



THE EUROMONEY

INTERNATIONAL DEBT CAPITAL MARKETS HANDBOOK

2006

EUROMONEY
YEARBOOKS

Part of Euromoney Institutional Investor PLC

Emerging Islamic CAPITAL MARKETS -

a quickening pace and new potential

by Zamir Iqbal and Hiroshi Tsubota, The World Bank

Describing the Islamic financial system simply as ‘interest-free’ does not do justice to the system. Promotion of entrepreneurship, preservation of property rights, transparency and the sanctity of contractual obligations, which are crucial to any sound financial system, describe its essence. Today, Islamic financial and banking activities have reached an impressive size of over US\$250bn, as compared to a meagre US\$6bn in the early 1980s. Market participants and policy makers are increasingly paying attention to its potential and how to take advantage of the opportunities presented.

The term ‘Islamic finance’ or ‘Islamic financial system’¹ is not as uncommon today as it was two decades ago when financial institutions in several Muslim countries started exploring ways to operate a banking system prohibiting the payments and receipts of interest. Islamic modes of financing have been in practice in some form or other since the early history of Islam. Throughout the Middle Ages, Islamic merchants became indispensable middlemen for fostering trade through development of sophisticated credit instruments in Spain, the Mediterranean and Baltic states.

In modern banking history, an interest in the revival of Islamic modes of financing emerged in several Muslim countries, during their post-colonisation period. In the early 1960s, independent but parallel attempts in Egypt and Malaysia led to the establishment of financial institutions, which were designed to operate on a non-interest basis so

as to comply with Islamic principles. But it was not until the first wave of oil revenues in the 1970s and the accumulation of petro-dollars which gave momentum to this idea, that the Middle East saw a mushrooming of small commercial banks competing for surplus funds. At the same time, interest grew in undertaking theoretical work and research to understand the functioning of an economic and banking system without the institution of ‘interest.’

Continuing demand throughout the 1980s led to sustainable growth and, by the nineties, the market for Islamic financial products had attracted the attention of several western commercial banks, which started to offer specialised financial services to high net worth individuals and later at the retail level through ‘Islamic windows.’ Today, there are more than 240 financial institutions operating on the basis of non-interest based instruments in more than 40 different countries.

BASICS OF ISLAMIC ECONOMIC AND FINANCIAL SYSTEMS

An Islamic economic and financial system is a rule-based system comprising a set of rules and laws, collectively referred to as *Sharia*' governing economic, social, political and cultural aspects of Muslim societies. *Sharia*' originates from the rules dictated by the *Quran*, from the practices of the Prophet Muhammad, and further elaboration of the rules by scholars in Islamic jurisprudence through the process of deduction (*Qiyas*) and consensus (*Ijma*'). Over time, four different schools of thought – Hanafi, Maliki, Shafei and Hanbali have emerged with some variations on the rules depending on respective interpretations.

The central tenet of the financial system is the prohibition of '*Riba*' – a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether through loans or sales.” More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (i.e., guaranteed regardless of the performance of the investment) is considered *Riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” as widely practiced. This prohibition is not to be confused with a rate of return or profit on capital, as Islam encourages the earning and sharing of profits, because profit, determined ex post, symbolises successful entrepreneurship and the creation of additional wealth; whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses.

Undoubtedly, prohibiting the receipt and payment of interest forms the nucleus, but it is supported by other principles of Islamic doctrine;

- advocating risk sharing;
- promotion of entrepreneurship;

- discouragement of speculative behaviour;
- preservation of property rights;
- transparency; and
- the sanctity of contractual obligations.

The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the expected responsibilities of the individual, society, the state and all stakeholders.

EMERGING ISLAMIC CAPITAL MARKETS

During the 1980s and 1990s, Islamic financial institutions were able to mobilise funds successfully through deposits invested in a handful of financial instruments, dominated by trade financing. Activities on the asset side of Islamic financial institutions included

- cost-plus-sale or purchase finance (*Modaraba*');
- leasing (*Ijara*');
- trust financing (*Modaraba*');
- equity participation (*Musharika*).

