Bahrain	353.13	405.60	288.42*	80.905 mil BD	102.261 mil BD	363.01 mil USD	1.78	1.74	2.69
Malaysia	---	116,853.1**	122,680.4	---	195.373 bil RM**	243.862 bil RM	---	30.5	33.8
Pakistan (KSE)	41,627.20	76,380.08	51,413.60	805 bil Rs	2270 bil Rs	4925 bil Rs	135.3	238.7	346.5
Sudan	4,060.23	9,745.45	2,185.99	24.906 billion SD = USD95 mil	24.41 billion SD	44.772 billion SD	16.0	13.0	12.0

* End of Nov. 2004.

** 11 month period Feb-Dec 2003

Data Sources:

Data for Bahrain: Bahrain Monetary Agency, Annual Report, various years; Bahrain Stock Exchange, Annual Report, various years; BMA, Islamic Finance Review, various issues.

Data for Malaysia: Calculated from data from KLSE Website

Data for Pakistan: are from SBP, Financial Markets Report, Chapter 4, Capital Markets. It covers only KSE for Fiscal Year (i.e. July of a year to June next year); IMF Pakistan Financial Sector Assessment 2003.

Data for Sudan: from annual reports of Khartoum Stock Exchange.

Table-2 (Continued)

Panel-B: Liquidity & Listing Comparison with some other OIC countries and World

Country	Market Liquidity		Turnover Ratio		Listed Domestic Companies	
	Value Traded as % of GDP		Value of Shares Traded as % of Market Capitalization		Number	
	1990	**2003**	**1990**	**2004**	**1990**	**2004**
Bangladesh	0.0	0.6	1.5	36.1	134	250
Egypt	0.3	4.0	--	17.3	573	792
Indonesia	3.5	7.1	75.8	43.3	125	331
IR Iran	--	3.9	30.4	21.7	97	370
Jordan	10.1	26.4	20.0	36.3	105	192
Kazakhstan	--	1.4	--	22.0	--	41
Kyrgyz Rep.	--	--	--	58.1	--	17
Lebanon	--	0.7	--	10.3	--	13
Morocco	0.2	1.6	--	9.1	71	52
Oman	0.9	2.6	12.3	31.5	55	96
Palestine	--	1.7	--	1.7	--	27
Saudi Arabia	1.7	74.1	--	204.1	59	73
Tunisia	0.2	0.7	3.3	9.2	13	44
Turkey	3.9	41.4	42.5	182.3	110	296
UAE	--	0.0	--	3.4	--	--
WORLD	*28.5*	*83.4*	*57.2*	*72.4*	*25,424*	*50,038*
LIC	*5.0*	*42.5*	*48.2*	*130.5*	*3,321*	*7,988*
MIC	*5.1*	*21.6*	--	*60.9*	*4,370*	*14,456*
HIC	*31.4*	*96.8*	*59.4*	*110.1*	*17,733*	*27,594*

LIC: Low Income Countries; **MIC**: Middle Income Countries; **HIC**: High Income Countries
Source: Complied from *World Development Indicators* (2005) Table 5.4 Stock Markets. World Bank.

As can be observed the turnover ratio has increased in all four sample markets between 2003 and 2004. However, it is still very small in Bahrain and Sudan. While it is better in Malaysia but still less than benchmark of 80 per cent or more for the developed markets with similar market size. However in Pakistan, this ratio is quite high 346.5% in 2004 relative to the low market capitalization ratio. This suggests the possibility that high turnover is speculative in nature.[7]

2.4 Too Few Listings:

With the exception of Malaysia, too few companies are listed in the stock exchanges of the other three countries. This is true both in terms of the proportion of listed companies out of the total newly registered private limited companies, and in terms of percentage of new listings to the stock of existing total listed companies. The table below provides a comparison between the four selected member countries and some other developed markets. Low proportion of listings are also expected to be a norm in other OIC countries. While a number of internal firm specific factors determine the choice of firm to raise funds through internal or external resources the access to and confidence in financial markets also matters in this choice. Even those firms that are listed have weak financials and not actively traded in the market, where the activity is concentrated in only few shares.

[7] SECP (2004) Report of the Expert Committee, page 39, commenting on speculative trade in the three stock markets of Pakistan points out that less than 10 per cent of trade settles with delivery. "As much as 90% of the traded volume is squared up within the day or carried over and squared up later on."

Table-3

Number and Proportion of New Listings

Panel-A: Main Sample

Country	**Description of Variable**	**2002**	**2003**	**2004**
Pakistan	New Companies Listed (R1)	4	6	17
	Total Number of Listed Companies (R2)	711	701	661
	Percentage of New Listed Companies in the Total Listed Companies (R3) = R1/R2 x 100	0.56%	0.86%	2.57%
Malaysia	New Companies Listed	51	58	72
	Total Number of Listed Companies	865	906	963
	Percentage of New Listed Companies in the Total Listed Companies	5.9%	6.4%	7.5%
Bahrain	New Companies Listed	---	4	1
	Total Number of Listed Companies	40	44	45
	Percentage of New Listed Companies in the Total Listed Companies		9%	2.2%
Sudan	New Companies Listed	---	1	1
	Total Number of Listed Companies	46	47	48
	Percentage of New Listed Companies in the Total Listed Companies	4.35%	2.13%	2.08%

Panel-B: Comparison with other countries

Country	Percentage of New Listed Companies in the Total Listed Companies in 2003
Singapore	10.71%
Shanghai	08.59%
Australia	07.27%

Notes:

1. Data reflects total number of companies after new listings and de-listings from the market.

2. Data for Singapore, Shanghai, and Australia from *WFE Annual Report 2003.*

3: SURVEY OF SELECTED ISLAMIC CAPITAL MARKET PRODUCTS

The Islamic capital market with its distinct character is a natural outcome of the growth of Islamic financial services industry. The very initial entrants in the field of Islamic finance were Islamic savings and investment companies at small level. Mit GhimarBank (1961) in Egypt, earliest Islamic bank, is an example of it. Investment in stocks of *shari[ah* compatible businesses was always deemed fit in Muslim societies. If a firm is conducting *halal* (permissible) business then sharing in it through stocks is perfectly legitimate. However, the participation of masses in such activity was low and carried out at individual level or mostly through government operated mutual funds that invested in state-owned enterprises. National Investment Trust (NIT) in Pakistan is an example of it. Similar examples are found in other countries. On the whole the stock markets as such were not very vibrant.

In the later decades of 1970s and 1980s the creation of many Islamic banks, investment companies, and takaful companies gave rise to the need of products for their liquidity management requiring more structured involvement of Islamic finance in financial markets. The boost in capital markets of the Muslim countries came about after financial liberalization which allowed for foreign investment, repatriation of profits, and flow of funds. In Malaysia such moves started in the 1980s while in Bahrain, Pakistan, and some other countries in early 1990s.

Developments in Islamic capital market products have come about in response to the growing needs of the Islamic financial industry. An important stimulus is also provided by liberalization of financial sector in many countries which opened up new avenues as well as new concerns. Table-4 lists the major kinds of products that are currently available in the capital markets of four selected countries. For the purpose of this study we will focus only on few products: equities, and stable income products such as *ijarah sukuk* which are a recent phenomenon.

Trade in stocks or shares of companies having businesses not incompatible with *shari[ah* was always deemed possible. However, in the 1990s it became more structured by the entrance of Islamic banks, investment companies, and Islamic funds into stock markets. As a result various Islamic market indices were launched.

In the following section we discuss in some details two key products in Islamic capital markets (1) Equity and (2) *Sukuk*. We also propose new structures in *sukuk*, and propose introduction of (3) Islamic Depository Receipts as means to expand market and bring convergence in product standards, *shari[ah* rulings, and regulatory structures.

"Table-4

Kinds of Capital Market Products Available (in various markets)

Bahrain	**Malaysia**	**Pakistan**	**Sudan**
Ordinary Stocks	Ordinary Stocks	Ordinary Stocks	Ordinary Stocks
Preferred Stocks	Preferred Stocks/Warrants	Preferred Stocks/Warrants	
		Mudarabahs (or *Mudarabah Sukuk*)	
	Futures	Single Stock Futures	
	Index Futures Contracts (if underlying asset is *shari[ah* approved)		
Bonds	Bonds	Bonds and Term Finance Certificates (TFC)	
Ijarah Sukuk	*Ijarah Sukuk*	*Ijarah Sukuk* (issued but not available in local market)	
		Partnership *Sukuk* (Participation Term Certificates)	
Salam/*Istisna[* based *Sukuk*	*Salam*/*Istisna[* based *Sukuk*		*Salam*/*Istisna[* based *Sukuk*
			Special Gov Inv Cert., Central Bank *Musharakah* Certificates, Government *Musharakah* Certificates
Mutual Funds (Islamic/ Conventional)	Mutual Funds (Islamic/ Conventional)	Mutual Funds (Islamic/ Conventional)	
	Discounting Products		
	Murabaha Bonds (Securitized Debt)		
Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities

3.1 SHARES AND EQUITIES:

Main *shari[ah* issues pertaining to trade in stocks relate to (i) the business of the company whose stocks are to be traded, (ii) the form of stock/share contract, and (iii) *shari[ah* compatibility of trading practices pertaining to stocks. While some systematic screening has started on the basis of (i) above very little work has been done on (ii) and (iii) pertaining to form of the contract and elimination of *shari[ah* non-compliant trading practices. Conscious individuals and firms use their own judgment in such matters. We discuss current state of *shari[ah* screening criteria below.

3.1.1 *Shari[ah* compatibility of underlying business of the company:

A very early review and identification of *shari[ah*-compliant stocks was undertaken in 1983 by Bank Islam Malaysia Bhd., which led to introduction of a centralized process of such identification under Securities Commission of Malaysia in June 1997. The first Islamic equity index was launched in Malaysia by RHB Unit Trust Management Bhd. in May 1996. It was followed by Dow Jones Islamic Market Index (DJIMI) in February 1999, Kuala Lumpur Shariah Index (KLSI) in April 1999, and Financial Times Stock Exchange Global Islamic Index (FTSE-GII).[8] Various global, regional, and country specific Islamic index have been introduced since then by these companies. The most recent one being DJIM Turkey Index launched in September 2004.

In case stocks of the companies whose core business activity violates *shari[ah* restrictions there is consensus for non-permissibility of trade in those stocks. However, when it comes to mixed activity businesses then different jurisdictions and stock exchange players apply different criteria for screening of stocks. Three such criteria are compared below. The DJIMI at global level and Meezan Group in Pakistan's markets use screening criteria that screen stocks not only for the permissibility of underlying business of the company using source of income benchmarks (requiring information generally found in incomes statement); but also apply balance sheet composition bench marks to validate re-trading in them.[9] They however differ in their levels of benchmark for tolerance.

[8] IOSCO (2004) p. 28.
[9] A discussion with some Islamic fund managers revealed that they have to rely on much more deeper company level information than what is found in the income statements and balance sheets of the companies in order to correctly screen the stocks.

Whereas in Malaysia only income statement bench marks are used. No debt or liquidity ratio benchmarks are used. It can be seen that some of these criteria are ad hoc and agreed as a second best arrangement. However, the objective criteria serve better than subjective criteria.

Screening Criteria Differences

Screening Criteria of SEC Malaysia

Screening for *shari[ah* complaint stocks is done at central level by the Shariah Advisory Council (SAC) of the Securities and Exchange Commission (SEC). A list of permissible stocks is issued by the SAC twice a year. The screening criteria is mainly activity or income based. No debt or liquidity screens are used. Thus screening will require income statements but not the balance sheets of the companies. Individual funds or investment companies do not make their own *shari[ah* screening criteria. Following screening criteria are used:

1. Core Activities: The core activities of the companies should not be *shari[ah* incompatible. Therefore companies with following as their core business activities are excluded: Financial services based on *riba* (interest); gambling; manufacture or sale of non-*halal* products or related products; conventional insurance; entertainment activities that are non-permissible according to *shari[ah*; manufacture or sale of tobacco-based products or related products; stockbroking or share trading in *shari[ah* non-approved securities; and other activities deemed non-permissible according to *shari[ah*.

2. Mixed Activities: For companies with activities comprising both permissible and non-permissible elements, the SAC considers two additional criteria:

a) The public perception or image of the company must be good; and

b) The core activities of the company are important and considered *maslaha* (public interest) to the Muslim *ummah* (nation) and the country, and the non-permissible element is very small and involves matters such as *umum balwa* (common plight and difficult to avoid), *uruf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

3. Bench Marks of Tolerance: Applicable in case of mixed activities. If the contributions in turnover or profit before tax from non-permissible activities of a company exceed the benchmark, the securities of the company are classified as *shari[ah* non-approved. The benchmarks are:

a) ***The five-percent benchmark*** Applied to assess the level of mixed contributions from the activities that are clearly prohibited such as *riba* (interest-based companies like conventional banks), gambling, liquor and pork.
b) ***The 10-percent benchmark*** Applied to assess the level of mixed contributions from the activities that involve the element of *'umum balwa"* which is a prohibited element affecting most peopled and difficult to avoid. For example, interest income from fixed deposits in conventional banks.
c) ***The 25-percent benchmark*** This benchmark is used to assess the level of mixed contributions from the activities that are generally permissible according to *shari[ah* and have an element of *maslaha* (public interest), but there are other elements that may affect the *shari[ah* status of these activities. For example, hotel and resort operations, share trading etc., as these activities may also involve other activities that are deemed non-permissible according to the *shari[ah*.

4. Debt and Liquidity: No restrictions on the proportion of debt or proportion of liquid assets in total assets.

Dow Jones Islamic Index Screening Criteria

1. Screens for Acceptable Business Activities:

Activities of the companies should not be inconsistent with *shari[ah* precepts. Therefore, based on revenue allocation, if any company has business activities in the *shari[ah* inconsistent group or sub-group of industries it is excluded from the Islamic index universe. The DJIMI Shariah Supervisory Board established that following broad categories of industries as inconsistent with *Shari*[ah precepts: Alcohol, Pork-related products, Conventional financial services (banking, insurance, etc.), entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.), Tobacco, and Weapons and defense industries.

2. Screens for acceptable financial ratios

After removing companies with unacceptable primary business activities, remove companies with unacceptable levels of debts or impure interest income.

2.1.Debt to Assets:

Exclude companies if Total Debt divided by Trailing 12-Month Average Market Capitalization is
greater than or equal to 33%.
(Note: Total Debt = Short-Term Debt + Current Portion of Long-Term

Debt + Long-Term Debt)

2.2.Liquid Assets to Total Assets:

Exclude companies if the sum of Cash and Interest Bearing Securities divided by Trailing 12-
Month Average Market Capitalization is greater than or equal to 33%.

2.3.Receiveables to Assets:

Exclude companies if Accounts Receivables divided by Total Assets is greater than or equal to 45%.
(Note: Accounts Receivables = Current Receivables + Long-Term Receivables)

Companies passing the above screens are included as components of the Dow Jones Islamic Market Index.

Meezan Islamic Fund Criteria

It under takes investment in Equities, *Mudarabahs*, Islamic *Sukuks*, and other *shari[ah*-compliant fixed income securities. The *shari[ah* screening criteria for equities and other securities is given below:

Equities – *Shari*[ah compliant investments in equities would meet the following five criteria, which have been researched upon and approved by Meezan Islamic Fund's *shari[ah* adviser:

1. Business of the Investee Company

The basic business of the Investee Company should be *Halal*. Accordingly investment in shares of conventional banks, insurance companies, leasing companies, companies dealing in alcohol, tobacco, pornography, etc. are not permissible.

2. Debt to total assets

The total interest bearing debt of the Investee Company should not exceed 45% of the total assets.

3. Net illiquid to total assets

The total illiquid assets of the Investee Company as a percentage of the total assets should be at least 10%.

4. Investment in *Shari*[*ah* non-compliant activities and income from *Shari*[*ah* non-compliant investments

The following two conditions will be observed for screening purposes:
The total investment of the Investee Company in *Shari*[ah non-compliant business should not exceed 33% of the total assets.
The income from *Shari[ah* non-compliant investment should not exceed 5% of the gross revenue. (Gross revenue means net sales plus other income).

