



ISLAMIC FINANCIAL SERVICES BOARD

Development of *Ṣukūk* Markets in the Middle East and Africa:

Growth Potential and Policy Considerations

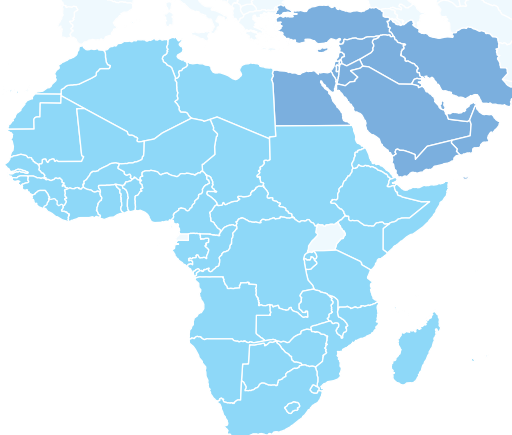





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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions, and market players.

For more information about the IFSB, please visit www.ifsb.org

FOREWORD

Dr. Bello Lawal Danbatta

Secretary-General of the Islamic Financial Services Board

This paper is based on the proceedings of a seminar held jointly with the Africa/Middle-East Regional Committee (AMERC) of the International Organization of Securities Commissions. The seminar took place in Abu Dhabi, United Arab Emirates (UAE), on 26 September 2019, hosted by the UAE Securities and Commodities Authority (SCA).¹ We are very grateful to the SCA for their hospitality, and for the support of the sponsors, the Dubai Islamic Economy Development Centre, the Gulf Bond and *Shukūk* Association, National Bonds and S&P Global Ratings. Responsibility for this publication, however, rests with the Islamic Financial Services Board alone.

Funding for development and infrastructure are critical issues in many areas of the world, including Africa and the Middle East. There are also closely related issues of financial inclusion and funding for small and medium-sized enterprises. Islamic finance offers great potential for meeting these needs, not only because of the religious preferences of many potential customers in the region, but also because its underlying values and its focus on the real economy make it well-suited to development and infrastructure projects.

Shukūk are the most distinctive feature of Islamic capital markets. Although many *shukūk* are economically analogous to conventional bonds, *shukūk* are capable of a wide range of risk–return profiles. These, and some of their structural features, create some issues for regulators, if *shukūk* are to fulfil their potential. At the same time, technology is opening up new possibilities for reducing the costs associated with *shukūk* issuance. These are among the issues explored at the seminar and in this paper.

The region is diverse, including a number of countries where Islamic finance is well established and where there is active *shukūk* issuance and investment. In others, Islamic finance has yet to establish itself, and *shukūk* represent a new concept for issuers, investors and regulators. The seminar offered a fruitful opportunity to exchange experiences and perspectives, and we look forward to continuing to work with AMERC in the future.

In this paper, some of the key presentations given at the seminar are reported in detail, though not verbatim. Elsewhere, the emphasis is on summarising the discussions and drawing out major themes for action both now and in the future.

¹ The programme for the seminar is at Annex A.

OPENING STATEMENTS

H.E. Dr. Obaid Al Zaabi

In his opening statement, His Excellency Dr. Obaid Al Zaabi, Chief Executive Officer of the United Arab Emirates (UAE) Securities and Commodities Authority (SCA), welcomed the delegates and commented that the Islamic capital market (ICM) products we have today originated from the scarcity of Sharī'ah-based short-term paper and long-term bonds needed to manage the balance sheet liquidity of Islamic banks and *takaful* undertakings. This scarcity led to the development of the *shukūk* market, and was followed by identification of Sharī'ah-compliant stocks, and the establishment of Islamic indices and Islamic investment funds.

However, the key catalyst for the growth of the Islamic capital market has been the increasing wealth and capacity of investors, particularly socially responsible or ethical investors, be they Muslim or non-Muslim. Another phenomenon observed was the durability of Islamic financial institutions during the 2008 Global Financial Crisis (GFC), which impacted financial systems around the world but left these institutions relatively untouched.

Total Islamic finance assets in 2018 stood at USD 2.2 trillion. In that year, new *shukūk* issuances were USD 93 billion, with strong issuances from the Gulf Co-operation Council (GCC) countries, including the UAE, on both the sovereign and corporate sides. On the Sharī'ah-compliant equity side, although it was a poor year for equities in general, the S&P Global 1200 Sharī'ah Index outperformed its conventional counterpart, and has done so on three-, five- and 10-year timescales. Islamic funds rose in number to 1,292, with assets under management of USD 67.4 billion.

The UAE has now emerged as a popular destination for listing of *shukūk*, as it provides a legal system and a judiciary that are familiar with the principles of Sharī'ah. The total current listed value of *shukūk* on Nasdaq Dubai currently stands at USD 49.1 billion.