Due to market conditions, lack of liquid assets and other constraints, the composition of Islamic financial institutions' assets stayed fairly static and heavily focused on short-term instruments (mainly commodity finance). By the late 1990s, there were many calls for the introduction of new products and the promotion of financial engineering.² Main areas of concern were the lack of liquidity, a lack of portfolio and risk management tools and the absence of derivative instruments.

One of the impediments to growth was the lack of understanding the fast changing landscape of modern financial markets as well as the intricacies of rules demanded by the *Sharia*'. The task was further complicated by the different schools of Islamic thought in various parts of the globe. Nevertheless, by the late 1990s, Islamic financial institutions had realised that the development of capital markets was essential for their survival and further growth. Meanwhile, deregulation

and liberalisation of capital movements in several countries led to close cooperation between Islamic financial institutions and conventional financial institutions in order to find solutions for liquidity and portfolio management. The result was two distinct developments – the introduction of equity funds which were compatible with *Sharia*' and the launch of Islamic asset-backed securities more commonly known as *Sukuk*.

Whereas Islamic equity funds became popular with investors who had a risk appetite for equity investment, Islamic financial institutions, driven by the nature of their intermediation, kept demanding securities which could behave like conventional fixed-income debt securities but also comply with *Sharia*'. In addition, Islamic financial institutions wanted to extend the maturity structure of their assets beyond the typical short-term maturities provided by trade-finance instruments. This led to the creation of *Sharia*' compliant asset-backed securities, *Sukuk*, which have risk/return characteristics similar to

conventional debt securities. The result is that within a short span of less than five years, the market for *Sukuk* have reached an impressive size of US\$30bn which includes several sovereign and corporate issues (see Exhibit 1 - notable transactions in the first half of 2005).

WHAT IS A SUKUK?

The idea behind a *Sukuk* is simple. Prohibition of interest virtually closes the door for a pure debt security but an obligation which is linked to the performance of a real asset is acceptable. In other words, *Sharia*' accepts the validity of a financial asset which derives its return from the performance of a real asset. The word *Sukuk* (plural of the Arabic word *Sakk* meaning certificate) reflects participation rights in the underlying assets. The design of the security is derived from the conventional securitisation process in which a special purpose vehicle is set-up to