5. Net liquid assets vs. share price The net liquid assets (current assets minus current liabilities) per share should be less than the market price of the share. The *Shari[ah* compliance criteria represent the minimum acceptable criteria for investment by MBF. After initial screening of the companies on the above criteria, MBF will invest in short-listed companies: which provide opportunity to earn regular income in the form of dividends, which have good growth prospects in terms of future expansion, or which are liquid so as to provide the ease of entry and exit. Note: Valuation of assets is by market capitalization not by book value.

3.1.1.1 Size of Islamic Equity Market

An important aspect for many purposes, including policy making for development, is to gauge the size of Islamic stock market. Market capitalization of Global DJIMI as of March 31, 2005 was estimated to be USD 10.65trillion, and the universe of *shari[ah* compliant stocks was 1942 stocks[10]. Since the Global DJIMI takes up only those stocks in which an international investor can invest and repatriate the proceeds they exclude many local stocks. Given the various restrictions of ownership and capital repatriation in the countries the Islamic capital market is not that global; it is rather segmented. Therefore we applied the DJIMI criteria to local markets to assess the comparative size of *shari[ah* acceptable stock market. Table-5 below shows the existing size of the Islamic market in terms of the universe of *shari[ah* compatible stocks available in a sample of countries.

[10] Dow Jones Islamic Market website at http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicStats.

Table-5

Market Capitalization of Shariah-compliant stocks (USD Million)

Year	Bahrain		Malaysia		Pakistan		Turkey	
	M-cap of *Shari*[*ah*-compliant stocks	% of total market capitalization	M-cap of *Shari*[*ah*-compliant stocks	% of total market capitalization	M-cap of *Shari*[*ah*-compliant stocks	% of total market capitalization	M-cap of *Shari*[*ah*-compliant stocks	% of total market capitalization
1998	411.8	6.13%	55,982.8	56.00%	---	---	---	---
1999	462.7	6.46%	70,082.4	48.00%	---	---	---	---
2000	647.3	9.77%	65,129.3	54.70%	---	---	---	---
2001	612.9	9.30%	75,131.6	59.20%	---	---	---	---
2002	603.2	7.98%	76,426.3	57.55%	---	---	---	---
2003	621.2	6.40%	102,926.3	57.70%	7,007.7	42.27%		
2004	---	---	---	---	14,824.3	51.78%	11,700	12%

Data sources:
Bahrain and Malaysia: IOSCO (2004) Report of Islamic Capital Market Task Force.
Turkey: DJIMI and Istanbul Stock Exchange[11]
Pakistan: Meezan Islamic Fund and Karachi Stock Exchange.

[11] The DJIM Turkey Index also includes some stocks from neighboring countries. The market capitalization of Istanbul Stock Exchange in 2004 was USD97,354 million which is used to obtain per cent of market capitalization of Islamic market in Turkey.

Malaysia has the largest segment of *shari[ah* compliant market (57.7 per cent) within its domestic stock market in terms of market capitalization. Bahrain, the next important hub for Islamic finance in the OIC countries, has only 6.4 per cent of its market capitalization from *shari[ah* compatible securities. In case of Turkey the percentage of *shari[ah* compliant stocks in total domestic market capitalization stood at 12 per cent.[12] In Pakistan the Karachi Stock Exchange (KSE) comprised 42.27 per cent (during 2003) and 51.78 per cent (during 2004) of capitalization from *shari[ah* compliant stocks when DJIM screening criteria for financial ratios are used. The low proportion of *shari[ah* compatible market is the manifestation of high debt to equity ratio in the financial structure of corporate firms in majority of third world countries as pointed out earlier. Therefore, for all practical purposes the Islamic funds in KSE use a more lenient financial screening criteria allowing up to 45 per cent of debt to market capitalization ratio. The size of Islamic market in KSE using the lenient criteria comes to 55 per cent of total market capitalization of KSE in 2003; and 60.23 per cent in 2004.

3.1.2 The *shari[ah* compatibility of the form of share contract:

There is a general consensus among the scholars on permissibility of ordinary shares as they represent undivided ownership in the business of the company by the share holder. <see AAOIFI *shari[ah* standards>. However, as for the preferred shares and warrants that promise a definite return to its holder (e.g. during low profit years) while same is not available to other shareholders is considered *shari[ah* incompatible. It is also acceptable that shares may have different classes defined by degree of intervention in the business decision it allows to its holders. Similar to the familiar class-A and class-B shares other share classes based on other attributes and rights can be created. However, in all cases the liability of loss has to be strictly according to the financial contribution of each share.

While partnerships can be of many types in terms of conditions on tenure, transferability with or without detailed negotiations, limited or unlimited

[12] This number is based on the market capitalization of DJIM Turkey Index divided by market capitalization of Istanbul Stock Exchange. The estimate is biased slightly downwards because DJIM Turkey Index universe is defined as all stocks in the Dow Jones Emerging Europe Index that are traded on the Istanbul Stock Exchange.

liability etc. What matter most for a successful and brisk share market are: (i) limited liability of the firm, (ii) possibility of exit without foreclosure (non-binding partnership), and (iii) standardized form of shares. These factors simplify the trade in shares by making price and/or quantity the only market negotiated variables.

AAOIFI *shari[ah* standard no.12 pertains to various forms of partnerships. It covers the rules for conventional *fiqh* nominate partnerships as well as various forms of modern partnerships. These rules allow for staggered profit sharing ratio (*shari[ah* standard 12/3/1/5/9) that permit different profit sharing ratios for different levels of profit subject to conditions (described in *shari[ah* standard 12/3/1/5/3) which ensure that the variable ratio shall not preclude a party from sharing in profit.

3.1.3 *Shari[ah* compatibility of various trading practices:

While various pieces of literature in *fiqh*, Islamic economics and finance have highlighted the *shari[ah* incompatible practices in stock trading that are in vogue in different stock markets, no binding *shari[ah* compatibility standards on the practices have been issued. OIC *fiqh* academy provide some guidelines. As for AAOIFI *shari[ah* standards (e.g. standard 12 on *shirakah*) it explicitly states that the standard only deals with contractual form it does not deal with regulatory policies and procedures required for operations in the market.

Likewise in the research arena, size of Islamic capital markets based on practices criteria has also not been analyzed. At present different individuals and financial entities, depending upon their degree of consciousness for *shari[ah* compliance, are voluntarily adopting or avoiding certain practices.[13] This also shows why standardized practices are important for reduction in transaction costs as well as risks. There is a clear need to develop mechanisms to phase out *shari[ah* incompatible trade practices. One way to implement *shari[ah* compatibility of trading practices is to construct a carefulness rating ladder which test for the existence of standardized written procedures for operations and their actual practice in the companies.

[13] For example, the management of an Islamic Fund informed that they participate in stock futures market as seller (through salam contract) but do not buy futures in stocks because the counter party may not be adhering to the rules of salam in their transactions with others in the futures market which results in increased credit risk for the Islamic Fund.

3.1.4 Performance of Islamic Equity Market:

Various studies have been done on the performance of Islamic equity market. Most of these studies deal with how good the Islamic market indices (such as DJIMI or FTSE-GII) performed in comparison to the entire market indices that does not apply a screening criteria. Hussain (2004) finds that FTSE Global Islamic index performed at least as good as FTSE All-World Index. During a bull market the Islamic index performed better than the All-World index, however during the bear market its performance was lower than that of All-World index. Thus he concludes that it is a general expectation of the many that an ethical index which applies various ethical criteria for screening and reduces the size of available universe would perform poorly than the unscreened index. But contrary to this expectation ethical index like FTSE Global Islamic Index performed at least as good as the overall market on the aggregate level during the period July 1996 to July 2003.

3.1.5 Issues in Stability of Islamic Equity and Equity Index:

The present approach in some jurisdictions of defining the Islamic portion of market as a subset of the larger stock market and leaving this set to develop on its own is not very conducive for its growth. If there is no conscious effort to develop the Islamic portion into the dominant portion of the market some stability issues will arise. For example, suppose the Islamic portion of the market is small in terms of number of companies that qualify various *shari[ah*-financial tolerance ratios (such as debt to market capitalization). This assumption is not unrealistic in the present state of Islamic capital markets. Let us call the set formed by the companies that qualify *shari[ah* screening as the *shari[ah*-admissible set.

Now suppose that the overall market is facing a bearish trend hence stock prices in general are declining. It is likely that the market capitalization of companies would be declining in general including those in the *shari[ah* admissible set. The companies at the higher end of debt to market capitalization ratio (i.e., boundary) in the *shari[ah*-admissible set will start to become disqualified as this ratio grows. Therefore, all the Islamic mutual funds and *shari[ah* conscious individuals will try to avoid buying or start to offload these securities in anticipation and re-adjust their portfolios. This mass behavior (or correlated behavior) has the potential to drive the prices of these boundary shares further down and quicken their exit from the *shari[ah*-admissible set. Thus the *shari[ah*-admissible set will shrink. If this set was initially small a further shrinkage in its size will reduce the profit sharing investment choices of Islamic investors leaving them either to choose from less diversified and more volatile set of equities or to rely on the fixed return contracts like *murabaha* etc.

The effect of bear and bull market will not be symmetric in magnitude of price fluctuations and risk on the Islamic portion of the market as long as the set of *shari[ah*-admissible stocks is small.

During a bull run when stock prices start increasing some stocks will move from *shari[ah*-non-admissible set into *shari[ah*-admissible set by qualifying the debt to capitalization criteria. However, there is no direct role of shriah conscious investors in bringing them into the set as these investors do not invest in them until these stocks qualify for admissible set either by exogenous rise in price or by a change in the financial structure of the firm. Further, as the *shari[ah*-admissible set grows it provides better diversification opportunities to Islamic investors.

These issues are not of a concern when the *shari[ah*-admissible set of stocks is very large. Therefore, it is important to maintain a reasonable size of *shari[ah*-admissible stocks as long as the above financial ratio based Islamicity criteria is used.

Another point to note with the current criteria is that with the present approach the shares of Islamic banks (if any) remain out of the *shari[ah* admissible set due to high concentration of *murabaha* receivables on the asset side of Islamic banks. This means their stocks cannot be traded on the stock market. This also implies that market discipline on these banks will not work through market for corporate control.

3.2 *IJARAH-SUKUK*:

Ijarah-Sukuk are the latest product in the market that is rapidly gaining ground in the capital market. It has emerged as a different asset class among the Islamic financial products. It has gained acceptance among *shari[ah* scholars and high in demand by large investors and Islamic financial institutions. On the supply side, many governments have found it useful to raise funds for their fiscal needs and long-term financing of big projects. Corporate entities are also finding it useful to generate funds for their project specific needs. Initially, the cost of issuance was very high because of uncertainty of the untried product, large documentation requirements, rating expenditures, and various fees such as legal, underwriting, and investment banking services required in the issuance process. However, these expenditures have since come down because *ijarah-sukuk* has become a replicable product. Each new *sukuk* now is copy of the previous one with some changes to suit the needs of the issuer or the nature of the market.

The idea of *ijarah-sukuk* in the form of asset-*ijarah*-bonds was first proposed by Monzer Kahaf in his various writings culminating in his important paper "The Use Of Assets *Ijarah* Bonds for Bridging the Budget Gap" published in *Islamic Economic Studies* as well as in Ahmed and Khan (1997) edited *Islamic Financial Instruments for Public Sector Resource Mobilization*. Usefulness of asset-*ijarah* bonds in long-term financing of non-revenue generating public projects was also suggested in *IIIE's Blueprint of Islamic Financial System* (1999) that was presented to the Shariat Appellate Bench of the Supreme Court of Pakistan during its deliberations on judgment on *riba*. In the same publication ideas on some other forms of *sukuk* were also presented. However, the practical issuance of the *ijarah-sukuk* is the result of two factors. The first factor was the birth of the concept which was within *shari[ah* parameters and a forceful presentation of its viability as developed in the literature that has been cited above. The second factor had been the rise of the use of asset securitization in the financial markets. The concept of securitization had gained currency in 1980s in the conventional finance and by early 1990s it had already been utilized in various structured financing deals by Islamic investment banks in the context of partnerships or projects however, not in structured *ijarah* finance. Because of such experience, both the finance professionals in Islamic banks and the *shari[ah* scholars were familiar to some extent with the securitization concept and its practical requirements. Thus the concept of asset-*ijarah* bond and the familiarity with operational details of asset securitization resulted in development of *ijarah-sukuk*.

There are some useful legal and economic characteristics of *ijarah* contract that distil into its securitization in the form of Asset *Ijarah* Bonds. It provides flexibility of sale and ownership of the underlying asset without affecting its *ijarah* contract, independence from synchronization of usufruct and payment flows, flexibility in setting the rent, its term, combination with other contracts, and initiation of the contract without the asset in place.

Legal and Economic Features of *Ijarah* contract and Asset *Ijarah* Bonds[14]

Asset *Ijarah* Bonds (AIB) Definition: "The AIBs are securities of equal denomination for each issue, representing physical durable assets that are tied to an *ijarah* contract as defined in the *shari'ah*".
Economic features of *shari[ah* nominate *Ijarah* contaract: 1. Flexibility of sale: *Ijarah* contract in *shari'ah* does not restrict the right of lessor to sell the leased asset. 2. Independence of ownership: Persons who share the ownership of a leased asset can dispose of their property by, say, selling it to new owners individually or collectively as they may desire. 3. Flexibility in timing of inflows and outflows: It is not necessary that the flow of usufruct benefits should coincide with the timing of rent payments. 4. Flexibility in initiation: *Shari'ah* does not require that the asset-subject of *ijarah* contract, should be in existence at the time of the contract. 5. Flexibility in length of term: The *ijarah* contract can be of any length as long as the asset which is the subject of the *ijarah* contract remains in existence and renders its usufruct. 6. Flexibility in determination of rent: In an *ijarah* contract, it is necessary that rent must be known. But it can be determined by a variety of flexible ways. 7. Possibility of hybrid with wakalah: An *ijarah* contract is open for combination with the *wakalah* contract. 8. Restriction on liability for maintenance: Maintenance expenditures related to the basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be taken care of by the lessee. 9. *Ijarah* contract is amiable to securitization in the form of a bond. The

[14] Summarized from Kahaf (1997).

idea of an *ijarah* bond stems from the ability of transforming leased assets into financial assets.
10. Decision No.5 of the 4th Annual Plenary Session of the OIC *Fiqh* Academy, held in Jeddah 18-23/6/1408H (6-11/2/1988G), asserts that (a) any combination of assets can be represented in a written note or bond, and (b) this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts. Furthermore, the decision clearly mentions that assets that can be grouped together for the purpose of securitization may consist of any combination of the following four types of assets:

i) physical assets,
ii) financial rights (such as the usufruct in *ijarah*),
iii) interpersonal debts, and
iv) money.[15]

3.2.1 Structure of Existing *Ijarah Sukuk*:

There are different variants of *ijarah-sukuk* but a generic structure is as depicted in figure-1. There are three parties to the structure: the originator or (beneficiary) of *ijarah-sukuk*; the Special Purpose Vehicle (SPV) the issuer of *ijarah-sukuk*; and the investors (*sukuk* holders). A single or a group of assets that are admissible for *ijarah* contract are selected. The beneficiary (initiator) creates a Special Purpose Vehicle (SPV) [or Special Purpose Entity SPE] with separate independent legal personality to whom it sells the asset(s) with the understanding that the beneficiary will lease back the asset from the SPV[16]. Rent is negotiated and a term specific lease

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[15] The OIC Islamic Fiqh Academy *Resolutions and Recommendations*, pp. 60-63. The above mentioned resolution requires that if the majority of securitized assets is in the form of money and debts, the negotiability of the representing security must follow the rules of currency exchange and transfer of debts as known in *shari'ah*. This essentially means that debts and money can only be exchanged at a price equal to their face value.