SCA is considering a plan to regulate over-the-counter (OTC) capital market transactions and in this context, would like to see the introduction of local currency retail *shukūk* through public- and private-sector issuances. In support of this, local rating agencies are needed to rate retail *shukūk* issued by the corporate sector.

In today's dynamic economy, innovation is the key to survival. However, traditionally, Islamic financial products represent a reengineering of conventional products, seeking to replicate the risk, return and rating profile of a corresponding conventional instrument. This approach may not continue to hold as market demand and expectations evolve and ICM products compete not only on liquidity, cost and return, but also on sustainability. Instruments such as green *shukūk* and socially responsible investment *shukūk* are being seen in the market. In another area of innovation, banks are issuing regulatory capital *shukūk* to meet Basel III Tier 1 and Tier 2 capital requirements. However, more is needed in terms of research by Sharī'ah advisers, experts and Sharī'ah research institutions, and pro-active use of risk-sharing structures in actual issuances, to carry forward this innovation drive. All stakeholders – policymakers, regulators, Sharī'ah experts and industry – must work together to facilitate innovation.

OPENING STATEMENTS

In the UAE, in December 2018, the SCA launched its Master Plan for Sustainable Capital Markets, which incorporates recommendations of the United Nations Sustainable Stock Exchanges Initiative and is in line with recommendations of the International Organization of Securities Commissions (IOSCO). SCA has now established a core working group for sustainable finance in capital markets consisting of various stakeholders, including financial regulators, exchanges, the UAE Central Bank, the UAE Ministry of Climate Change and Environment, the Dubai Financial Services Authority and Abu Dhabi Global Market, to implement the plan which is expected to be completed by mid-2020.

The core group is currently in Phase 1, which includes defining the guidelines for sustainable investments in the UAE and will be followed by Phase 2, which moves towards practical implementation, during which each regulatory authority will have an opportunity to consider further detailed guidelines, taxonomy, policy and, in time, legislative initiatives for different sectors.

On the regional front, the UAE set up the Dubai Islamic Economy Development Centre (DIEDC) in 2013 and launched its Islamic economy strategy (2017–2021) with the vision to transform itself into a global hub of the Islamic economy and a global leader in Islamic capital markets. This centre has developed a first-of-its-kind accelerator to support Islamic FinTech. To promote standardisation, the UAE has set up the Higher Shari'ah Authority for Islamic Banking and Financial Services managed by the Central Bank of the UAE. To further promote this vision, the SCA, in cooperation with DIEDC, has launched the UAE's strategy for developing the ICM which focuses on forming regulations, developing capital adequacy standards, launching a sandbox initiative, introducing Shari'ah governance systems and raising awareness of the Islamic capital market.

A key policy concern on policy aspect is the standardisation of cross-border issuances which is required to establish a global ICM. The need for standardisation of contracts and practices has been underlined by virtually all experts in Islamic finance. Despite the considerable work done by international bodies such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM), much remains to be done. The regional Middle East and North Africa (MENA) industry is now looking at standardisation for cross-border issuances, which is expected to boost volumes, restore the attractiveness of the instruments through a faster issuance process, and ultimately harmonise the global ICM. However, given the hyper-connected world we live in, the success of international standardisation ultimately requires global collaboration.

In addition, Dr. Al Zaabi discussed the legal and governance issues underlying the *shukūk* structure. On the legal side, there is a need to highlight the fact that there are actual assets underlying a *shukūk* structure. On the governance side, there are concerns around standardised disclosures for issuance-related documents, financial reporting, and corporate governance issues such as Shari'ah audit and Shari'ah business conduct, which require standards and policy guidance.

Another key issue is the fees structure, especially when investors are comparing a traditional *shukūk* against a typical bond structure.

Much work is also required to develop guidelines for intermediaries and consultants dealing in such products who are instrumental in promoting the products to investors. This work needs to be supported with a detailed framework for documentation standardisation for all *shukūk* issuances.

OPENING STATEMENTS

Dr. Bello Lawal Danbatta

Dr. Bello Lawal Danbatta, Secretary-General of the Islamic Financial Services Board, added his welcome to the delegates. He thanked IOSCO for partnering with the IFSB in holding this event, the UAE Securities and Commodities Authority for hosting it, and the speakers and panellists for their participation.

He discussed the IFSB's role, the prospects and future of Islamic capital markets, the pivotal role that Islamic finance can play in achieving the development objectives in the region, and the importance of ensuring that appropriate infrastructure and regulations are in place to facilitate orderly growth and development of the market and to reinforce the objectives of financial stability and investor protection.