Notable transactions in the first half of 2005

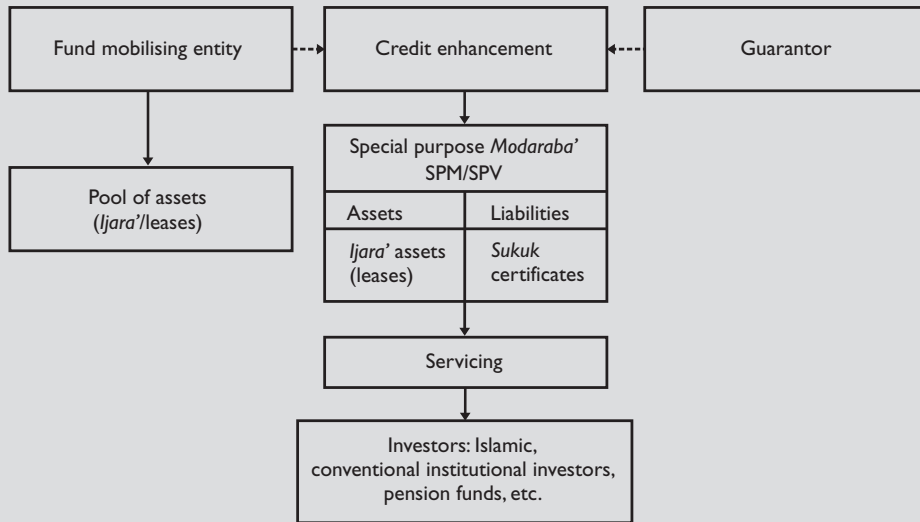
Exhibit 1

Issuer	Country	Issue date	Amount	Maturity (year)	Type	Manager(s)
<i>Sovereign</i>						
Government of Bahrain	Bahrain	February-05	BD30m	5	<i>Ijara</i> ' (Leasing)	Bahrain Monetary Agency
Government of Pakistan	Pakistan	January-05	US\$600m	5	<i>Ijara</i> ' (Leasing)	Citigroup, HSBC Amanah
<i>Supranational</i>						
Islamic Development Bank	Supranational organisation	June-05	US\$500m	5	<i>Sukuk</i>	HSBC Amanah, Deutsche Bank, CIMB, Dubai Islamic Bank
The World Bank	Supranational organisation	April-05	M\$760m	5	<i>Bai' Bithaman Ajil</i> (BBA) (deferred-payment sale)	CIMB, ABN Amro Bank Bhd
<i>Corporate</i>						
PLUS Expressways Bhd	Malaysia	June-05	M\$2,410m	11 - 14	<i>Bai' Bithaman Ajil</i> (BBA) (deferred-payment sale)	CIMB
Jimah Energy Ventures	Malaysia	May-05	M\$405m	6 - 16.5	<i>Istisna</i> ' (purchase order)	Ammercchant Bank Berhad, RHB Sakura Merchant Bhd, MIMB,
Commercial Real Estate Company	Kuwait	May-05	US\$100m	5	<i>Ijara</i> ' (leasing)	Kuwait Finance House, Liquidity Management Centre
Time Engineering (Musyarakah One Capital Bhd)	Malaysia	April-05	M\$566.55m	1 - 5	<i>Musharika</i> ' (profit and loss-sharing)	CIMB
Durrat Sukuk Company BSC	Bahrain	January-05	US\$152.5m	5	<i>Istisna</i> ' and <i>Ijara</i> ' <i>Sukuk</i>	Kuwait Finance House

Source: Compiled from various market sources

Anatomy of a Sukuk

Exhibit 2



Source: Iqbal, 1999

acquire assets and to issue financial claims on the asset. Such financial claims represent a proportionate beneficial ownership for a defined period when the risk and the return associated with cash-flows generated by an underlying asset, is passed to Sukuk holders (investors).

The core contract utilised in the process of securitisation to create a Sukuk is an Islamic contract of intermediation known as Modaraba' (trust financing), which allows one party to act as an agent (manager) on behalf of a principal (capital owner) for an agreed fee or profit-sharing arrangement. The contract of Modaraba' is used to create a Special Purpose Modaraba' (SPM) entity, similar to the conventional Special Purpose Vehicle (SPV), to play a well-defined role in acquiring certain assets and issuing certificates against the assets. The underlying assets acquired by SPM need to be Sharia' compliant and can vary in nature. Depending upon the nature of underlying assets and the school of thought, the tradability and negotiability of issued certificates is determined.

The majority of Sukuk issued to date are based on two classes of assets. The first class of assets fall into financial claims created out of a spot sale (Salam) or a deferred-payment sale (bay' mu'ajjal) and/or a deferred-delivery sale (bay'salam) contract, whereby the seller undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin.

Salam-based Sukuk have proved to be a useful investment vehicle for short-term maturity since underlying commodity financing tends to be for a short-term tenor ranging from three months to one year. However, due to the fact that the Sukuk results in a pure financial security and is somewhat de-linked from the risk/return of the underlying asset, Sharia' treats it as a pure debt security. Consequently, many investors, including those in the GCC countries cannot trade these Sukuk in the secondary market, either at a discount, or at a premium. Trading will introduce a mechanism to indulge in Riba or interest in the

transaction. Due to this restriction, investors tend to hold *Salam*-based *Sukuk* up to the maturity of the certificate.