[16] *Shari[ah* scholars in general are of the opinion that these two contracts (sale and *ijarah*) should be independent of one another. They accept the combination as long as they are legally two different contracts, however in substance they are interdependent. AAOIFI *shari[ah* standard no.9 (paragraph 9/8/8/1) on *Ijarah* calls for complete independence of the two contracts.

contract is signed.[17] The SPV then securitizes its assets by issuing *ijarah-sukuk* for sale to investors. These are certificates of equal value representing undivided shares in ownership of tangible assets. The *sukuk*-sale proceeds provide funds to SPV to pay for the asset(s) purchased from the beneficiary (originator). A rent-pass-through structure is adopted by the SPV to pass on the rents collected from the originator-cum-lessee to the *sukuk* holders. These returns along with low risk and exit possibility through secondary market (liquidity) constitute the incentives for investors to buy the *sukuk*.

At the expiry (or termination) of the lease deed the flow of rents would stop and ownership of the asset pool would be with the *sukuk*-holders as a group. If the underlying asset has a market value the *sukuk*-holders can realize capital gain (or loss). However, if the underlying asset is a public good or if it has no ready market then the *sukuk*-holders are certain to incur capital loss. This would either discourage investment in *sukuk* or raise the cost of finance for the originator. Likewise, sometimes the originator is not interested in permanently parting away with his assets. Or the asset in question has strategic value to the *sukuk* originating governments. In these cases the supply of *ijarah-sukuk* will be discouraged. Therefore, to close the *ijarah-sukuk* structure with features attractive for both supply and demand the *sukuk* contract embeds a put option to the *sukuk*-holders that the originator is ready to buy the *sukuk* at their *face value* on maturity or dissolution date. However, there is a *shari[ah* objection to this last arrangement. As per AAOIFI *shari[ah* standard no. 17 para5/2/2

> "In the case of negotiable *Sukuk*, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however, it is not permissible for the issuer to undertake to purchase the *Sukuk* at their nominal value."

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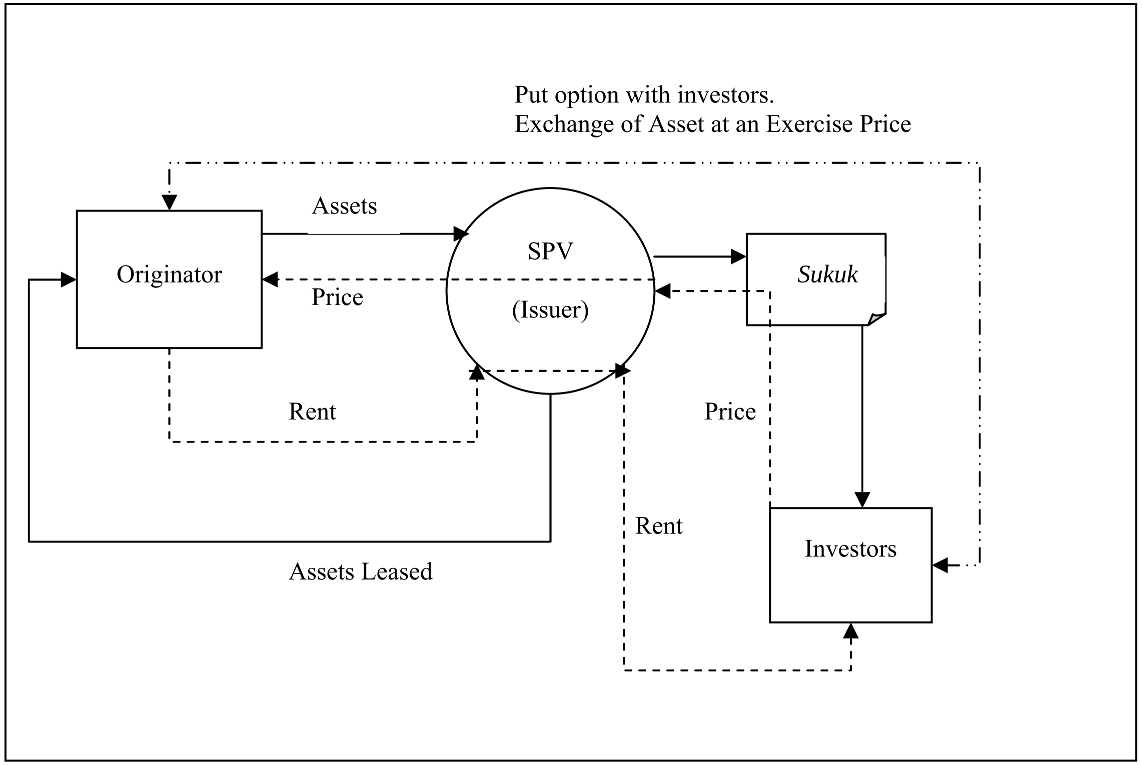
[17] The *ijarah*-bi-zimmah contract can be signed between SPV and the beneficiary even before the sale of asset to the SPV.

Figure-1 Structure of a generic *Ijarah-Sukuk*



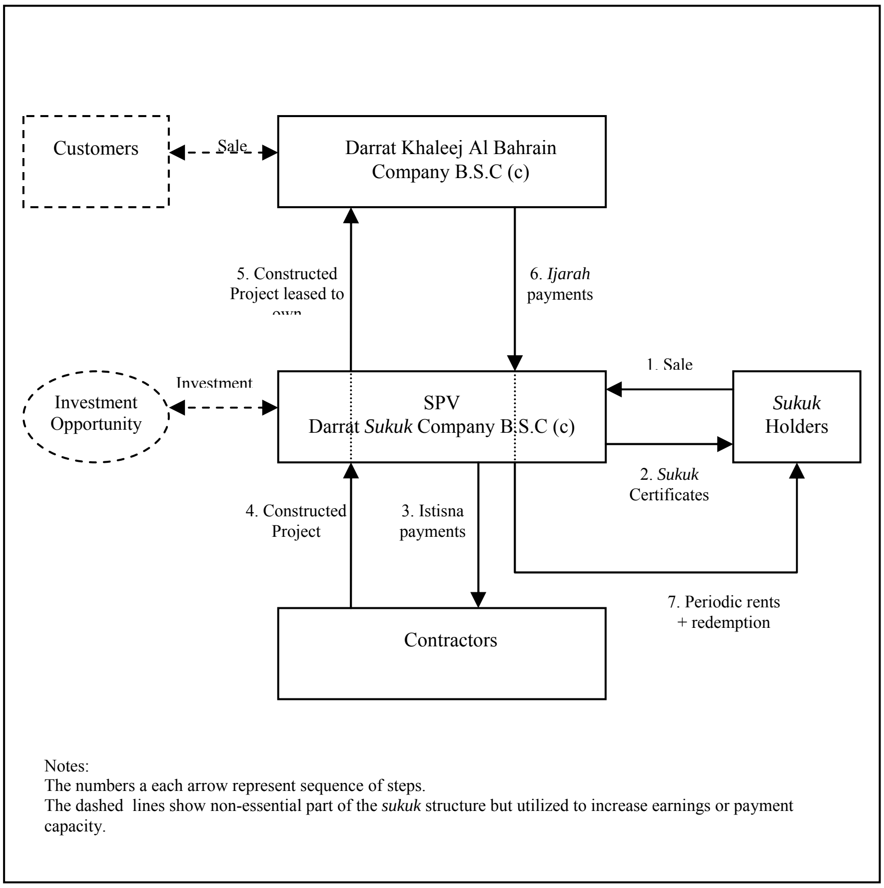
Most *sukuks* issued so far are similar to each other in their structures, however some are quite different in utilizing *ijarah*, *istisna*[and *murabaha* to suit the needs of the originator. In the following we briefly discuss three such other structures:

1. IDB *Sukuk*: These *sukuks* are innovative in isolating and defining the underlying asset. The underlying asset of IDB *sukuk* is not a particular physical asset but a pool of real and financial assets; comprising of leased assets (*ijarah*)[18] and receivables from *murabaha* and *istisna*[contracts. Such that the portion of leased assets is dominant (more than 50 per cent) in the total asset pool separated for the *sukuk* issue. Dominance of non-financial assets make its *sukuk* admissible for trade in secondary market.
2. Caravan *Sukuk*: These are *ijarah sukuk* against existing moveable property –rental cars and trucks- and securitizes their receivables for the rent-a-car company. The innovative part is the use of IT technology to link the earnings from each automobile in the fleet to the rent passed through to the *sukuk* holders. Another distinguishing aspect was involvement of cross-border parties in issuance. The issuer and the underlying assets were in different countries.
3. Darrat *Sukuk*: These are innovative in several aspects. These are *sukuk* against assets which do not exist at the time of securitization. A combination of *istisna*[and then *ijarah* is used in the structure of the contract to first create the asset and then to rent it back to the originator. There are four parties to the contract: originator, SPV, *sukuk* holders, and construction contractor. The lease contract employed between the SPV and the originator is the lease-ending-with-ownership of the originator (*ijarah muntahi bi-tamleek*) contract. The proceeds of rents and by-out price installments are passed on to the *sukuk* holders. The *sukuk* are initially pure debt hence not tradable until physical asset is created through *istisna*[and delivered to the SPV. Further, the construction project is broken into several portions/segments/phases with separate *istisna*[and the *ijarah* contracts for each portion under a master agreement, which generates an early income stream for *sukuk* holders and also enables the secondary market tradability of the *sukuk* as the project

[18] Leased assets whose ownership was with the IDB at the time of sale of the asset pool to the SPV.

progresses. Lastly, the surplus cash proceeds of *sukuk* sales with the SPV waiting for *istisna*[payment in the queue will be utilized in commodity *murabaha* and the earnings will become part of the *sukuk* capital.

Figure-2 *Istisna*[based *Ijarah Sukuk* (Example of Darrat *Sukuk*)



3.2.2 Other forms of *Sukuk*:

Ijarah sukuk are only one form of investment *sukuk*, other forms and their variants are also possible. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its *shari[ah* standard no. 17 has defined 'investment *sukuk*' as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however this is true after receipt of the value of *sukuk*, the closing of subscription and the employment of funds received for the purpose for which the *sukuk* were issued." The standard gives example of fourteen different types of investment *sukuk*:

1. Certificates of ownership of leased assets (*ijarah sukuk*)
2. Certificates of ownership of usufruct:
   (i) of existing assets
   (ii) of described future assets
   (iii) of services of specified party
   (iv) of described future services
3. *Salam* certificates
4. *Istisna[* certificates
5. *Murabaha* certificates
6. *Musharakah* certificates
   (i) Participation certificates
   (ii) Mudharabah certificates
   (iii) Investment agency *sukuk*
7. *Muzara[ah* (share cropping) certificates
8. *Musaqah* (irrigation) certificates
9. *Mugharasa* (agricultural/seed planting) certificates

Most of them are *shari[ah* admissible for trade in secondary market except the *salam*, *istisna[*, and *murabaha* certificates; and in some particular cases of *muzara[ah* and *musaqah* certificates when certificate holder does not own the land.[19]

This shows that there is no dearth of possibilities in creating financial instruments suitable for capital markets. However, it would not be a good strategy of product development to try to replicate each product of conventional finance by stretching *shari[ah* principles. The philosophies of the conventional and Islamic system of finance are not the same therefore the financial instruments are bound to differ in their emphasis. A better approach is to design *shari[ah* compatible products according to the current and future needs of the market, keeping in view the objectives of Islamic financial system and a plan for the future market structure.

3.2.3 Current Size of *Ijarah* based *Sukuk* Market

At present *ijarah sukuk* are floated by governments as well as some corporate firms. These warrant separate discussion of the two.

[19] For details see AAOIFI *shari[ah* standard no. 17 paragraphs 5/2/14 to 5/2/18.

3.2.3.1 Sovereign Ijarah based Sukuk:

There has been so far eighteen such *sukuk* totaling to US$5.650 billion over a span of past three and a half years. These are issued by Bahrain, Dubai, Malaysia and its states, Pakistan, Qatar, and Saxony-Anhalt state of Germany. Almost all the sovereign *sukuk* are rated and they were rated as the rating of the country. It is note worthy that initial *ijarah sukuk* issued by Government of Bahrain were non-rated and they were meant for the local market. It was however Malaysia that took the lead in launching first Global *Ijarah Sukuk* (GIS) with international rating. For the *ijarah sukuk* to have global appeal and secondary markets in multiple jurisdictions it is necessary that they follow some common standard in design, *shari[ah* validation rules, and investor protection. In order to provide a wider *shari[ah* acceptance to this issue Malaysia did not structure it on the usual *Murabaha* or *Bay[Bi-saman Ajil* (BBA) principles commonly used in Malaysian domestic market but used the *ijarah* structure.

There has been oversubscription of almost all sovereign *ijarah* based *sukuk*. Further, there is a tendency of their buyers to hold them till maturity. No secondary market trade of any *ijarah sukuk* has been witnessed so far. These facts show that the supply is far shorter than the demand for such *sukuk*. This also raises the question whether the price of these *sukuk* is right? Given the sovereign backing, attached guarantees of performance, and over-collateralization these *sukuk* probably could have been offered at much lower rates of return than currently offered and still could clear the market. We are experiencing a *sukuk* trap phenomenon—to coin a term similar to liquidity trap. Whereby the supply of more *sukuk* is not pushing the price of *sukuk* down because its buyer financial institutions are just hording the *sukuk*. That is there is almost infinite demand for *sukuk* at the offered rates.

Another thing to note is that the rating of sovereign *sukuk* of each country is same as the rating of conventional sovereign bond of that country. This shows that isolation of specific assets through the SPV structure has no significant net effect on the rating of sovereign *sukuk*. This is a logical outcome of the facts that in almost all cases (i) the rents payable to *sukuk* holders are not necessarily generated from the use of *sukuk* assets but from general revenues and other earnings of the state enterprises; and (ii) therefore what matters is the aggregate payback capacity of the government given its existing obligations, political stability and commitment to pay. Which is essentially the sovereign rating.

<u>Table-6</u>
Chronological List of Sovereign *Sukuk*

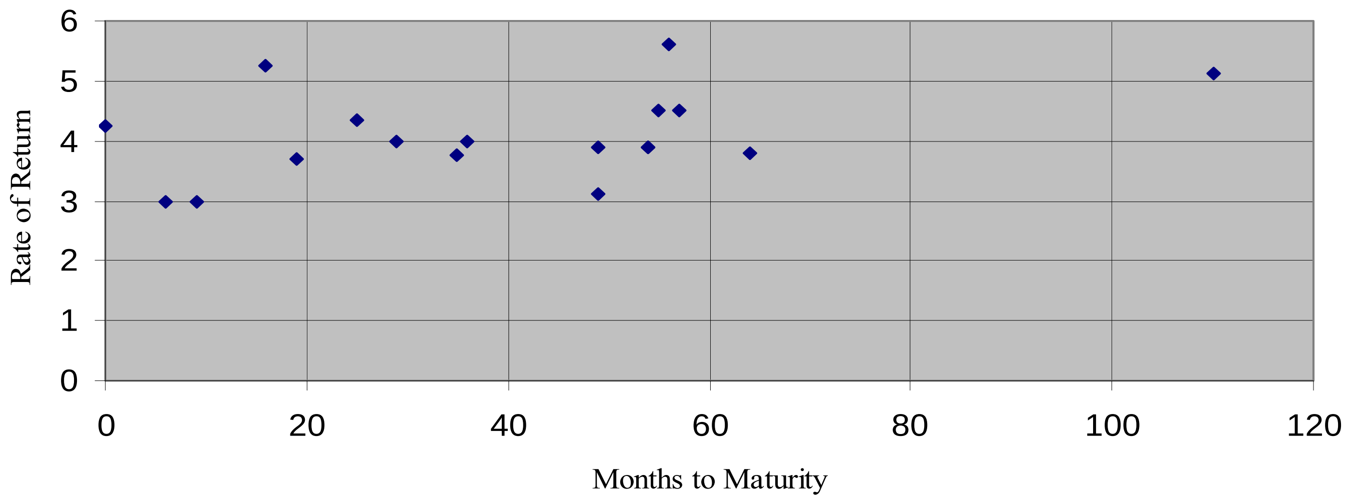
Issuer	Issue Date	Issue Size (Source currency MM)	Issue Size (US$'MM equivalent)	Margin or Return	Tenor	Rating /Listing	Comments
Govt. of Bahrain - BMA	February 2005	BD 45	119	4.5% fixed	5 Years	S&P: A / Bahrain Stock Exchange (BSE)	Oversubscribed by 50%
Pakistan International *Sukuk* Co. Ltd. (Govt)	January 2005	USD 600	600	6m LIBOR + 2.2%	5 Years	S&P: B+ Luxembourg SE	Initial issue was for USD500 mil. Oversubscribed by 233% (USD 1.2 billion) M-East 47%, Asia 31%, & Europe 22%
Sarawak Corporate *Sukuk* (Govt)	December 2004	USD 350	350	6m LIBOR + 1.1%	5 Years	S&P: A- /	Three times oversubscribed
Dubai Global *Sukuk* (Govt)	November 2004	USD 1000	1,000	6m LIBOR + 0.45% /	5 Years	Govt. rating applicable	-
Dubai Civil Aviation (Govt)	November 2004	USD 1000	1,000	6m LIBOR + 0.45%	5 Years	Govt. rating applicable A2 implied	-