The IFSB serves as an international standard-setting body with a mandate for ensuring the soundness and stability of the Islamic financial services industry (IFSI). The IFSB's role includes identifying emerging global risks and policy gaps for the IFSI; developing guidance and standards, where appropriate, to deal with those risks and policy gaps; supporting members in implementation of the IFSB standards in their jurisdictions; and promoting awareness of issues that are relevant to or have an impact on the regulation and supervision of the IFSI. It is now recognised as the leading international institution promoting the development of a prudent and transparent Islamic financial services industry.

The mandate of the IFSB broadly includes the banking, capital market and insurance sectors. For this reason, the work of the IFSB is complementary to that of conventional standard setters, including that of the Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commissions and the International Association of Insurance Supervisors (IAIS), and it works closely with those institutions in delivering its mandate.

Its membership includes 78 regulatory and supervisory authorities, nine international inter-governmental organisations such as the Bank for International Settlements, the Asian Development Bank, the International Monetary Fund, the Islamic Development Bank and the World Bank, and 97 market players operating in 57 jurisdictions.

The IFSB has so far issued 30 standards, guidance notes and technical notes that provide the basis for the orderly development of Islamic financial services across the three sectors. Its annual standard implementation survey indicates that the adoption of these standards by national supervisory authorities has helped in promoting the harmonisation and standardisation of regulatory approaches to provide a level playing field in the Islamic financial services sectors of members' jurisdictions. However, more work needs to be done collectively to improve the level of adoption across jurisdictions. To this end, the IFSB has now greatly expanded its implementation initiatives in order to promote, facilitate and support the assessment of the consistent implementation of its standards, as well as several other initiatives to meet the growing interest and needs of stakeholders, reflecting the increasing size of the industry and its expansion into new jurisdictions.

The combined total asset size of the IFSI is now estimated at upwards of USD 2 trillion.

OPENING STATEMENTS

Among its three major sectors, the Islamic capital markets sector has been the fastest growing in the last three years, owing to the increase in *shukūk* issuances and Islamic funds.

The tremendous growth in *shukūk* issuances in particular, from USD 64.3 billion in 2015 to USD 93.4 billion in 2018, appears to reflect a number of factors on both the demand and supply sides.

First, *shukūk* are being used to finance real sector investments, in particular for physical infrastructure in both Asia and the Middle East. In recent years, *shukūk* financing has also been used for social infrastructure in Africa. In addition, there are now new initiatives for *shukūk* financing for such goals as climate change and the green economy or, more broadly, to address the expanding socially responsible investment (SRI) agenda. Some initiatives link *shukūk* explicitly to the United Nations' (UN) Sustainable Development Goals. The huge potential of ICM instruments in filling the gaps in financing for infrastructure, as well as economic, social and environmental sustainability, is now well recognised, and more jurisdictions are expected to utilise *shukūk* in such initiatives in the coming years.

Second, short-term *shukūk* continue to be used for liquidity management purposes in the banking sector, something that has been taking place in a wider set of jurisdictions. These issuances have been by the public sector and principally by central banks. It is expected that the liquidity buffer standards under Basel III and the IFSB's GN-6, and their requirements for Islamic banks to hold high-quality liquid assets (HQLA), will lead to additional *shukūk* issuances from sovereigns and quasi-sovereigns to help banks meet these requirements. In addition, there will be longer-term – indeed, frequently perpetual – issuances by the Islamic banks themselves as they seek to raise regulatory capital to comply with the Basel III and IFSB capital adequacy standards.

Third, there is an expanding set of jurisdictions that are seeking to integrate Islamic finance into their public expenditure programmes to diversify their funding base. Sovereign *shukūk* have been the key instruments for this. In 2018 alone, sovereigns in at least 13 jurisdictions tapped the global sovereign *shukūk* market. These issuances were used to fund a variety of public-sector projects, including infrastructural development, budgetary support needs, and capital expenditure and working capital requirements. The benefits, and opportunities for development, of *shukūk* programmes as an alternative financing source are available to all jurisdictions and institutions seeking to diversify their funding services and are being taken up by more and more jurisdictions.

These developments suggest a thriving sector, and a widening global engagement in Islamic finance and Islamic capital markets that sets the stage for the future. However, there are still persisting challenges. It will be important to overcome these challenges by addressing key legal, regulatory and financial infrastructure issues that will serve to facilitate the growth, stability and resilience of ICM.

The scope for the expansion of ICM in the Africa and Middle East region is enormous but will need concerted efforts by public and private sectors to create the preconditions, and the legal and financial infrastructure needed to sustain it. There has already been considerable progress made in terms of *shukūk* market infrastructure and its ancillary services.

OPENING STATEMENTS

If we are to see a greater shift towards the use of *ṣukūk* by both sovereign and corporate issuers in the region, the legal framework is particularly critical, so as to provide greater legal certainty in a number of areas where there are gaps in Islamic finance.