In order to provide longer-term maturity and limited tradability and negotiability to investors, a second class of *Sukuk* is based on leasing (*Ijara*). An *Ijara* instrument is one of the instruments which bears the closest resemblance to a conventional lease contract and offers flexibility of both fixed and floating-rate payoffs. The cash-flows of the lease including rental payments and principal repayments are passed through to investors in the form of coupon and principal payments. *Ijara*-based *Sukuk* provide an efficient medium-to long-term maturity mode of financing.

CURRENT MARKET ENVIRONMENT

Islamic capital markets are now gaining the momentum to grow into a vibrant marketplace, especially for emerging market borrowers in the regions of the Middle-East, South-East Asia, South Asia and North Africa.

On the supply side, the volume of Islamic investments – with a preference for *Sharia*' compliant instruments – has grown to form a critical mass that can support a well-functioning and efficient capital market. It is evolving into a truly international market. Not only highly rated borrowers such as the Multilateral Development Banks (for example, the World Bank), but also developing country borrowers with lower credit ratings, such as Pakistan, have successfully raised a considerable volume of funds in this market.

On the demand side, countries in the developing world, especially the middle-income countries, will require a significant volume of investments in infrastructure over the next decade. To illustrate, for Indonesia alone, additional infrastructure investments of US\$5bn (2% of GDP) are required annually, to reach a 6% medium-term growth target, as estimated by the World Bank.³ Because the domestic capital markets of these borrowers are often not deep enough to satisfy their large

investment needs, they would have to access external sources of financing.

Furthermore, Muslim stakeholders in middle-income countries are increasingly expressing their preference for *Sharia*' compliant financing. Borrowers, especially public-sector institutions, are starting to reflect their stakeholders' voices in the implementation of financial operations. In turn, financial intermediaries, including private-sector commercial and investment banks, as well as development finance institutions, are likely to start paying more attention to such 'non-financial' needs of their clients - in addition to satisfying these borrowers' funding needs, in order to stay successful in the marketplace.

For the Multilateral Development Banks (MDBs), such as the World Bank, the development of Islamic capital markets will be a highly relevant topic. Firstly, MDBs are deeply involved in infrastructure finance in their borrowing member countries and would therefore naturally be interested in the emerging Islamic capital market as a new and alternative source of financing. Secondly, by channeling the funds available in Islamic financial markets, which are mostly based in the countries with high savings such as the GCC countries and Malaysia, to finance investments in developing countries, MDBs can create a new model for international development cooperation while responding to the stake-holders' voices on both sides. Thirdly, MDBs can promote financial stability by encouraging the development of Islamic capital markets to enhance liquidity, and enabling Islamic financial institutions to have more diversified portfolios and sound risk management. Furthermore, this could also provide the momentum to integrate the Islamic financial markets within the framework of the international financial system.

GOING FORWARD: CHALLENGES AND POLICY ACTIONS NEEDED

In the near future, it is most likely that structures which provide investors with a pre-determined return as well as

full recourse to the obligor (such as *Ijara*' and *Murabaha*') would have more market potential than other structures. As discussed earlier, this will be driven primarily by investor preferences, but a large proportion of potential borrowers would also prefer to lock-in their borrowing costs rather than engage in pure profit sharing schemes.

While the overall market background appears promising, certain obstacles and constraints may lie ahead and market participants and regulators need to take concrete steps to support market take-off.

Firstly and most importantly, market development requires a strong sponsorship and leadership of the host country government, especially on legal and regulatory issues. For example, for an *Ijara*' transaction, the owner of operating assets needs to enter into a leasing transaction. While the owners of operating assets are often the government itself or its related public-sector bodies, the relevant laws and regulations in the host country may not allow these public-sector bodies to pledge or lease assets needed to structure an *Ijara*' transaction. This is a fundamental point; the host country's policy actions to promote such Islamic finance will be a key prerequisite for the market to develop further.