Govt. of Bahrain - BMA	July 2004	BD 40	106	5.125% fixed	10 Years	S&P: A- / Bahrain Stock Exchange (BSE)	-
Govt. of Bahrain – BMA	June 2004	USD 250	250	6m LIBOR + 0.45%	5 Years	S&P: A- / BSE, Luxembourg & Lubuan SE	Land Europe-offshore US 22%, Asia 12% &M. East 66%
Saxony-Anhalt State Properties (Govt) (Europe)	June 2004	Euro 100	145	EURIBOR + 1%	5 Years	S&P: AAA Fitch: AA /	-
Govt. of Bahrain – BMA	December 2003	USD 50	50	6m LIBOR + 0.30%	3 Years	S&P: A- / BSE	Oversubscribed by 60%
Government of Qatar	September 2003	USD 700	700	6m LIBOR + 0.4%	7 Years	S&P: A+ / Lubuan & Luxembourg SE	72% Middle East, 14% Asia, 13% Europe, 1% US offshore
Govt. of Bahrain – BMA	May 2003	USD 250	250	6m LIBOR + 0.60%	5 Years	S&P: A- / BSE	Airport Oversubscribed by 40%
Govt. of Bahrain – BMA	April 2003	USD 100	100	3.75% fixed	5 Years	S&P: A- / BSE	Oversubscribed by 13%
Govt. of Bahrain – BMA	February 2003	USD 80	80	3.00% fixed	3 Years	S&P: A- / BSE	-

Govt. of Bahrain – BMA	November 2002	USD 50	50	3.00% fixed	3 Years	S&P: A- / BSE	-
Govt. of Bahrain – BMA	August 2002	USD 80	80	4.00% fixed	5 Years	S&P: A- / BSE	Oversubscribed by 110%
Government of Malaysia Global *Sukuk*	June 2002	USD 600	600	6m LIBOR + 0.95%	5 Years	S&P: A- / BSE & Lubuan	Govt. property
Govt. of Bahrain – BMA	February 2002	USD 70	70	4.25% fixed	3 Years	Not Rated	Oversubscribed by 60%
Govt. of Bahrain – BMA	September 2001	USD 100	100	5.25% fixed	5 Years	Not Rated	-
Total Number of *Sukuk*	18	5,650					

Source: Liquidity Management Centre Website (with amendments and corrections by the author).

Figure-3 Term Structure of Sovereign Ijarah Sukuk



The Figure-3 shows pseudo term structure of sovereign *ijarah sukuk*. For the purpose of construction we assumed that:

1. sovereign rating of all *sukuk* issuing countries is the same, and
2. that all sovereign *sukuk* are available for investment to global investors.
3. For the floating rate benchmarked *sukuk* we used 6 month LIBOR= 3.408 and 6m EURIBOR=2.103 in May 2005.
4. Time to maturity is calculated from May 2005 on the existing *sukuk*.

3.2.3.2 Corporate Ijarah based Sukuk:

So far there has been eleven issues of *ijarah sukuk* by corporate and non-government sector institutions amounting to US$1.601 billion. Except for the IDB *sukuk*, Ample Zone (Malaysia) *sukuk*, and Ingress (Malaysia) *sukuk* none have been internationally rated; and still all of them were oversubscribed. Unlike sovereign *sukuk* each of the corporate *sukuk* have some innovative structure differentiating it from the other. This shows not only the potential but viability of various other structures in the market.

Table-7

Corporate *Ijarah* based *Sukuk*

Issuer	Issue Date	Issue Size (Source currency MM)	Issue Size (US$'MM equivalent)	Margin or Return	Tenor	Rating /Listing	Comments
IDB (Corporate)	April 2005	USD 500	500	Fixed rate	5 Years	S&P: AAA Fitch: AA /	1st stage of $1BN program
Bahrain Financial Harbour (Corporate)	March/April 2005	USD 170	170	TBA	5 Years	Not rated	-
Durrat Al Bahrain *Sukuk* (Corporate)	January 2005	USD 152.5	152.5	3m LIBOR + 1.25%	5 Years	Not Rated	Oversubscribed by $32.5 MM
Ample Zone Berhad (Corporate) (Malaysia)	January 2005	RM 150	39.5	6% - 9% fixed	2 – 7 Years	MARC: AAA MARC: AA MARC:A	-
First Islamic Investment Bank (Corporate)	October 2004	EURO 76	103	1.25% + EURIBOR	2 Years	Not Rated	General Corporate use Oversubscribed by €26 MM
Tajeer (Saudia) *Ijarah Sukuk*		USD 1.6	1.6	Floating 5% net IRR	2 years	Not listed	
Emaar (Corporate) (UAE)	July 2004	USD 65	65	6m LIBOR + 0.7%	5 Years	Not Rated	Initially the issue was for US$50mm and then increased to $65MM. Related to financing for commercial buildings.

Ingress *Sukuk* Barhad (Corporate) (Malaysia)	July 2004	RM 160	42.1	6.45% - 7.6% fixed	3 Years	MARC: A+	-
Caravan 1 Limited (Corporate) (UK)	March 2004	SAR 102	27.3	6% fixed	3 Years	Not Rated /	-
Tabreed (Corporate) (UAE)	January 2004	USD 100	100	6% fixed	5 Years	Not Rated / Luxembourg SE	-
IDB (Corporate)	July 2003	USD 400	400	3.738% fixed	5 Years	S&P: AAA Fitch: AA / Lubuan & Luxembourg SE	Initially issue was for US$300MM and then has been increased to US$400MM 1/3 of *sukuk* placed in UAE FI's – Others included central banks of Saudi, Bahrain, Pakistan, Qatar & Kuwait
Malaysian Global First Guthrie Co., (plantation company)**		USD 150		Floating reference rate on underlying *Ijarah*	5 years		
Total Number of *Sukuk*	11		1,601				

Source: Liquidity Management Centre Website (with amendments and corrections by the author).
** This *sukuk* is listed as *ijarah sukuk* in the literature (e.g. Arsalan 2004) but the issue documents does not reflect such. Our understanding is that this is a *murabaha* based, not *ijarah* based, *sukuk*. Therefore, not counted in aggregation in last row.

3.2.4 Players (originators and holders)

Originators:
Most of the *sukuk* originators are governments while only few are originated by corporates. In terms of amount raised through *sukuk* the ratio is 3.5:1 between sovereign and corporate *sukuk*. The market is currently accessible for floatation to only very large companies owing to high costs of rating, contract documentation, investment banking and distribution fee involved in such issue.

Islamic banks are not among the *sukuk* originators, except two banks, including IDB. This is the case because a large proportion of the assets of Islamic banks are in short-term *murabaha* and *istisna*[receivables. *Sukuk* against these assets, if issued, are not tradable at prices other than the face value. Thus *sukuk* option is not attractive to majority Islamic banks. Moreover, these banks have surplus liquidity.

IDB on the other hand possesses substantial tangible/tradable assets on its balance sheet. It also wants to increase its funding for expanding the developmental operations. The securitization of its tangible/tradable assets is therefore a suitable option for generating such funds.

Investment banking and other service providers in sukuk:
Most of the investment banking, underwriting, lead managing, and book making services for the *sukuk* are currently provided by Islamic banks in cooperation with conventional banks that have Investment banking arm and Islamic window operations. It is felt that there are only few full-fledged Islamic Investment banks.

Subscribers and investors in sukuk:
The subscribers of these *sukuk* are large financial institutions like central banks, private sector Islamic banks and non-bank financial institutions. These institutions are flush with surplus liquidity that does not have alternative places for parking. Therefore they tend to hold these *sukuk* dearly, so much so that no secondary market is forming in *ijarah sukuk*. Secondary market trade occurs due to heterogeneity in the nature, opportunities, information and beliefs/expectations of the players. Therefore, an alternate way to create a secondary market in *ijarah sukuk* is to increase its distribution to a wider class of investors by creating a special *sukuk* class for ordinary investors which the banks are not allowed to hold. Yet another way is to lower the returns on the *ijarah sukuk*.

3.2.5 Risk Factors of *Sukuk*

Sukuk carry certain types of risks and at the same time they also help in mitigating and managing other types of portfolio risks. *Sukuk* transform different kinds of assets and contracts into financial certificates therefore each *sukuk* structure can have different risk transformation properties which depends upon the type of underlying contracts; the nature and composition of underlying assets; and whether within or cross jurisdiction services are provide.

3.2.5.1 Risks in Sukuk:

For the purpose of analysis risks can be classified in various ways. In terms of their implication for the system it can be classified as systemic risk and idiosyncratic (firm specific) risk). In terms of the sources of risk it can be classified in various other components. Tariq (2004) discusses risks inherent in various kinds of *sukuk* structures which are summarized in Table-8. He classified risk according to its source as market risk (comprising of rate of return risk, foreign exchange risk, price risk); credit risk; and other risks (such as liquidity risk, *shari[ah* compliance risk, and infrastructure rigidity risks).

In fact the *sukuk* risks depend on:

a) Fixed or flexible return structure in the contract between issuer and investor.
b) Nature of fixed or flexible rate contract between issuer and originator.
c) Time to maturity.
d) The composition and nature of the underlying asset.
e) Put or call option given to the originator or the investor.
f) Payment capacity of the originator or its guarantor.
g) Tradability and liquidity of the *sukuk*.

The rate of return risk is faced in all fixed rate *ijarah sukuk* and affects the investor and originator in opposite ways. The severity of this risk is directly proportional to the change in market rents and the term to maturity of the *sukuk*. In case of flexible rate *ijarah* suku[20] where the returns are tied to LIBOR, an increase in the benchmark rate will increase the payment obligations of the originator which may or may not be

[20] A genuine *shari[ah* compatible flexible rent contract is essentially periodic revision or re-contract with revised rents combined with an exit opportunity to the lessee and the lessor (which ever is the effected party).

sustainable. This is more pronounced when the paying capacity of the originator depends largely on income from a pool of assets with substantial proportion earning fixed returns. For example, when the underlying assets comprise a substantial portion (say the maximum 49 per cent) of *murabaha*, and *istisna[* contracts.

3.2.5.2 Risk Management Properties of Sukuk:

Sukuk also have risk management potential in various ways for the investor and the originator, some of these possibilities are listed below.

From the perspective of originator:

1. *Sukuk* mitigate liquidity risk of an otherwise illiquid asset.
2. If an SPV serves multiple originators by buying their individual isolated relatively small assets, pooling them and then securitizing the pool. It can reduce the cost of finance to the originators, mitigate the liquidity risk of their assets, and provide new source of funding for them thus reducing the funding risk. In this sense it works as a reverse bank: collecting fragmented investment opportunities consolidating them into a sizeable pool and delivering them to the providers of fund (investors) for investment.
3. *Sukuk* takes the assets off the balance sheet of the originator while providing it its use through *ijarah*. Therefore, if appropriate assets are isolated for securitization through *ijarah sukuk* it can, without loss of its use to the originator, serve as a tool for streamlining the balance sheet: by matching the assets and liabilities of the originator to minimize risk in maturity mismatch, currency mismatch risk, liquidity risk etc.

From the perspective of the investor:

1. If the underlying assets in the pool is denominated in terms of multiple currencies it reduces the foreign exchange risk of the investor.
2. Likewise, if the underlying assets are a pool of diversified assets (or have heterogeneous risk factors) then the diversification reduces the earnings risk of the investor particularly in case of *mudarabah sukuk.*
3. As opposed to conventional bond the tradability feature of *sukuk* stems not from the rental returns that *sukuk* holder is entitled to but from the ownership in the underlying asset. This is an added protection which can enhance liquidity of *sukuk*. Moreover, the risk characteristic of rentals (a credit risk of the originator) may be different from the risk characteristic of the underlying asset in which *sukuk* holder possesses an undivided joint ownership. The

two risks may have different sensitivities to external factors which contribute to reduction of risk faced by the investor.

3.2.6 Advantages and Disadvantages of *Sukuk*

1. Increase the liquidity of the originator and investor. This will reduce risk premium in the other products of the capital market and hence contribute to lower cost of funding to entrepreneurs.

2. Increase the flow of funds to the securitized asset market

3. Can tap new and diversified source of funding through the capital market. Institutional investors and passive investors would find it more attractive.

4. Can help development of capital markets by allowing thinly capitalized market players who may have specialization in securitization and issuance to participate in the capital market.

5. With development of *sukuk* markets specialized issuers for different kinds of *sukuk* in different kinds of asset/contract pools will emerge which will again lower the cost of funding.

6. At the moment *sukuk* have become an avenue for parking of the excess liquidity available with Islamic banks. By this the buyers directly participate in some useful economic activity generated through their finance. The facility is for relatively long term with an option to exit at any time through secondary market. It is a better economic alternative than the commodity *murabaha* used by Islamic banks. In commodity *murabaha* the bank purchases some metal in bulk on spot payment from a metals exchange and sell these to another trader on deferred price marked-up by a percentage over the cost. This is a very inefficient way of earning on its liquidity by indulging in an trade that is neither needed by the bank nor by its client. It therefore has gross productive and allocative inefficiency.

7. The *ijarah sukuk* are limited use liquidity management instruments, at least until a large supply with periodic issuance becomes the norm and a secondary market in them develops. Because as opposed to commodity *murabaha* that (in vibrant metals and commodity market) can be initiated at the will of the Islamic bank the *ijarah sukuk* route has to wait until an issue is offered by the issuer. A way to develop *ijarah sukuk* based liquidity management instruments for Islamic banks is to offer some *ijarah*

sukuk series specially for the Islamic banks with periodic issues spaced at regular interval on or before maturity of each issue.

8. The initial structuring and issuance cost of *ijarah sukuk* at the moment is quite high. It requires a large size of isolatable assets, upfront legal, rating, and investment banking fee, as well as lots of documentation. Only large, credible, and more transparent institutions are so far able to participate in *ijarah sukuk* deals.

3.2.7 New Potential *Sukuk* Structures

Credit Enhancing Structured Ijarah Sukuk for Project Financing:[21]

As known and in practice, *Ijarah sukuk* can be issued by a sovereign country on the basis of its own capacity to meet the obligations of rent, and the commitment to buy back the asset. If the underlying asset is marketable and productive enough to generate the rent obligation then the *sukuk* can be issued on more favourable terms and lower cost. Another way for a country to raise funds through *sukuk* is to use a third party guarantee of another country or a multilateral institution like Islamic Development Bank (IDB) to enhance the credit rating. Again lowering the cost of funds.

Islamic Development Bank (IDB) is mandated to contribute in the development needs of its member countries. For this purpose it has started issuing *ijarah sukuk* by isolating some of its assets. The objective of this securitization is to increase the pool of funds that the IDB will use to help finance development projects in its member countries through other Islamic modes of finance such as *murabaha*, *istisna*[, and *ijarah*. In raising money by *sukuk* it is usually the better assets which are utilized; as their use can reduce the cost of funds. However, in *ijarah sukuk* process the same better quality assets of IDB get tied up for the duration until maturity. These assets are also taken off from its balance sheet until they are bought back. The funds raised indeed increase the liquidity of the bank but the *sukuk* process also increases the off-balance sheet commitments of the bank. Moreover, the composition and risk profile of the asset side will also change, more likely towards deterioration. Therefore, the *sukuk* issue process has its own limits, while the development needs of the member

[21] The structure is proposed in Khan, Tariqullah (2005). "Resource Mobilization for Islamic Development Bank: A Note", mimeo. April. Other alternate structure based on *sukuk* on donated assets can also be found in that note.

countries are large. The funds issued by existing *sukuk* process are not earmarked for specific projects.