It is also important to identify the existing regulatory gaps and challenges in the region, and to address them in the development of international standards, in order to enhance the understanding of issues in the regulation of ICM intermediaries and products.

In view of the importance of these issues from both a national and cross-border perspective, the IFSB has in place a programme of ongoing and planned standards for the Islamic capital markets. The IFSB has thus far issued standards on governance of Islamic collective investment schemes (ICIS) and on transparency and disclosure of ICM products, as well as a set of Core Principles for Islamic capital market regulation which is benchmarked against the IOSCO's objectives and principles of securities regulation. The IFSB is also currently working on the preparation of a standard for investor protection in the Islamic capital markets, which is another critical area for the effective regulation of the ICM. The new standard seeks to address key investor protection issues across not only the traditional ICM instruments and entities, but also emerging investor protection issues arising from new financial technologies in the ICM.

With this background, today's seminar provides a platform for global dialogue to deliberate on the role of Islamic capital markets in achieving the development objectives in the region, as well as to exchange experiences and ideas on how new innovations and emerging technology can play a role, and to engage on the various issues and challenges that need to be addressed collectively by policymakers.

KEYNOTE ADDRESS

Mr. Paul Muthaura

Mr. Paul Muthaura, Chief Executive of the Kenya Capital Markets Authority and Chair of AMERC, drew attention to the significant investment in infrastructure and the real economy called for within the rapidly developing Africa and Middle East region, and to the opportunity offered by the adoption of Islamic finance as a viable alternative and complement to conventional finance. With the growing tensions about an impending global recession and the risks of market instability, the significant resilience that Islamic finance showed during the GFC in 2008 reinforced the view that the timing was right to accelerate adoption of the products and principles provided.

The seminar was born out of the recognition that, despite the rapid growth in global *shukūk* markets, there remains significant work to be done in the following areas

- **Capacity building:** The level of uptake of Islamic finance products and services is to a large degree determined by the depth of stakeholders' technical knowledge and understanding of the products. Continuous capacity building is therefore a key element.
- **Education and awareness:** For jurisdictions that are just starting off in Islamic finance, education and awareness could make or break the uptake of this system of finance. The key challenge here has been simplifying the value proposition of this system of finance, without losing potential stakeholders through difficult jargon that they may find hard to relate to.
- **Enabling environment:** For most of the AMERC jurisdictions, in addition to having a framework, there may be a need for deliberate effort backed by government goodwill for this system of finance to gain traction and attract wider acceptance.

The experience of Kenya confirmed the central importance of these preconditions. The creation of a conducive environment and growth of capacity building and awareness are a continuous journey rather than a defined destination. In addition, this experience suggested a number of key issues. While in the more developed Islamic finance markets many of these issues may seem non-contentious and have already been addressed, the following remain key considerations in supporting new jurisdictions to create a conducive environment.

Terminology

The implications of using the term "Islamic" when discussing this form of finance are varied. Even in Muslim-majority countries, some have preferred to use terms such as "participation finance" or "non-interest finance". At the institutional level, some corporates have sought to re-brand in order to appeal to wider segments of society.

The main challenge, especially for young non-Muslim jurisdictions that are just adopting this system of finance, remains devising strategies to make this system of finance appealing to their non-Muslim populations who are not used to religious terminology in their day-to-day conduct of financial transactions.

KEYNOTE ADDRESS

Islamic governance

It may be pertinent for AMERC jurisdictions to have policy clarity on the ideal Islamic governance model (centralised vs decentralised and internal vs external Sharī'ah audits, etc.), while taking account of the unique circumstances of some of these jurisdictions, especially at the initial stages of adopting Islamic finance.

In jurisdictions with multiple financial sector regulators, unless there are efficient mechanisms for resolution of outstanding Islamic governance issues, there may be extended delays in creating the desired conducive environment to allow for consensus building before clear governance frameworks are developed.

Şukūk issuance

In a significant percentage of *şukūk* issuances, there has been a challenge in having enough assets set aside in a “true sale” arrangement for an issuer (usually a special purpose vehicle, or SPV) before the issuance of *şukūk*. The debate on whether to focus on asset-based, rather than asset-backed, issuances is therefore a real one, with clarity on policy helping to further improve understanding and, ultimately, uptake of *şukūk*.

There has also been the challenge, for some sovereigns, of having to establish SPVs offshore to facilitate the issuance of *şukūk*. Some jurisdictions have got around this challenge by establishing two SPVs (one onshore and another offshore).