Furthermore, borrowers, investors as well as intermediaries need to nurture the market patiently. As of now, Islamic transactions often face a competitive disadvantage to conventional bond issues in terms of cost-efficiency. Each new issue incurs higher levels of legal and documentary expenses as well as distribution costs; and involves examining structural robustness in addition to evaluating the credit quality of the obligor. Also, since the terms available in Islamic capital markets are mostly derived from the pricing levels in the more liquid conventional bond markets, there is no inherent funding cost advantage for borrowers tapping Islamic markets. Borrowers, therefore, would need to formulate a comprehensive, long-term and strategic view on how to reduce the overall funding cost by tapping Islamic markets, rather than focusing on a single transaction.

Investors, on the other hand, can significantly support market development by expressing their preference for *Sharia*' compliant instruments more concretely, namely in terms of their bid prices. For intermediaries, they can lead the process to reduce transaction costs, perhaps through further standardisation of transaction schemes and instruments.⁴

Sharia' scholars can also play an important role. It is essential that multi-disciplinary expertise, covering topics ranging from theological interpretation to financial structuring, be developed through knowledge-sharing, cross-training and acquiring an understanding of the functioning of markets. To stimulate cross-border activities in the primary as well as secondary markets, the acceptance of contracts across regions and across schools of thought and markets will also be helpful.

CONCLUSION

In the wake of the current wave of oil revenues and increasing demand for *Sharia*'-compliant products, Islamic capital markets are emerging at a quickening pace and stakeholders are starting to realise the potential. Development of institutional infrastructure in the international fora, such as establishment of accounting standards and regulatory bodies, are all steps in the right direction.⁵ However, for the market to grow further, it also needs strong leadership and constructive policy actions of host governments, to enable market participants to originate Islamic finance transactions.

Well-developed Islamic capital markets will not only be beneficial for borrowers and institutional investors, they can also further enhance the stability of Islamic financial institutions, providing them with improved portfolio, liquidity and risk management tools. Ultimately, all these developments will contribute to integrating Islamic financial markets, as well as the people who form these markets, into the framework of the broader conventional international financial system.

Notes:

1. For a further description of Islamic financial systems refer to Iqbal (1997).
2. See Iqbal (1999) and Iqbal and Mirakhor (2002).
3. Indonesia – Averting an Infrastructure Crisis: A Framework for Policy and Action, The World Bank, 2004.
4. For example, in the Malaysian market, market participants have developed a few well standardised structures, such as Bai' Bithaman Ajil. Structuring as well as distribution costs for these standardized Islamic deals in Malaysia are now reduced to a competitive level, making them a viable alternative to conventional debt instruments.
5. These institutions include Islamic Financial Service Board (IFSB), Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), Liquidity Management Center (LMC), International Islamic Financial Markets (IIFM) and International Islamic Rating Agencies (IIRA).

References:

- Iqbal, Zamir (1997) *Finance and Development*, International Monetary Fund, Washington, D.C. June, <http://www.imf.org/external/pubs/ft/fandd/1997/06/pdf/iqbal.pdf>
- Iqbal, Zamir (1999), “*Financial Engineering in Islamic Finance*,” Thunderbird International Business Review, Vol 41, No. 4/5, July-October 1999, pp. 541-560.
- Iqbal, Zamir and Abbas Mirakhor (2002), “*Development of Islamic Financial Institutions and Challenges Ahead*,” in Simon Archer and Rifaat Abdel Karim (eds.) *Islamic Finance: Growth and Innovation*, Euromoney Books, London, UK.

Views expressed in the article are of the authors and do not reflect views of the Board of Directors and of the World Bank Group. Authors wish to thank Hennie Van Greuning, Doris Herrera-Pol, and Kenneth Lay for their comments.

The World Bank Jakarta Office (2004), “*Indonesia – Averting an Infrastructure Crisis: A Framework for Policy and Action*”, Jakarta, Indonesia.



Hiroshi Tsubota and Zamir Iqbal

Zamir Iqbal and Hiroshi Tsubota are Principal Financial Officers in Quantitative Strategies, Risk and Analytics (QRA), and Banking, Capital Markets and Financial Engineering (BCF) departments of the World Bank Treasury in Washington, DC.

For further information, please e-mail: ziqbal@worldbank.org or htsubota@worldbank.org