An alternative proposal for financing specific development projects in a member country is to use some good assets of the member country requesting finance, along with some assets of the IDB to form the asset pool of a SPV. This asset pool is securitization through *ijarah sukuk* for utilization of funds in that specific project.

This will have the advantage that (i) IDB will be able to spare some of its good assets from getting tied-up for long period. (ii) The member country asset will be securitized which may not be liquidate-able on stand alone basis at low cost. (iii) The member country will directly participate in the fund raising which will create better incentives to utilize the funds efficiently so as to pay the obligation and get back its assets.

Another way to achieve same goal is for the member country to first transfer some good quality unencumbered assets to the IDB balance sheet. The IDB then securitize it in a pool of its assets. Thus the *ijarah sukuk* is issued on the full balance sheet strength of IDB. This second procedure has all the advantages of the previous proposal with the addition that (iv) the credit enhancement role of IDB is further played out. Thus more cheaper funds can become available. However, the proposal hinges on sovereign members willingness to transfer some of their assets to IDB or to a SPV.

Other alternative structures are also possible on similar lines involving assets obtained on donation. For details the reader is referred to Khan (2004).

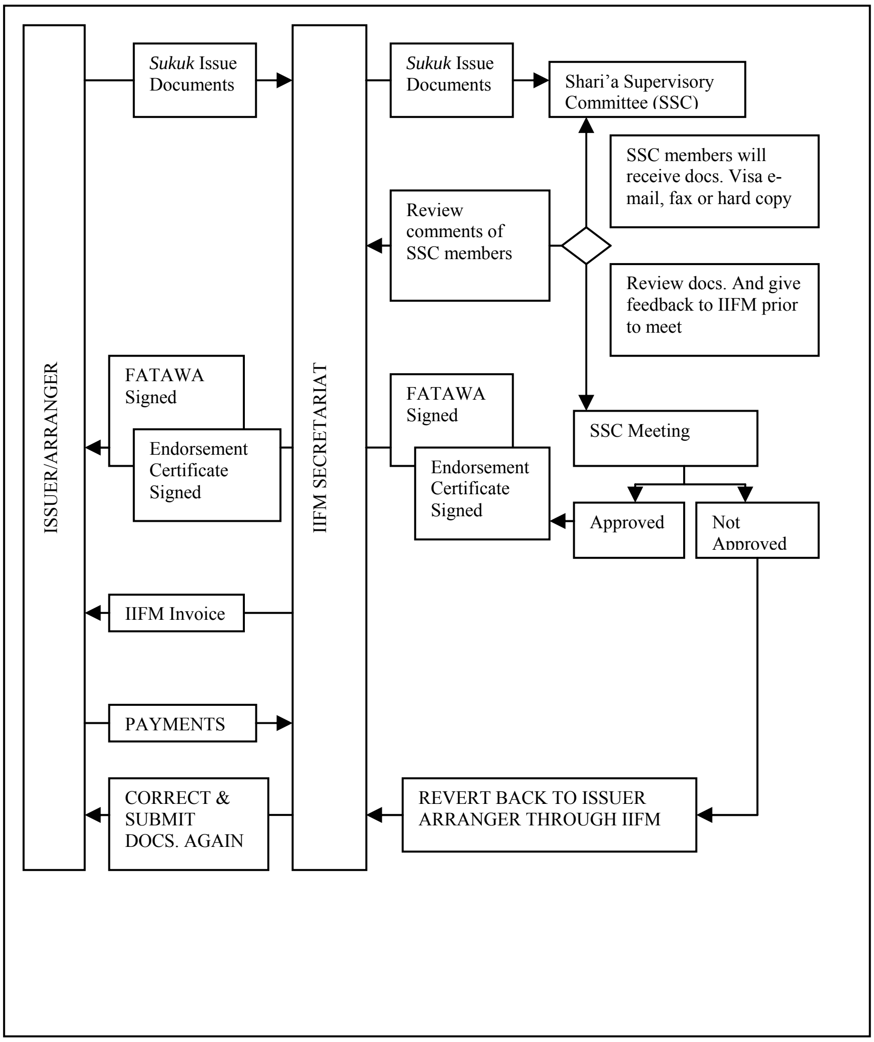
3.2.8 Development of Infrastructure for *Sukuk*

- There are complex legal and other infrastructure requirements for securitization of tangible assets through *sukuk*. These requirements further increase if securitization of usufruct or services is involved. In general, the laws must specify rights of each party, cover each stage of transaction, and enforcement must be strong. Some degree of standardization is needed in the underlying assets, its valuation process, rating process, *shari[ah* approval process, and in the documentations that are required at each stage. Similarly, servicing standards have to be considerably standardized. These elements speed up the securitization process, save costs, help valuation of instruments, avoid ambiguities, help coordinate the expectations that build confidence of all parties in the market and the instruments.

- In the context of currently available legal infrastructure for *sukuk* it may be noted that many steps involved in *ijarah sukuk* are covered by local laws in many of the jurisdictions that have issued *sukuk*. It is however the trust law (the law that covers the issuance and relation of the SPV with the originator) which is often chosen to be governed under English law as implemented in the jurisdiction of issue; which in most cases is a foreign market. A partial reason for this is the underdeveloped state of trust laws in the local market. Some degree of standardization is appearing in the structure of sovereign *sukuk* partially because it is a copy able product and one model is replicated by others. And also because the same set of investment banks and legal firms are involved as advisors and underwriters in most of the issues. However, given the few number of issuances, the contracts and processes at various stages of the *sukuk* issue have not converged yet.
- Importance of starting on the right foot in terms of product types, characteristics and standards for each type, and international acceptance.
- AAOIFI *shari[ah* standards for investment certificates cover *sukuks*. A positive development.

Shari[ah supervision in *Sukuk* issuance and monitoring overtime through its different stages is initiated by the originators. A positive step. For greater acceptability and investor confidence they are also involving *shari[ah* boards of other parties to the contract. For example, *shari[ah* board of the underwriters, of arrangers, as well as of institutional investors. This is also positive. A better and cost effective way will be to create shared institutions. One such *shari[ah* authentication institution is IIFM. Another step would be to streamline, standardize (not necessarily unify), and write out the *shari[ah* authentication and monitoring procedure. IIFM has done it as follows, and created a benchmark of practice.

Figure-4 IIFM Shariah Authentication Process



Source: IIFM Website

3.2.9 *Shari[ah* Issues in *Ijarah Sukuk*

Shari[ah scholars have discussed *shari[ah* compatibility of various kinds of *sukuk*, including *ijarah sukuk*, with qualifying conditions for each.[22] However, *sukuk* as a new product has acquired some controversial features during its development phase that were not part of the original asset-*ijarah* bond. These features induce the risk that the *shari[ah* acceptance of the *ijarah-sukuk* may become shaky in future if the product is perceived by the public to be contradicting *shari[ah* rules.

The most controversial feature in most of the *sukuk* is the buy-back arrangement in explicit form or in implicit form as a unilateral promise by the originator.

The purpose of SPV in conventional securitization involving private sector business is to create:

(i) a limited liability device for the investors who will provide funds and

(ii) a commitment device for the company that it will use the funds in the particular way it has announced.

Thus on one hand SPV creates bankruptcy remoteness from the many other businesses of the originator company, and on the other hand increases the credit-worthiness or trust in the company: both features which will attract investors and allow for cheaper funds. But in case of a sovereign like a government an SPV is not a credit enhancer because unless a more credible multilateral institution or a more credible foreign government is the trustee the bankruptcy remoteness is as high as possible in the given country for a private investor in the government projects. Similarly, the SPV structure in case of government projects is also not a proper commitment device. Other kinds of commitment devices such as constitutional amendments, curtailment of executive powers and enhancement of judiciary's authority and independence, enhancement of collective decision making etc are the right commitment devices in case of governments. Thus the use of SPV in Islamic financing of government projects becomes only a device to create a buy-back arrangement without explicitly statement.

By creating an SPV and selling rentable assets to it with a unilateral promises that government is ready to buy back the asset at face value after a certain period if the SPV so wishes (giving put option to SPV)

[22] AAOIFI *Shari[ah* standard no. 17 is an example of such conditions.

government ensures that the assets are reverted back to it on maturity. Since the SPV is creation and dependent of the government itself, therefore it is obliged to exercise the option of selling the asset to the government at face value even if the market price of the asset at maturity date were higher than its face-value.

The problem can be highlighted with following extreme example. If the unilateral promise has binding implications then a very simple and more efficient structure can be devised without the SPV. To see this suppose we drop the SPV and let the government sell a mundane asset like a barren mountain, a garbage dump, or a barren piece of small land at inflated price to the public and offer to lease it back on a inflated rent (which can be tied to LIBOR with periodic revisions on each extension of the lease). At the same time it gives a unilateral firm promise to buy the asset at face value from whoever is willing to sell it at a certain future date (maturity date). Since the asset is of lesser market value than its face value at maturity (in fact throughout the contract period) this is in-the-money put option for the investors and they will always exercise it on maturity. Thus the government does not have to worry about loosing any strategic asset. Hence an *ijarah* suk can be devised without involvement of any useful asset to meet the financial needs of the government.

Some *ijarah sukuk* have rightly stated that the originator unilaterally promises to buy the asset at its market value that will prevail at the time of maturity. But in case of public good nature of the underlying asset (or a specific purpose asset), which is the case in most of the sovereign *sukuk*, its market may not exist. How to evaluate the fair value of such underlying asset and who will do it is not clear, as those *sukuk* which stipulate this condition have not matured yet.

Another *shari[ah* issue in some *ijarah-sukuk* is that they put all maintenance expenditures on the lessee while it should have been the responsibility of the lessor. To see this let us examine the terms of a typical sovereign *sukuk* contract:

The master lease agreement stipulates the parties agree to execute consecutive semi-annual leases of the property between the start and dissolution period of *Sukuk* and lessee pay rents semi-annually. Being a lease contract it states that the “Ordinary Maintenance and Repairs” cost will be borne by the lessee (Gov.) while “Major Maintenance” costs will be borne by the lessor (Issuer). But effectively it is the lessor who is incurring both types of costs because:

(i) the amount of rental payment by the lessor into the Transaction Account is defined in the contract as the amount what is *equal to* the amount of Periodic Distribution to Certificate holder from the Transaction Account.

(ii) And, the first priority in distribution from Transaction Account is given to the Certificate holders.

By implication there remains nothing in the account for major maintenance.

Such *shari[ah* issues in the existing *sukuk* structures are a source of legal uncertainty needing the attention of finance professionals and *shari[ah* scholars. In order to streamline the practices in *sukuk* issuance, their secondary trade, and their retirement a *shari[ah* audit system is necessary. It is particularly important because the *sukuk* products are in their formative period which will set precedence and standards for the future of *sukuk*.

Table-8
Summary of Risk Characteristics of *Sukuk*

Types of Sukuk	*Description of Sukuk structure*	*Credit Risk*	*Rate of return (Interest rate risk)*	*FX risk*	*Price risk*	*Other risks*
Zero coupon Sukuk	Istisna', *Murabaha* debt certificates – **non-tradable**	Unique basis of credit risks exist, see, Khan and Ahmed (2001)	Very high due to fixed rate, remains for the entire maturity of the issue	If all other conditions are similar, FX risk will be the same for all cases of *Sukuk*. However, those *Sukuk* which are liquid or which are relatively short term in nature will be less exposed. The composition of assets in the pool will also contribute to the FX risk in different ways. Hence this can be very useful tool to overcome the FX risk by diversifying the pool in different currencies.	Price risk relates to the prices of the underlying commodities and assets in relation to the market prices. Ijara *Sukuk* are most exposed to this as the values of the underlying assets may depreciate faster as compared to market prices. Maintenance of the assets will play an important part in this process. Liquidity of the *Sukuk* will also play an important part in the risk. Salam is also exposed to serious price risks. However, through parallel contracts these risks can be overcome	**Liquidity risk**is serious as far as the non-tradable *Sukuk* are concerned. **Business risk**of the issuer is an important risk underlying *Sukuk* as compared to traditional fixed incomes. ***Shari'ah*compliance** risk is another one unique in case of *Sukuk*. **Infrastructure rigidities,** i.e.,non-existence of efficient institutional support increases the risk of *Sukuk* as compared to traditional fixed incomes, see *Sundararajan, & Luca (2002)*
Fixed Rate Ijara Sukuk	Securitized Ijara, certificate holder owns part of asset or usufructs and earns fixed rent – **tradable**	Default on rent payment, fixed rate makes credit risk more serious	Very high due to fixed rate, remains for the entire maturity of the issue			
Floating Rate Ijara Sukuk	Securitized Ijara, certificate holder owns part of asset or usufructs and earns floating rent indexed to market benchmark such as LIBOR – **tradable**	Default on rent payment, floating rate makes default risk lesser serious – see previous case	Exists only within the time of the floating period normally 6 months			
Fixed rate Hybrid/ Pooled Sukuk	Securitized pool of assets; debts must not be more than 49%, floating rate possibility exists – **tradable**	Credit risk of debt part of pool, default on rents, fixed rate makes credit risk serious	Very high due to fixed rate, remains for the entire maturity of the issue			
Musharakah Term Finance Sukuk (MTFS)	Medium term redeemable musharakah certificate based on diminishing musharakah – **tradable as well as redeemable**	Musharakah has high default risk (see Khan and Ahmed 2001), however, MTFS could be based on the strength of the entire balance sheet	Similar to the case of the floating rate. This is however, unique in the sense that the rate is not indexed with a benchmark like LIBOR, hence least exposed to this risk			
Salam Sukuk	Securitized salam, **fixed-rate and non-tradable**	Salam has unique credit risk (see Khan and Ahmed 2001)	Very high due to fixed rate			

Source: Ali Arsalan (2004)

3.3 ISLAMIC DEPOSITORY RECEIPTS (IDR):

While aggregate volume of *shari[ah* compatible products for capital markets is increasing, their markets are segmented between countries and regions.[23] At present, large scale high frequency cross boarder trade in assets is a rarity among many OIC member counties. Various factors such as capital account restrictions, nationality based ownership policies, economic and political risks, and high risks and costs of such transactions count towards it. The situation is gradually changing. A number of OIC countries with fast developing capital markets have eased or removed restrictions on capital flows, business ownership, repatriation of capital and profit.[24] In order to expand the market for Islamic products and make them available at global level efforts are also underway to cross list *shari[ah* compatible products across the markets.[25]

However, the high transaction cost is still an issue which stems from differences in regulatory and listing requirements, different trading platforms and trading rules, exchange rate instability, lack of support institutions for cross-border transactions, as well as a spectrum of *shari[ah* compatibility criteria.

Under similar difficulties involved in cross-listing, use of a system of depository receipts have evolved in the conventional emerging capital markets. Instruments such as Global Depository Receipts (GDR), European Depository Receipts (EDR), and American Depository Receipts (ADR) have emerged. For example, ADR "are foreign currency-denominated derivative instruments, issued by international banks like Bank of New York or Citibank, representing home securities held with a local custodian." (Claessens, et al., 2002a). These are cost effective and easy to increase or decrease as per requirement of the issuer. A depository receipt is a negotiable and transferable instrument that is traded on the

[23] This situation restricts the utilization of economies of scale and scope that are otherwise possible in larger markets; increases the operational costs; and restricts the benefits of the infrastructure institutions created at global level for Islamic finance.

[24] For example in the four countries of our focus—Bahrain, Malaysia, Pakistan, and Sudan—restrictions on capital flows have either been completely removed or they are removed for certain kinds of assets.

[25] For example, some Malaysian and Bahraini *sukuk* are cross-listed in Labuan-Malaysia and Bahrain. Similarly, Sudan Telecom has been cross listed in Bahrain.

stock exchange of a country (or jurisdiction) but represents a stock that is listed and issued by a firm in another country (or another jurisdiction).