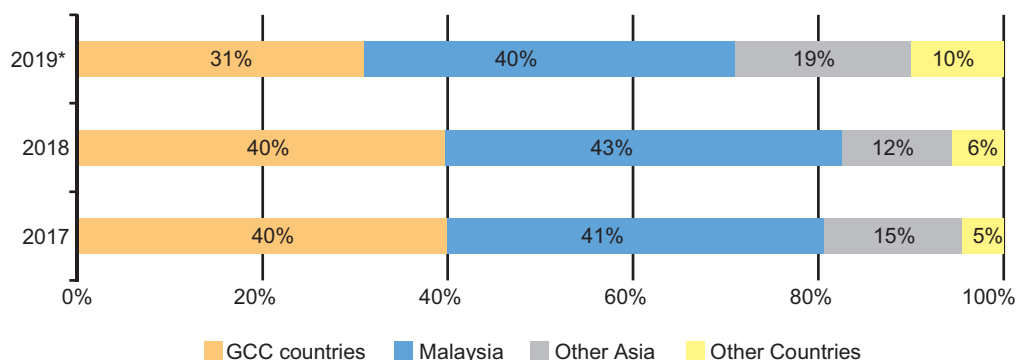
SESSION SUMMARIES

Session 1: Islamic Finance and *Shukūk*: Key Concepts, Global Significance and Outlook

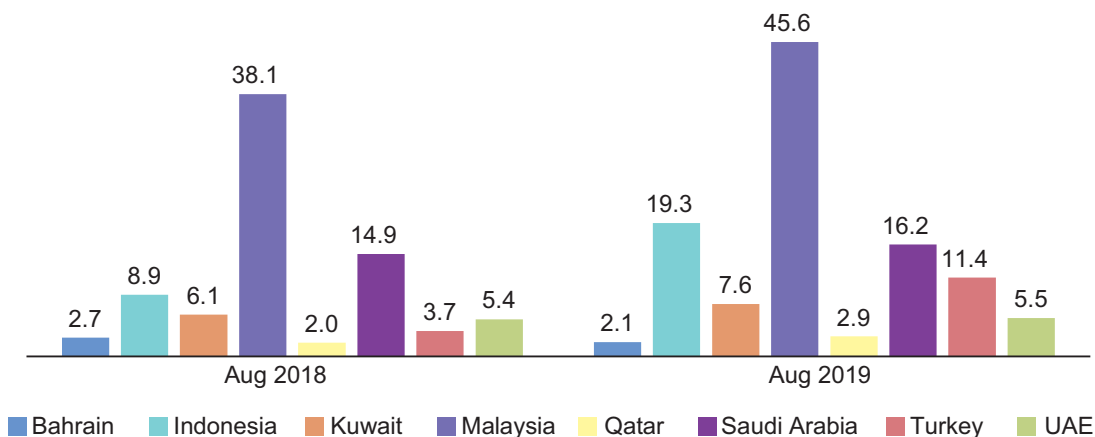
Moderator: Peter Casey, IFSB Consultant

Panellists: **Dr. Mohamed Damak**, Global Head of Islamic Finance, S&P Global Ratings
Gregory Man, Partner, Norton Rose Fulbright
Nadjima Hannoucene, Head of Islamic Finance, Natixis

This session was opened by Dr. Damak with a presentation in which he set out both forecasts for the market and the issues as seen by S&P. He argued that slow growth would be the new norm for Islamic finance, because of its concentration in a limited number of countries expected to show modest economic performance. *Shukūk* issuances (both new issues and reissues) had been strong in the first eight months of 2019, including strong issuances by some countries with a limited presence in the market in 2017 and 2018, such as Turkey, Indonesia and Qatar.



* To end August.

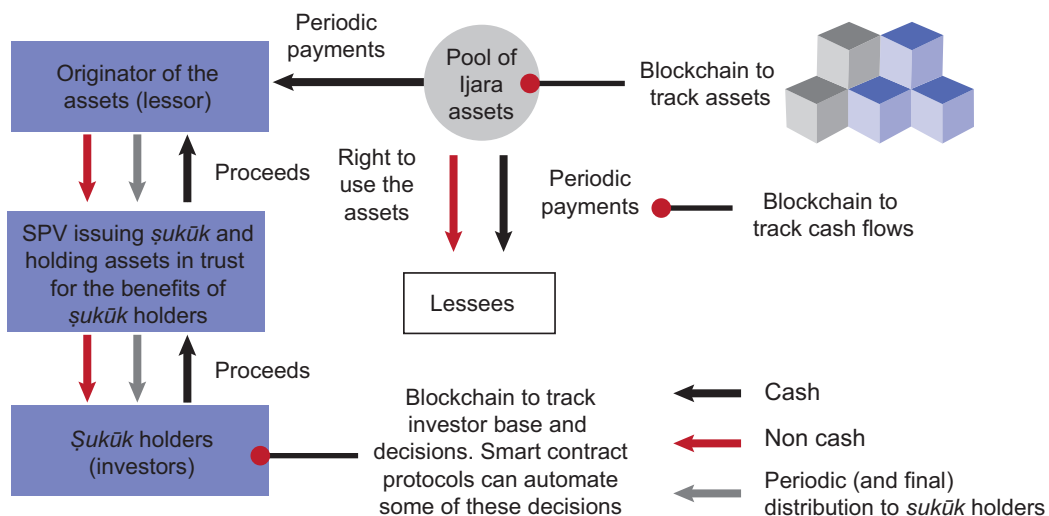


SESSION SUMMARIES

S&P's expectation for the year was a modest increase on the 2018 figure, but not as great as the figures for the first eight months would suggest. While global liquidity is improving, and investors are searching for yield, the negative factors include oil price volatility, geopolitical tensions (involving Iran, in particular), and a continued preference by Gulf issuers for conventional bonds because of the lack of standardisation and higher costs for *shukūk*.

Dr. Damak saw standardisation and reduction of complexity as critical. In this respect, S&P was of the view that the recent AAOIFI proposals on *shukūk* governance could result in unforeseen risks, as some are contrary to current market practice and likely to increase costs.

Fintech had the potential to accelerate financial services developments in a number of ways. Specifically, blockchain appeared particularly useful in the *shukūk* market with potential to automate a number of processes.



A third potential accelerator for the *shukūk* market is the increased interest in environmental, social and governance (ESG) issues in investing. These concerns fit naturally with the underlying goals of Sharī'ah. Ultimately, Islamic finance should be moving from negative screening to positive screening, from what is compliant to what is both compliant and impactful.

In discussion, important points made included the need by Islamic financial institutions to have access to *shukūk*. However, the availability of assets on which they can be based is a key issue, especially given the difficulty some sovereigns have in transferring government assets. As a result, there was an evolution in the market towards "asset-lite" structures, though this was constrained by the need from the investor side for *shukūk* to be tradable. In addition, the range of usable assets was being widened. However, jurisdictions entering the market for the first time always needed to assess whether their legal systems, including their tax system, would allow issuance without unacceptable economic penalties.

SESSION SUMMARIES

As to the economics of *shukūk* as against conventional bonds, yields were now being driven dominantly by the creditworthiness of the ultimate obligor, with the previous gap between bonds and *shukūk* now largely closed. The main problems were the time taken to bring *shukūk* to market and the structuring costs involved.

Many people in Islamic finance argue that *shukūk* should be materially different from bonds in their risk–return profiles, particularly in infrastructure financing. There are examples of this – for example, the Al Rayan securitisation of part of its mortgage portfolio, which did truly transfer the risks related to the portfolio. Similarly, the regulatory capital *shukūk* issued by some banks involved investors taking equity-like risk in certain circumstances. The evidence suggested that it was Western investors who were more attracted by novel instruments, with regional investors being more conservative. However, intending issuers needed to consider what was their ultimate aim, and both the rating and the pricing of the instrument would need to reflect its actual risks.

Session 2: *Shukūk* in Addressing Developmental Goals: Prospects and Challenges

Moderator: **Sohail Zubairi**, Senior Advisor, Dubai Islamic Economy Development Centre (DIEDC)

Panellists: **Fawaz Amin Abu Sneineh**, Managing Director, Head of Debt Capital Markets & Issuer Services, First Abu Dhabi Bank
Maya Marissa Malek, Chief Executive Officer, Amanie Advisors Ltd
Leong See Meng, Senior Vice President Corporate Strategy & Communications, Cagamas Berhad

Mr. Leong discussed the activity of Cagamas, which issues *shukūk* to buy existing home financings. He noted the huge global need for affordable housing, in a period when rapid urbanisation, especially in Asia, is driving up living costs, including house prices. Sustainability *shukūk* issuances with a social focus issued to ESG investors can potentially help alleviate affordable housing issues. The *qard* principle can potentially be embedded into social-focus *shukūk* issuances to fund shared equity schemes to allow an easier entry to affordable home ownership.

More generally, Ms. Malek noted the consonance between the goals of Shari‘ah and ESG investing. However, the Shari‘ah screening required for *shukūk* was not in itself sufficient to ensure that the *shukūk* would indeed meet ESG goals. One particular area where *shukūk* might make an impact was in financial inclusion, where, in principle, funds raised through *shukūk* might be brought together with charitable/philanthropic funding. She commented, however, that practical examples of the use of *shukūk* in this way were so far very limited. Panellists noted that there were some interesting, if small-scale, ESG *shukūk* – for example, that from Edra Solar. There were also attempts to produce standard criteria for green *shukūk*.

Mr. Abu Sneineh argued that capital markets in the region are not as yet fully developed for infrastructure/project finance. Regional issuances have been very limited, usually concurrent with conventional bonds, and often placed in international markets. The regional *shukūk* investors are largely banks, or asset management funds owned by banks. Such investors have limited interest in accepting construction risks and very long tenors. However, *shukūk* have proved to be a very flexible mechanism, and are capable of meeting infrastructure/project finance needs where a market exists.