On the similar pattern there are suggestions to increase the possibility of tapping capital markets across countries through issuance of Islamic Depository Receipts (IDR) (IOSCO, 2004 p.67) which will increase the liquidity of Islamic markets at lower the cost of funds. A system of Islamic Depository Receipts (IDR) on *shari[ah* compatible products will prove to be very useful and appears promising in expanding their markets and integrating them.

Box-1

How a depository receipt system works?

Let X be a foreign country and Y the domestic country. Our investor is based in (domestic) country Y while the firm of our interest is based in (foreign) country X. A stock broker of country Y through its agent in country X purchased the stock of the country X firm. These shares do not cross border but are deposited and frozen on trust in a foreign country branch of the domestic (country-Y) bank. Selection of domestic bank is to increase the level of confidence. After getting the confirmation from the bank the custody of shares has been completed the stock broker in country-Y issues Depository Receipts (DR) through a due process of country-Y stock exchange. These receipts are issued on some determined ratio between the DR and the underlying stock, which does not have to be 1:1, and after converting the value of underlying stock from foreign to domestic currency at appropriate exchange rate. Thus the listing in domestic market takes place of the DR and not of the underlying stock of the foreign firm which are however backed by foreign assets. The DRs are traded in domestic market under domestic trading rules and any change in material information about the underlying asset is reported by the domestic broker in the domestic market.

In short, as the central depository in a stock market helps in dematerialization of shares by keeping custody of the physical certificates which reduces clearance and settlement risks the DR system does same for cross-border transactions.

The pricing of DRs is affected by domestic factors of supply and demand, and the performance of underlying stocks of the foreign firm. However, the foreign country's market pricing factors influence the price of DRs in domestic markets through the degree of cross-border price arbitrage and the extent of such arbitrage trading activity.

3.3.1 Possible advantages of IDR on *shari[ah* compatible stocks and *sukuk*.

3.3.1.1 Advantages for the foreign (country-X) firm i.e., the originator of the underlying asset:

- A firm can expand its investor base and obtain funding from other country markets if X-country market does not have sufficient funds or appetite for it.
- If the Y-country market is more liquid in terms of higher turnover and trading volume the originating firm may find it cheaper to raise funds from Y-country market than from the market in its own country.
- If the transparency and trading requirements in Y-country market is stronger than in the X-country market, the firm can signal to local X-country investors that it is a better quality risk by having its IDRs traded in the Y-country market. This signaling can reduce cost of funding to the firm as well as increase its valuation.
- Depending on market conditions, the IDR structure can also be used to raise funds in foreign exchange while the payouts can still be in domestic currency. Thus reducing the foreign exchange mismatch risk involved in direct cross-listing.

3.3.1.2 Advantages for the domestic (Y-country) investor:

- Investor can diversify his portfolio of assets by tapping into equities and *sukuk* in other markets
- Investor can hold and trade using his own country trading system and rules with which he is more familiar.
- Higher return and higher risk assets of other jurisdictions can be held without exposing oneself to additional risks of directly investing in foreign markets. Similarly, clearance and settlement risks of less developed foreign financial market can be reduced.
- While exchange rate risk cannot be avoided in IDR, the investor avoids high costs of small and/or frequent cross-border transactions that he would otherwise incur in adjusting his portfolio. This is an added

benefit for small investors for whom the cross-border transactions would otherwise not be feasible.

3.3.1.3 Advantage for the system and development of Islamic capital markets:

There are multiple advantages in IDR for the development of Islamic capital markets if such instruments are strategically used. Given that at present cross-listing possibilities exists only across few Muslim countries therefore IDR offers a good alternative to start with.

While cross listing has often been successfully used between emerging and developed markets, one of the consequence has been migration of liquidity to the developed market.[26] This is particularly the case if the trading activity in less-developed market was concentrated in few companies before the cross-listing. It is usually only the good companies that seek and qualify for cross-listing. As a result a substantial portion of liquidity is affected in the domestic market. If in response to reduced liquidity, the firm moves altogether out of the emerging market then market development suffers. In case of IDR liquidity migration effects are possible but the domestic firm will not altogether leave the domestic stock market.

A consequence of IDR will be that the jurisdictions with better investor protection laws, better run stock exchanges, and better reputation for *shari[ah* compliance will be rewarded by attracting more trade.

A more important aspect of IDR will be that it can lead to regulatory competition between jurisdictions.[27] with each jurisdiction trying to improve the level of investor protection as well as *shari[ah* compliance. This will also result in much needed convergence of product standards as well as *shari[ah* applications.
How this convergence can be achieved?
It is the originators who choose to issue IDR. But it is the investors who choose to buy. Originators' and issuers' choices are governed by market liquidity, cost, and reputation considerations. While investors' choice of

[26] Claessens, et al. (2002b). For analysis of investor behavior in context of American Depository Receipts see Aggarwal, et al. (2005).
[27] See Coffee (2002) for regulatory competition between jurisdictions; how it prevents emergence of super-exchanges on one hand and contributes to improved corporate governance of firms on the other.

Islamic securities, and IDRs are governed by investor protection as well as *shari[ah* compliance. If the investor demand certain degree of corporate governance and certain degree of *shari[ah* compliance in the underlying asset of the IDR, then those that do not meet the required levels will not benefit. This will force the individual firms to improve corporate governance and the regulators to amend the regulations towards more converging views.

In the long-run such competition will not necessarily produce identical rules, practices and governance standards but more of specialization with each jurisdiction specializing in certain kinds of products and the rules governing those products will be accepted.

What is important in starting this phenomenon and continuing with it is the selection of *shari[ah* compatible instruments for IDR issue. Authenticating and *shari[ah* approving institutions like IIFM can play a role. Similarly, the central banks of individual Muslim countries can promote such convergence.

An often discussed and lamented aspect in Islamic finance is non-standardized products and procedures as well as varying application of *shari[ah* opinions. This is often cited as obstacle to growth and integration of markets. This small step of IDR can promote the much needed convergence.

4: CASE STUDIES IN PRODUCT DEVELOPMENT

A way to increase the share of *shari[ah* compatible products in the capital market is to develop new products that suit different kinds of users—i.e., issuers and investors of varying characteristics. Experiments in development of *shari[ah* compatible products for general use in the capital markets reveal that product development and its market acceptance is a complex issue. In this section we survey a few selected products form our sample of the four countries. The products surveyed are: *Mudarabahs*, and Participation Term Finance Certificates of Pakistan; various categories of public finance certificates of Sudan; and Cagamas of Malaysia. These case studies provide details on these products as well as bring out a few lessons for product development.

4.1 *Mudarabah* Companies an Innovation—Case Study of Pakistan:[28]

Mudarabah (management) Companies (MCo) are unique innovation for Islamic financial sector in Pakistan, they evolved and increased their activities since 1984. They face tough market competition from incumbent and new market players such as the leasing companies; as well as from established textile and pharmaceutical companies which started offering financial products similar to *mudarabahs* offered by MCo to raise new finance. The evolution, practices, and performance of *mudarabah* companies as they operated under "*Mudarabah* Law" can provide useful lessons of do and do-not for the development of Islamic capital market products and institutions.

Mudarabah contract is historically well-known and used in various forms in present day Islamic financial industry. However, the new aspect of the *mudarabah* companies (MCo) in Pakistan is that on one hand they issue *mudarabah* certificates (MC) to raise funds which is invested using various Islamic modes of finance (including *musharakah*, *mudarabah*,

[28] This section draws heavily on Khan, Tariqullah (2004) "Modaraba Companies of Pakistan: Profile and Analysis". While Khan in his paper focuses on the profile and ways to revive the *Mudarabah* (management) Company sector, we have used his data and analysis to derive lessons for Islamic product development.

leasing, *murabaha* etc.); on the other hand the companies are themselves listed on the stock market where their shares are traded.

Theoretically this structure is similar to an open ended *mudarabah* based mutual fund. However, as opposed to mutual funds it was not necessary for MCos to diversify investments. Rather, the MCos were expected to use their specialization and experience in some lines of business to generate profit and share it with their certificate holders. The stock exchange listing and tradability feature of the certificates provided the possibility for the certificate holders of full realization of the value in the form of profits as well as capital gains. The MCo sector had great potential to direct finance to productive enterprises.

However innovative, a majority of MCos were not able to perform up to the expectations. Whereas the product – *mudarabah* – have been successful as evidenced by its replication by other Non-Bank Financial Institutions. There were many reasons for the less than optimal performance of MCos. We briefly elaborate these factors below to point out the importance of enabling regulatory environment, incentives, and level playing field for success in Islamic product development.

The MCos still exist and some have performed very well. Their success factors have also been pointed out below. The potential of the mudarbah sector can be enhanced by providing more scope and space either for funding choices or for fund retention. More innovative structured products using *mudarabah* will go a long way in creation of successful capital market products.

4.1.1 Lessons for product development:

The principal reasons for less than optimal performance of MCos can be attributed to the following factors which also provide lessons for development of new products:

1. Over-regulation and incentive distortion.
2. Regulation by multiple regulatory bodies.
3. Law centered—rather than market centered—conceptualization of the operational requirements that stifled growth.
4. Competition from other market segments where the regulations were not stifling.
5. Lack of on-going *shari[ah* supervision structure.
6. Scarcity of human capital and expertise to run *mudarabah* business.

These are discussed below in some detail.

4.1.1.1 Governing laws that over-regulate or distort incentives:

At the outset it is useful to understand the nature of MCos and their scope as defined in the regulation. The establishment and operations of the *Mudarabah* Companies are governed by the *Modaraba Companies and Modaraba Floatation and Control Ordinance* 1980 and the subsequent amendments and guidelines issued by the regulating authority. Most recent of which was issued on January 28, 2004 by the Securities and Exchange Commission of Pakistan (SECP) entitled as "Prudential Regulations for Modarabas"[29]. A *Mudarabah* is defined in the Ordinance as, 'a business in which a person participates with his money and another with his efforts or skill or both his efforts and skill and shall include Unit Trusts and Mutual Funds by whatever name called'.

Mudarabah Companies (MCos) are like a special purpose vehicle (SPV). These are separate companies formed for multi-purpose or specific purpose operations by an existing registered company or a private company or a public corporate body. The MCos are then registered under Companies Ordinance 1984 as either a private or a public company. These MCos then issue *Mudarabah* Certificates (MCs) to raise funds. If these certificates are to be issued and traded through stock market then MCo also have to be listed on the stock exchange, otherwise it can do private placement. In all cases the MCos are also required to be registered with the Registrar of Mudarabahs.

Other salient features of the *Mudarabah Law* are:

- *Mudarabah* Certificates (MCs) issued by MCos are *non-voting* shares of common stock in the MCo. (However no compensating benefits are specified for the MC holders).
- The minimum capital requirement for a multi-propose MCo is Rs. 7.5 million, and for a single-purpose MCo it is Rs. 5 million.
- In both cases, the MCo has to contribute the initial 10 percent of the subscribed capital.

[29] As cited in Khan (2004) the related guidelines are available from the Website of Securities and Exchange Commission of Pakistan at http://www.secp.gov.pk

- The MCo, as a manager (*mudarib)*, will charge not more than 10 percent of total annual profits as its remuneration, besides the returns on its capital contribution to the MCo.
- The MCo can issue rights, stock dividends and distribute cash dividends.
- The MCo cannot involve in any activity prohibited by the *Shari[ah*.
- At least 75 percent of the MCo's operations must be kept in the main line of its business.

The low capital requirement, tax advantages, the non-voting nature of MCs, and other features provided existing businesses the incentive to create *Mudarabah* Companies which worked as their captive financing arms.

4.1.1.2. Multiple regulatory bodies:

The process of registering and commencing of business for MCo is complicated and lengthy without much value added through the process. For example, to register as MCo the initiators have to apply to Securities and Exchange Commission which evaluates the application on the basis of above law. If approved for registration by SECP it applies for registration and permission for commencement of operations to Registrar of Mudarabahs. The application is also evaluated by Religious Supervision Board for *shari[ah* compliance. When cleared from these entities; registered; and permission for operation is obtained; it applies to Controller of Capital Issue and the Stock Exchange for listing and flotation of *Mudarabah* Certificates which bring in the investment funds.

The State Bank of Pakistan (SBP) has no separate regulations for the MCos or for the floatation of *Mudarabah* but a common *Prudential Regulations for Non-banking Financial Institutions* which also applies to MCos. Some of which are difficult to abide by the MCos given their small size and capital. Some salient features of these regulations are given in Box-2.

Box-2

Salient features of regulations for Non-bank financial institutions which also affect the MCos.

- Each *Mudarabah* will establish a reserve fund equivalent to its own paid up capital with the SBP. This reserve fund will be established by annual contribution of at least 20 percent of the after tax profits of the *Mudarabah* floated. Once the reserve fund equals the paid-up capital, the annual contribution will be decreased to 5 percent of after tax profits. Stock dividend is considered as an appropriation for this purpose.
- At least 15 percent of the liabilities of the *Mudarabah* must be invested in the National Investment Trust Certificates (NIT Units) or in securities of public corporations.
- For initial two years, the debt/equity proportion of the *Mudarabah* will be 1:7, thereafter, it can be 1:10 and may be further changed with the consent of the concerned regulatory authorities.
- A *Mudarabah* will not be entitled for any financial assistance if its debt/equity ratio remains below 60:40 on long-term basis. This level of debt/equity ratio must be maintained by all energy sector *Mudarabah*s.
- Current assets/current liabilities ratio will have to be maintained at 1:1 of the *Mudarabah's* equity.
- A single business group cannot be financed by more than 20 percent of the *Mudarabah's* equity.

List taken from: Khan (2004).

4.1.1.3. Law centered rather than market centered conceptualization:

As can be seen from the rules governing the establishment and operations of MCo the regulators were focused on traditional structure of *mudarabah* as found in *fiqh* literature. Which is essentially a restricted or unrestricted *mudarabah* concluded by liquidation. Therefore the very early law (which was changed later) restricted *mudarabahs* to operate only with their paid-up capital. The law also accounts for perpetual *mudarabah* which is in the context of a mutual fund. It thus allowed MCo to float *Mudarabah* Certificates (MC). The regulation also promoted *mudarabah* by tax incentives. However, a few important market realities were ignored. (i) Growth of MCo or any company cannot take place without capital expansion. Requiring the firms distribute large portion of their profits in dividends while their own capital is small is counter productive for growth. Short of cash and wanting to preserve their capital the MCo heavily relied on issuing rights shares instead of paying cash dividends. (ii) The laws ignored the possibility of regulatory and tax arbitrage created for the firms in other sectors on account of lower capital requirement and lower tax in *mudarabah* sector. Companies in other sectors which neither have *shari[ah* supervision requirement nor restricted in raising funds through alternate sources were able to avoid restrictions in one sector by tapping the benefits of the other sector. (iii) As mentioned earlier the specific purpose *mudarabah* came under companies law and capital market regulatory authority, however the general purpose *mudarabah* fringed into non-bank financial institutions framework. This forced the *mudarabah* companies to restrict their choices to a few areas of business such as leasing and *murabaha* financing. (iv) The compensation or payment structure for the executives and board members of the *mudarabah* were such that the management could claim it as cost instead of share in actual profit. This also resulted in creation of multiple *mudarabahs* launched by the same management.

The dynamics of the evolution of MCos shows the impact of not taking the market centered approach in design and implementation of *mudarabah* regulations. Initially the MCos attracted a considerable demand from the general public who readily provided the funds. The strong demand, lucrative tax incentive, low capital requirement, and executive compensation structure resulted in coming into being a large number of MCos within a short time. Starting with only 2 MCos in 1985, their number went up to 52 in 1994 which was a few years after liberalization of financial sector. However, by the end of 2004, only 30 *Mudarabahs* remained listed.[30] The financial strength of the *Mudarabah* sector has continuously weakened over the last decade. Table-9 summarizes the temporal performance of *Mudarabah* sector between 1998 and 2003. The data shows that this sector, as a whole, has not regained its due vigour and growth. The regulators have tried to strengthen the capital of *Mudarabahs* by encouraging mergers and mandatory capital enhancement but it has not helped the sector.[31]

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[30] The reduction in number of *Mudarabahs* is brought about by merger of four and closure of others.
[31] Khan (2004).