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In this context, it was suggested in discussion that regional investors, while preferring “green” investments, are not willing to accept materially lower yields. There are, however, funds in Europe and North America that invest only in green or ESG instruments, and these may be less price-sensitive.

The panel noted the efforts of DIEDC to standardise *shukūk*, and also the attempts to promote local-currency *shukūk* and to bring them down to retail level. It also noted that, while *shukūk* are commonly listed, and listings are valued for regulatory/transparency reasons, trading (as with bonds) is mainly OTC. This is natural with a primarily institutional market and instruments with a high unit size. It is likely that a move to more on-platform trading will be dependent on the emergence of a retail market.

The discussion also indicated a need for greater standardisation of criteria in the green/ESG/SRI area, possibly with elements of external certification; this was likely to require some government involvement.

The subject of cost again emerged prominently. One speaker considered that, for any fund-raising under about USD 250 million, bank financing (Islamic, where appropriate) would generally be more economic than either bonds or *shukūk*.

Session 3: Technological Innovation and its Potential for Growth of the Islamic Capital Market

Moderator: Khalid Howladar, Managing Director & Founder, Acreditus

Panellists: Fraser Brown, Executive Director, Banking & Insurance Authorisation, Financial Services Regulatory Authority, Abu Dhabi Global Market
Talal Tabbaa, Chief Operating Officer & Co-Founder, Jibrel Network
Xuan Jin, Counsel, White & Case

Discussion in this session focused on the way that technology might impact on the *shukūk* market. Technologies do not disrupt all markets simultaneously. In particular, capital markets are likely to lag behind other areas of financial services in terms of technological disruption, because the technologies being brought to bear do not fundamentally change what is done or solve major problems; rather, they allow broadly similar processes to be carried out more efficiently. This may, however, be a significant gain in areas such as clearing and settlement.

In addition, many of the issues in *shukūk* markets are concerned with questions of law, which are not easy to digitise. Indeed, capital markets in general are “documentation heavy”. While there is much discussion of “smart contracts”, which can be described as “contracts with embedded macros”, these depend on standardisation of the underlying contractual arrangements. In the area of *shukūk*, although the IIFM is making progress towards standardisation of some documents, full standardisation is unlikely to be possible, and there will remain judgment calls to be made by lawyers, rather than macros, as to the specific terms of the relevant contracts (which will be borne out of commercial negotiations). However, elements of the contractual process are already digitised (e.g. generating “skeleton” first draft agreements), and law firms are beginning to use artificial intelligence (AI) to assist with documentary due diligence.

SESSION SUMMARIES

For regulators, the objective (and challenge) is to effectively balance the benefits of innovation with the risks, including the consequences of a “lighter” regulatory touch. Regulators (as well as other stakeholders) also need to have sufficient understanding of the new technologies and innovations, so that they do not become out of step with market developments. One solution followed by a number of regulators around the world has been the creation of “regulatory sandboxes”, where start-ups can come in and have the freedom to test their innovations within the controlled environment of a specifically tailored regulatory regime. Typically, this will involve reduced requirements in a number of areas, such as capital, but also strict limits on the scale at which the firm can operate. To operate free of these limits, the firm will then have to go through standard authorisation processes and meet standard criteria, save to the extent that the regulator’s own experience with the sandbox has led it to modify its regime more generally.

One hope expressed was that technology would allow Islamic finance to go back to its roots, rather than repackaging conventional products. Another was that technology would allow smaller-scale *shukūk* to be economic, with the possibility even of microfinance *shukūk*, albeit to finance microfinance institutions which can then deliver to ultimate clients. These *shukūk* might well have returns dependent on the ultimate performance of the microfinancing. It might well be possible to offer *shukūk* as retail savings instruments, though it was unlikely that demand would be driven from the retail side. In conventional markets, there is a clear distinction between wholesale and retail fixed-income investments, and there was some discussion of whether bonds/*shukūk* are or are not more straightforward and comprehensible for retail investors than equities. (This question is key to assessing regional – Middle East – demand for retail fixed-income products which, to date, is overshadowed by wholesale demand.) The question was also raised whether robo-advice would help with some of the problems well known in retail markets, particularly mis-selling.