Table-9

Mudarabah* Sector - Key Statistics *(Million Rs.)

	1998	1999	2000	2001	2002	2003
Paid up Capital	6,799	6,828	6,867	6,648	7,859	7,600
Total Assets	18,849	14,899	15,103	15,216	17,243	15,800
Total Income	3,577	3,911	4,021	4,127	3,930	4,235
Net Profit after Tax	272	25	687	97	636	1,072
Earning per certificate (Rs.)	0.47	0.03	0.91	0.13	0.82	1.29
Debt Leverage (x)	0.94	1.1	1.11	1.36	1.3	1.02
Return on Equity (percent)	4.59	0.36	9.58	1.5	8.28	13.65
Return on Investment (percent)	2.37	0.17	4.55	0.63	3.6	6.76
Dividend per certificate (Rs.)	0.49	0.79	0.88	0.72	0.75	0.75

Source: Khan (2004).

4.1.1.4 Competition from other market segments:

Mudarabahs are classified as Non-Bank Financial Institutions (NBFIs) under the regulations and face competition from other NBFIs in investment allocation. The other NBFIs include leasing companies, investment banks, brokerage houses, and mutual funds. All of these are regulated under same regulations — now overseen by the Securities and Exchange Commission of Pakistan (SECP). However, *Mudarabahhs* are restricted in their funding sources as compared to other NBFIs which is considered to be a drag on their competitiveness.

Table-10 provides a comparative assessment of *Mudarabahs* and other NBFIs. It shows that average capital and average number of shares of *Mudarabahs* are similar to those of Leasing Companies and Investment

Banks. However, their average assets are significantly lower than those Leasing Companies and Investment Banks—indicating a low leverage. Likewise, their average profits are also less than other NBFIs indicating their weak performance.

Out of all the *Mudarabahs* listed in the KSE (32 in number), the top ten *Mudarabahs* constitute more than 60 percent of the sector in terms of paid-up capital, total assets and total profits. The funding sources of most of these *Mudarabahs* is diverse — the funding items include certificates of *Musharakah* (COM), payables on the basis of *Murabaha* and *Ijarah*. Whereas, most *Mudarabahs* which are not among the top ten have one significant common feature – that they rely on *Mudarabah* certificates as a sole funding source.

<u>Table-10</u>

Performance of *Mudarabahs* versus other NBFIs in Pakistan, 2003

(Amount in Mill.Rs)

TOTAL	Mutual Funds	*Mudarabahs*	Leasing Companies	Investment Banks and Companies
No. of Institutions	15	32	19	14
Paid-up Capital	10,705.778	6,762.805	3,888.533	2,982.530
No. of Share	1,080.628	746.252	388.853	298.253
Equity	19,828.437	7,223.981	6,529.433	12,147.354
Total Asset	21,259.890	15,752.426	43,551.337	33,092.377
Profit After Tax	4,189.830	828.156	971.948	5,085.252
AVERAGES				
Assets/Capital	1.99	2.33	11.20	11.10
Profit/Share	3.87	1.11	2.50	17.05
Paid-up Capital/firm	713.7185	211.337	204.659	213.038
No. of Share/firm	72.042	23.320	20.466	21.304
Equity/firm	1321.896	225.749	343.654	867.668
Total Asset/firm	1417.326	492.263	2292.175	2363.741
Profit Before Tax/firm	279.359	27.254	54.729	375.735
Taxation/firm	-0.0367	-1.374	-3.574	-12.503
Profit After Tax/firm	279.322	25.879	51.155	363.232

Source: Khan (2004).

4.1.1.5. Lack of ongoing shari[ah supervision

The Religious Supervisory Board (RSB) would examine the product and the company only at the time of establishment. Afterwards there was no mechanism of *shari[ah* audit and supervision of actual practices of the MCo. This created *shari[ah* compliance issues.

4.1.1.6. Scarcity of human capital and lack of expertise to run mudarabah business

Most of the managers of MCos did not have background in venture capital business. Their experience was of pure financial intermediaries. Therefore *mudarabahs* were not used to start a new business or to finance a venture enterprise. They were mostly used as a subsidiary of an established business to raise funds for its needs or the MCo applied the funds in fixed income contracts like leasing and *murabaha*. Thus lack of diversified human capital narrowed the scope of business activities undertaken by MCos.

4.1.2. Use of *mudarabah* as SPV for off-balance sheet transactions

MCo structure also has a strategic regulatory advantage that has been exploited very successfully in one context. Since a MCo can be registered for a specific purpose activity/business, the MCs issued by it does not give voting and control rights to its holders which remain with the MCo. Therefore, it is an ideal entity to serve as SPV for raising funds through flotation of MCs on *mudarabah* basis; use the funds to finance construction (or expansion) of plant; and then lease (or leas-to-own) it. The MC holders receive a regular stream of income in the form of rents. The strategic advantage is that the originator can raise funds without issuing new shares which otherwise would have diluted the value of the shares for existing shareholders. Because the MC are not on the balance sheet of the originator. This is the structure very successfully employed by Fayzan Manufacturing *Mudarabah*. A case study of it with some details are given in Box-3.

Box-3

Case Study: Fayzan Manufacturing Mudaraba

A relevant case study is Fayzan Manufacturing Mudaraba in Pakistan, which was exclusively formed to finance ICI Pakistan's US$ 200 million Polyester Fibre (PSF) expansion plans.

The transaction was uniquely structured to fulfill the off-balance financing requirements of the company, which was highly leveraged, in view of their ensuing Balancing Modernization and Replacement (BMR) activities. A consortium of banks and financial institutions formed an independent Mudaraba Management Company (Mudarib) that floated the Fayzan Manufacturing Mudaraba (FMM).

The Mudaraba was responsible for construction and operation of the plant. The share capital of FMM represented proportionate shareholding of the sponsors with representation in the board of the FMM.

The FMM had the legal capacity to leverage its balance sheet and raise equity in the local capital markets. Having agreed to float an industrial Mudaraba, the sponsors were faced with a number of risks associated with this project that broadly included:

Construction Risk; delay in commissioning, design defects, damage to machinery during transit/commissioning etc.

Business Risk; profit margins, competitors, regional situation, government Policies etc.

Asset Risks; obsolescence, machinery breakdown, damage, sub-optimal production etc.

Transaction was structured in a way that ICI Pakistan and the sponsors of the project shared these risks jointly. ICI Pakistan assumed business risks, and the FMM took on asset and construction risks. FMM owned the Plant, while land was leased by ICI to FMM.

ICI provided raw materials (Polymer), electricity and packing material to FMM for conversion to PSF and FMM manufactured PSF under a toll manufacturing arrangement with ICI at a fee dependent on the quantity processed. ICI operated the plant under an Operation and Maintenance Agreement, which covered supervision, personnel and plant maintenance arrangements. Utilities and consumables were supplied by ICI to FMM under a separate arrangement.

The legal agreements gave ICI the right to own and sell PSF produced by FMM's plant. The toll fee received on the basis of profit sharing arrangement by FMM formed the basis of return to the investors. A separate agreement to sell the plant to ICI was signed, the tenor and pricing of which were determined in consideration of the internal rate of return requirement of the investors.

Source: Akbar, Salman. 2003. "Islamic Securitization-from a practitioner's perspective" in BMA *Quarterly Newsletter,* October 2003, p.4-7.

4.2 Participation Term Finance Certificates—Pakistan

Another product that has been used in the capital market of Pakistan is Participation Term Finance Certificate (PTC). Whereby an investor shares in the profits of a business for a specified time through his investment. The initial experience with this product was not successful with respect to two aspects. First, certain conditions of PTC were not fully *shari[ah* compatible thus reducing its appeal to its purchasers. Second, taking advantage of weak regulatory and corporate governance environment a large number of issuers of PTC declared losses at the time of profit sharing.

However, a large business group operating in chemical industry issued a *shari[ah* compatible PTC in the form of *Musharakah* Term Finance Certificate (MTFC) with staggered profit sharing ratio and other features that proved very successful. The details of this product in given in Box-4 below.

Box-4

Case Study: Musharaka Term Finance Certificates

The Sitara Group, one of the high profile conglomerates in Pakistan formally decided
to free its balance sheet from all conventional exposures and restructure its balance sheet in line with Shariah. Over the course of the last few years, the company issued two successful Musharaka based term finance certificates (MTFC) worth a total size of PKR 510 million (US$ 9 million). These were both privately placed and listed on the Karachi Stock Exchange.

The certificates carry a fixed tenor with profit payments linked to the operating profit or loss of the company. The profit sharing ratio has been structured in a slightly unconventional way. The level of yearly operating profit is divided into two broad categories under the heading of Level 1 Profit and level 2 Profit. Level 1 Profit is levied on the first PKR 100 million of operating profit that the company would make at a profit rate of 12% of the outstanding principal and Level 2 profit levied at 2% of the outstanding principal on each subsequent PKR 100 million operating profit.

The profit sharing ratio was worked back according to the projected profitability results of the company and the expected level of internal rate of return (IRR) that the company is willing to provide to the investors.

However, this at best remains expected since the actual IRR would depend on the actual profitability of the company, hence the analytical rigour in financial projections is key to structuring the profit sharing ratio at the outset. Semi annual profit is made on account payment (provisional) on the basis of projections irrespective of profit and loss and the final profit payment is determined on the basis of annual audited accounts of the company and adjustments made accordingly.

In the event of continuous dismal performance of the company, the investors risk losing their entire investment. That is, in case of genuine business losses, verified by the separately appointed auditors. Under such circumstances, the investors will have no recourse to the security, which is hypothecated in their favour, the call of which is only warranted in case of fraud and negligence proven in the banking court.

To mitigate the risk of loss for the MTFC holders, the company created and maintained a Takaful reserve, contributed both by the issuer and investor that run till the entirety of the issue. On the contrary, in case the company performed better than anticipated the potential IRR to the investors on their investment would be significantly higher than a comparative conventional fixed corporate bond of similar risk.

Source: Akbar, Salman. 2003. “Islamic Securitization-from a practitioner’s perspective” in BMA *Quarterly Newsletter,* October 2003, p.4-7.

4.3 Product Development—Case Study of Malaysia

Case Study of Cagamas Malaysia

From Chiquier, Loïc; Olivier Hassler; and Michael Lea (2004) "Mortgage Securities in Emerging Markets" World Bank Policy Research Working Paper 3370, August 2004.

Cagamas Berhad was created in 1987 following a recession and liquidity crunch that restricted credit for housing, particularly for moderate income households. The purpose of Cagamas was to provide more liquidity to mortgage lenders, reduce market risks, assist social housing finance, sustain construction sector, and develop private fixedincome markets. Cagamas purchases mortgage loans (the principal balance outstanding) from mortgage originators, with full recourse to the primary lenders, at a fixed or floating rate for 3 to 7 years. This is in effect a secured financing with Cagamas looking first to the credit of the financial institutions when mortgage loans default.

Cagamas issues debt securities to investors, in the form of fixed or floating rate bonds, Cagamas notes, or Cagamas Murabaha (Islamic) Bonds. The debt is amortized independently of the mortgages. Cagamas is the largest non-government issuer of debt in Malaysia. Its securities are rated AAA by the Malaysian Rating Agency and subject to only a 10% risk weight for bank investors. As of the end of 2002, Cagamas had outstanding debt securities exceeding 24.9 billion Ringgit (approximately $6.6 billion) [Cagamas Berhad 2002].

Cagamas has successfully pioneered a number of products in the market including fixed and variable rate, longer maturities, recourse and non-recourse, Islamic debt, and leasing/commercial property lending.

Cagamas receives a number of significant privileges from the Malaysian government, without which its refinancing activities would not have been perceived as sufficiently attractive for primary lenders. Loans sold to Cagamas are not subject to the Central Bank reserve requirements. Its securities are eligible as liquid assets (banks and finance companies must keep an additional 10% of assets in liquid form). Cagamas securities carry a risk weighting of 10%, compared with a 50% rating for housing loans, for investing credit institutions.

4.4 Product Development —Case Study of Sudan

Sudan Financial Services Company (SFSC): The SFSC came into being in 1998. Its initial issuance was Central Bank *Musharakah* Certificates (CMCs), which were well received with high demand. These certificates represented Bank of Sudan's assets (ownership) in the commercial banking sector. These assets formed a closed-end Fund, managed by SFSC. The primary purpose of CMCs was to serve as monetary policy tool. However, they have been discontinued for several reasons. First, they proved to be costly for monetary management. Being an equity instrument which carried some risk for its holders it required payment of high rate of return. Second, their issue volume was limited by the size of the underlying asset – a monetary tool suitable for open-market operations needs relatively unconstrained availability. Third, the constraint on issue volume became quickly binding because the commercial bank assets were mostly *murabaha* receivables which cannot be re-traded in the secondary market for a price different from its face value. Doing so would have resulted in violation of *shari[ah* rule.

The SFSC also started a series of Government *Musharakah* Certificates (GMC) which are claims on the government owned enterprise and tradable in secondary market. These certificates were started in 2001. Since then 24 issues have been made. Now GMC are also being withdrawn and they will ceased to exist by 2007. A gradual withdrawal process has already been started by not reinvesting the profit in the new issues as the older securities mature. The GMCs are of short-term maturity instruments that mostly ranged from 3 to 6 months but some are also for a year. The net total amount raised under GMC scheme during various years (end December) had been: 12.9 billion Sudanese Dinar (SD) in 2004; SD 9.36 billion in 2003 [0.21 per cent of GDP]; and SD 5.18 billion in 2002 [0.13 per cent of GDP].[32]

4.4.1 Structure of GMC:

Certificates represented partnership in an identified set of state-owned enterprises. This set of enterprises formed the underlying asset pool of the

[32] Author's calculation based on data from Sudan Financial Services Company; Bank of Sudan; and Central Bureau of Statistics, Ministry of Finance and National Economy, Government of Sudan websites.

partnership through GMCs. The partnership was for a limited time, expiring on maturity of the certificate. The certificates were issued through Sudan Financial Services Company (SFSC). The sale of certificate would transfer a part of the ownership of the group of state-owned enterprise to the certificate holder. Only Sudanese nationals were allowed to participate. The holder of the certificate would receive a proportion of the profit generated by the enterprises in the GMC asset pool. At the expiry of the term (i.e., at maturity) the government redeems the GMC on a contractually pre-agreed price which normally were the face value of the certificate. In a sense GMCs were a kind of protracted or temporary privatization instrument in which the administration and control remain with the government but the ownership and the related financial flows pass in the private hands for a specific term.

4.4.1.1 Success Factors:

Given the meager alternate opportunities of investment to small savers and risky investment avenues otherwise available to the rich but passive investors the GMCs offered a good prospect. It was safe being backed by government and profitable (the first series ended up paying 32 per cent returns). The certificates were also very attractive to banks as a large number of banks had very small base of major-clients. Most banks had only 4 to 5 major-clients whom they trusted for large investments. Therefore GMC allowed them to avail of earnings with safety.

4.4.1.2 Controls:

A maximum limit was prescribed for banks' investment in GMCs.

4.4.1.3 Client base:

GMCs were very popular among individuals as well as banks. However, due to a high amount of its minimum denomination of 50,000SD the clientele were mostly institutions and wealthy individuals.

4.4.1.4 Problems:

GMCs were mostly short-term. Therefore government had to issue a new issue every now and then.

4.5 Government Investment Certificates (GIC):

Government Investment Certificates (GIC) are new instruments that has been introduced since 2003. Learning from experiments with earlier instruments CMC and GMC as well as changed economic needs are behind the development of this new instrument. Major Differences between Government *Musharakah* Certificate (GMC) and Government Investment Certificate (GIC) are:

	GMC	GIC
1.	Purpose of GMCs was to finance government budget deficit.	Purpose of GICs is to finance trade, procurement, and development projects of the government.
2.	Based on *Musharakah* in the (set of) state owned enterprises.	Based on partnership for financing of the state owned enterprise through *ijarah*, *murabaha*, and *istisna*[. With *ijarah* having a dominant portion in the contract pool.
3.	Holders of GMCs become owner of the assets in proportion to their investments.	The SFSC is a *mudarib* for GIC holders in a restricted *mudarabah* which allows it to deal only in government assets and projects. The SFSC becomes owner of the specific assets which it procures from the market or get them manufactured before it sells them on *murabaha* or rents them out (as the case may be); while it works as *mudarib* for the GICs holders. Therefore, GIC holders as *rabb al-mal* have undivided ownership in the business (or asset and contract pool) of the SFSC but not in the specific assets.
4.	Bullet payment of principal and profit at maturity.	Stream of profits paid at regular intervals (semi annually). Profit sharing ratio 95% for GIC holders (*rabb al-mal*) and 5% for SFSC (the *mudarib*).
5.	Tradable in the secondary market (from immediately after issuance).	Redeemable only on maturity at the then assessed market value of the asset pool. In between GIC is tradable in the secondary market (after transformation of proceeds into real assets).
6.	Short-term maturity ranging from 6 to 12 months.	Maturity of larger range from few months to several years.

7.	Large denomination 50,000SD minimum.	Small denomination 10,000SD minimum.
8.	Foreigners cannot invest	Foreigners can invest.

Why government is replacing GMC with GIC?

1. The government budget deficit has narrowed since last few years due to multiple factors such as: rise in tax revenue, increase in government income through rise in oil prices, increased remittances and financial inflows after 9/11. These factors not only decreased government deficit but also increased the availability of hard currency. Therefore government does not have a pressing need to raise funds to finance budget deficit.
2. GMC were more costly for the government due to their short maturity and bullet payment structure of the principal and the profit. While at the same time the proceeds from sale of GMC were not necessarily generating income as it were used for financing of current expenditures of the government. Where as the GIC are of longer maturity and payment structure is such that the government has to worry only about periodic profit payment in short-term. And in the long-run the investment allocations in development and construction have positive economic effects.

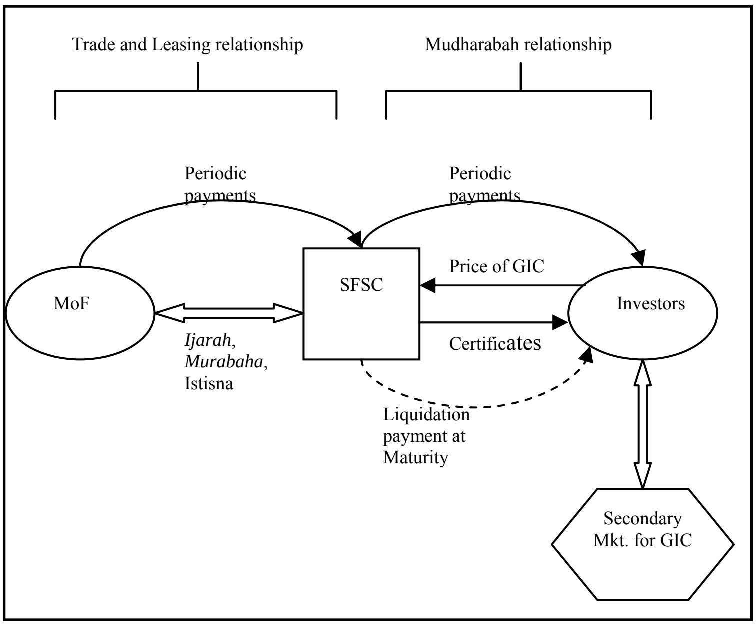
3. Government faced difficulty in using GMC as a monetary policy instrument because of constrained supply of certificates due to limited asset base against which these could be issued. Moreover, the rate of return is known ex post. While conduct of monetary policy requires ex ante knowledge of rate of return.

4.5.1 Structure of Government Investment Certificates (GIC):

There are three parties to the contract:

1. Investors or certificate holders who are the *rabb al-mal*
2. Sudan Financial Services Company (SFSC) which acts as *mudarib* (agent). It is an investment company.
3. The Ministry of Finance of the Government of Sudan which is the users of finance.

Figure-5: Structure of GIC



Government Investment Certificates are essentially *mudarabah* certificates that represent *mudarabah* capital in the business of Sudan Financial Services Company (SFSC). The SFSC can be though of as an investment company (or what is called a *mudarabah* company in Pakistan) that finances government's projects through *ijarah*, *murabaha*, and *istisna[* – all fixed return modes. The government is a party in the contract and being a sovereign entity it has the highest credit rating which reduces credit risk to SFSC. Thus the returns to the certificate holders through SFSC become almost guaranteed. SFSC retains 5 per cent as *mudarib* and passes on 95 per cent of the earnings to the certificate holders. To further reduce the risk an additional measure is taken in the form of a binding promise from the MoF (on behalf of the government) that it will utilize through *ijarah*, *murabaha*, and *istisna[* the entire amount raised by GICs for a period not less than the maturity of the certificates. To keep the certificates *shari[ah* compliantly tradable in the secondary market the SFSC chooses *ijarah* as the dominant form of the three contracts. The tradability feature provides exit and liquidity features which are attractive to the investors. The dominance of *ijarah* also reduces credit risk but introduces business risk (or price risk).

Table-11
Statistics on GIC

GIC Issue No.	Amount in billion SD	Issue Date	Maturity	Annual Expected Profit Rate	Frequency of Profit Distribution
1.	6.0	1-5-2003	2 years	20%	6 months
2.	1.0	25-8-2004	3 years	20%	6 months
3.	11.8	2-11-2004	6 years	16%	3 months
4.	22.8	Subscription open	5 years		

Composition of Subscribers of GIC:
The first issue was largely subscribed by foreign individuals and foreign banks (about 60 per cent of the issue) while Bank of Sudan was the largest single domestic subscriber (23 per cent). Domestic financial institutions formed rest of the subscribers.

The second issue of GIC, which came out almost a year after the first issue, was for a smaller amount but of longer maturity. It was predominantly subscribed by foreign individuals (about 99 per cent). Domestic individuals subscribed only a negligible amount (0.2 per cent).

The third issue, almost twelve times the size of the second issue and of longest maturity (6 years) with quarterly income stream, was predominantly subscribed by Bank of Sudan (86.7 per cent). This was a major change from past trend. Foreign individuals were the second largest group (9.8 per cent), while domestic individuals were still marginally represented (0.2 per cent). The remaining portion was subscribed by other financial institutions.

The subscription for the fourth issue is not closed yet which started on 15-2-2005. At the time of writing (mid March 2005) only 14.9 billion SD out of targeted 22.8 billion SD (65.6 per cent of the issue) has been subscribed so far. It seems that more individual subscribers are coming forward this time.

4.5 Lessons Learned for Product Development.

(Pakistan):

1. Tax neutrality across products is important for product development. Depending on its nature a differential tax can change the return and risk characteristics of a product relative to other products. Such implications should be carefully considered because it sometimes create un-intended consequences.

2. Adverse selection is also an unintended consequence of new products. That is, instead of a balanced group of agents all high risk economic agents get attracted to it either as issuer or as investor. As a result the market performance of the product is adversely affected. Fine tuning of the product characteristics and regulatory measures are needed which takes time to develop.

3. Sometimes the product's use can come from unusual sources not anticipated at the launch of the product, which exerts a healthy impact on expansion and growth of the product—a case of favorable selection. Regulatory arbitrage, special circumstances of some firms, and other such reasons can become the underlying factors in attracting a few big players in the market to support the product. The issuance of Fayzan Manufacturing Mudarabah in Pakistan is an example of such case, where a big multinational company due to its special financial circumstances found regulatory advantage in issuing *mudarabah* product (See Box-3 for details). The move helped the growth of the *mudarabah* sector.

4. An upshot of the discussions made in the above three points is that while care should be exercised in developing the right kind of features of a new product its launch should not be delayed too much for perfection. The true test and further refinement of the product takes place in the market. The issuer should be active in refining the products and the regulatory environment should be supportive of such refinements and changes.

5. State of the economy and the going interest rates in the conventional financial markets are important factors in the success of Islamic product innovations and its repeat issuance. For example, Islamic (Participation) *Musharakah* Term Finance Certificate (PTFC) of Sitara Chemicals in Pakistan was a successful product innovation in the sense that it combined many new ideas and proved attractive to the investors (see Box-4). However, the product (or its variants) have not been replicated by others in

the following years. This is possibly due to the fact that interest rates have gone down since then and banks flushed with liquidity are willing to lend on easy terms. Therefore, the big businesses who are the potential issuers of Participation Term Finance Certificates are finding bank borrowing much cheaper than to use capital market or to innovate a financial product for the market.

(Sudan):

1. Putting a product in practice brings out its good and bad features and allows for improvement. Initiation of Central Deposit Certificates led to development of other products like GMCs and now GICs while earlier products are phased out.

2. It is important that the issuers remain active in refining the products and the regulatory environment be supportive of innovation and retracting of the older products.

3. Education of investors and general public is also very important as it counts towards creating a demand for the product and informed investment decisions. Such education will contribute towards keeping new products forthcoming and ensuring *shari[ah* compatibility of innovations.

4. Simplicity of the product is also important for its acceptability in the market.

5. A slight change in the familiar (or standard) terms and conditions can have big effect on liquidity of the product. Therefore implications of new features of the product for its liquidity are important considerations in product development. Investors do not quickly shift from an older product with which they are more familiar to a new one either because of some unattractive features in the product's design or because of lack of their awareness. And it is sometimes hard to distinguish which factor is more likely cause. Similar issues are also important for inducing more firms to supply or replicate a product design. In Sudan the demand for the new product GIC is not as forthcoming from individuals as it was for GMC which the government wants to phase out.

6. Private benefits and public will both are important for development of Islamic capital market products. Private sector and public sector both can develop successful products in their spheres of activities.

(Malaysia):

1. Starting on the right foot is important in terms of standard setting features of the products. Malaysia has developed *murabaha* based, *bay[-bisaman-ajil* (BBA) based, *ijarah-suma-bay[* (ISA) based, and receivables discounting *sukuk*. All of them on the premise of tradability of certain kinds of debt. However, this is not an acceptable premise in the *fiqh* understanding of rest of the Muslim world. Thus the scope of such bebt based *sukuk* has become restricted to the East-Asian markets. Islamic product development therefore should look for more wider acceptable *fiqh* premises, as correctly set standards create their own positive spillover benefits. The Global *Ijarah* Bonds from Malaysia that were targeted to tap a wider investor base is therefore constructed on the wider acceptable contract of *ijarah* rather than *murabaha* or BBA concept.

2. *Shari[ah* authentication process for a product in Malaysia is centralized and performed by Shariah Advisory Council (SAC) of Securities Exchange Commission. It helps curtail the cost of issuance for the issuers of a product. However, centralization also gives SAC tremendous powers. A delicate balance is therefore required in minimizing type-I and type-II errors in authentication of the products and setting of the standards.

5: ISSUES IN FURTHER DEVELOPMENT

Every system develops its own culture; and the culture it develops helps perpetuate the system. Dominance of interest based finance is the result of interest based culture in the present financial system. Establishment of Islamic finance on firm ground will require a cultural change in the thinking, practices, products, and institutions of finance. While some aspects of this change will depend on collective behaviour of the society, some other aspects are in the control of policy makers and financial institutions themselves. Here we focus on these controllable policy aspects to promote Islamic capital market products.

It is important to note that financial sectors in different Muslim countries are at different stages of development. The spectrum ranges from very weak to financially strong banking sector; rudimentary to sophisticated electronic payment systems; and non-existent to vibrant capital markets. The reasons for such differences lie in the macroeconomic and institutional factors of each country.[33] In such circumstances one policy cannot be made to fit all. Since the focus of this paper is on Islamic capital market products to the exclusion of other Islamic financial institutions and tools following can be said in brief.

In countries where capital markets are underdeveloped (or non existent) due to scarcity of capital and low levels of economic activity, the focus should be on development of market for micro and small-to-medium enterprises. Simple listing and disclosure requirements to promote an over-the-counter (OTC) market would be useful. In countries where economic activity is high but the capital market weaknesses are due to institutional factors the focus has to be on basic institution building. Experience of Eastern European and Central Asian countries after the communist rule may provide some useful lessons.

In countries where some form of active capital markets exist the question of how to increase the share of Islamic capital market products in the

[33] See for example Seelig (2004) for diversity of financial development in less developed countries. Also see Zeinelabdin (1991) for level of stock market development in some OIC countries.

aggregate market takes a different dimension. This is a larger group of countries for which the present study is more relevant. At present, within this larger group one or more kinds of Islamic capital market products are offered in 21 countries. Following are some recommendations and observations for development and enhancement of the share of Islamic capital market products.

Table-12

Countries where Islamic Capital Market Products are Offered

Asia	Middle East	Africa	Europe	Americas
Bangladesh	Bahrain	Egypt	Luxembourg	Canada
Indonesia	Dubai	South Africa	UK	USA
Iran	Jordan	Sudan		
Malaysia	Kuwait			
Pakistan	Qatar			
Singapore	Saudi Arabia			
Siri Lanka	UAE			

Source: IOSCO (2004)

5.1 Strategic Issues to Enhance Share of Islamic Market Products:

- Starting on the right foot is important. If good precedence of product standards, trading practices, and regulatory rules are set then it becomes helpful in the long-run development. This is particularly important for creating sufficient liquid markets. Contrary to that if a wrong start is made and bad precedence are set then it is very hard to change them later. There are network externalities that make corrections difficult to make.

- There is a need to add market products that are suitable for Islamic banks. Entry of Islamic banks into the primary market will help both the markets and the economic investment.

- Investment banking offers greater opportunities for innovation and new product development to suit the needs of the customers. Later on the products can be adopted for general use in the capital markets. However, very few Islamic banks are active in Investment banking and in-house product development. Of recent more Islamic banks are moving into retail and consumer banking. This trend is not encouraging for capital market products development.

- There is a need for product development and facilitation centres in each country. The Islamic financial institutions, their associations, security market regulators, and the central banks should all be encouraged to have at least one such centre in each country.

- Targeting the *ijarah sukuk* towards smaller investors would create secondary market. Otherwise the liquidity surplus banks and institutional investors will acquire the lions share and they are not interested in secondary market trading. The other route is to lower the return on *sukuk* which will also provide incentives to trade in secondary market.

- Issuance of Islamic Depository Receipts (IDR) on suitable underlying Islamic instruments has potential to expand the market size, investor base, and liquidity of the products and markets. There is a need to study this aspect from operational side as well as to come up with *shari[ah* and market rules for such activity.

- Tax neutrality across various assets is very important for acceptance of new products in the market. The finance and fiscal managers of the countries can play an important role in this regard.

- Risk characteristics of the products and the markets change over time. IRTI in cooperation with IIFM or IFSB can institute an annual risk evaluation surveys of the Islamic capital market products and of the markets in order to benefit the industry. Other players in the market (investors, issuers, and other for profit institutions) may not be able to initiate such surveys as neutrally as can be performed by IRTI, IIFM or IFSB. Later on after 3 or 4 years of successful issues the risk evaluation exercise can be sold to some for-profit institution or to some association of stock exchanges to continue and improve upon the annual surveys.

5.2 Issues needing long-term attention:

It is important to create a benchmark for standardization of market tradable products.

Creation of necessary infrastructure institutions for Islamic capital markets is important. Progress has been made in this direction in the form of creation of institutions such as AAOIFI, IIFM, IFSB, LMC, IIRA, etc.

Need is to assess the performance of these institutions and chalk out medium- and long-term development plans for each.

Many product developments in the conventional finance has come about from efforts to find ways to circumvent the regulations and finding loopholes to create value. This approach is incorrect for designing '*shari[ah* compatible' products. Because both the form and objective of the Islamic product should confirm to *shari[ah*.

Investor education is very important for acceptability of new product. Similarly, financial expertise along with *shari[ah* knowledge is necessary for product development. It is also important for efficient working of the market. Teaching and training programs and human capacity building should be encouraged.

5.3 Long-run desirable goals (not necessarily in control of market players):

Development of a conducive investment climate is very important for capital markets to grow and perform a strong role in economic development. This is achieved by creating law and order, enforcement of rules, providing investor protection, and political stability. These are some important factors. Muslim countries currently lack in one or the other of these aspects.

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