Session 4: Strengthening Legal and Regulatory Frameworks to Enhance Investor Protection and Stability of *Shukūk* Markets: Key Policy Aspects and the Way Forward

Moderator: Dr. Bello Lawal Danbatta, Secretary-General, IFSB

Panellists: Ijlal Alvi, Chief Executive Officer, International Islamic Financial Market (IIFM)
 Dr. Umar Oseni, Acting Chief Executive Officer, International Islamic Liquidity Management Corporation (IILM)
 Basheer Ahmad, Senior Manager, Markets, Dubai Financial Services Authority (DFSA)

Mr. Alvi noted the very specific role of the IIFM in producing standardised documentation and products confirmation standards. So far, the IIFM has issued standards relating to Islamic hedging, liquidity management and trade finance, while work on other segments of the industry – such as capital markets, syndication and gold – is in either the consultation or the assessment phase. Generally, adoption of IIFM standards is voluntary; however, in recent years their use is increasing globally, as IIFM standards provide major benefits such as efficiency and cost saving, and streamlined operational and market practices. Shari’ah harmonisation and law reforms to create a sound legal system are matters for jurisdictional authorities, while choice of governing law is up to the counterparties to decide. The IIFM is currently in the final stage of market consultation for Sukuk Al Ijarah Standardized Documentation, while market consultation for Sukuk Al Mudarabah Standardized Documentation is progressing; the target is to issue these *shukūk*-related standards during the first half of 2020. Mr. Alvi also pointed out that almost all *shukūk* are issued on the

SESSION SUMMARIES

beneficial ownership basis, which is acceptable in common law jurisdictions such as Malaysia, while some jurisdictions applying civil law, such as certain GCC countries, recognise only title transfer of assets. The latter has a number of legal, investor preference, availability and quality of assets challenges; plus, for some countries, it is not possible to transfer title to state assets. Dr. Umar noted that this had also been an issue for the IILM during the early stage of developing its business model (which, however, had the advantage of operating solely through private placements). However, lawyers now had experience of navigating these waters and, where a legal system does not formally recognise beneficial ownership, it may well be possible to obtain an opinion that it will be accepted as true ownership in that system. Experience showed that this was likely to be acceptable to Shari'ah scholars.

Panellists noted that the *shukūk* market continues to develop, with perpetual *shukūk* (without purchase undertakings), and analogues to senior unsecured debt. Although some of these developments have been driven by Islamic banks' need for eligible capital, they have not been confined to banks. There was scope for the use of smart contracts in areas where approaches and documentation could be more or less standardised, but differences in the underlying assets and business from one *shukūk* to another limited the opportunities. Technology might, however, be particularly helpful where the pool of assets could change during the *shukūk*'s term in tracking the asset pool and its ownership.

Panellists discussed the issue of "fatwa shopping". There was some discussion of the extent to which technology, and specifically AI, might help to address this. It was relatively easy to see how it might find precedents, but it was likely to be some time before it could perform the full review of all the documentation that would be necessary for a fatwa; human verification would be necessary for the foreseeable future. Technology could also not prevent conscious fatwa shopping, though regulators might be able to intervene in any obvious cases.

The issue of investor protection around ESG *shukūk* was discussed. From a regulatory point of view, it was possible at issuance to take a disclosure approach, ensuring that the basis of any claim and any external verification of it were disclosed. Regulators could review the completeness of the disclosures made. It was, however, harder to continue this into the secondary market and, in particular, to pick up any subsequent changes in the relevant facts. In general, the market was perhaps still too immature for regulators to take a definitive approach.

Returning to the issue of technology, it was coming to be generally accepted by regulators that tokenised offerings which had other characteristics of a security should be regulated as securities. The most interesting question around the impact of fintech on the *shukūk* market was whether it could drive costs down to the point where micro*shukūk* and retail offerings would become economically viable from the standpoint of potential issuers.

SUMMARY AND SOME KEY ISSUES

Shukūk represent a huge opportunity that has not yet been fully realised. The challenges are many, and this paper, based on the issues discussed in the seminar, can cover only some of them.

Broadening the geography

First, there are challenges in broadening the geographic spread of *shukūk*. Jurisdictions new to the *shukūk* market face a number of issues in entering it. These are, in general, issues which have been resolved in other jurisdictions, but which the newer jurisdictions may not have the capacity to resolve in their own environments, especially since some of them will require relatively wide engagement across at least the public sector. It is not enough to have a handful of experts in one or two departments of government.

One challenge concerns the legal infrastructure. *Shukūk* normally involve a full or beneficial transfer of assets to a special purpose vehicle, with a repurchase at the end of the term. There are some *shukūk* that do have all these elements, but they often involve an additional degree of sophistication, which would not make them the natural starting point for a new jurisdiction. Thus, the legal system needs to support the use of an SPV, typically governed by trust, or some equivalent. Equivalents do exist – for example, in some civil law regimes that do not recognise trust; alternatively, it may be possible to use an SPV established in another jurisdiction. Second, it must be possible for the sale and repurchase to be made without attracting tax, including indirect or transaction taxes; without this, *shukūk* will be fundamentally uneconomic. Third, where the originator is a sovereign or quasi-sovereign, it must be possible to make these transfers without falling foul of provisions preventing or restricting the sale of assets by the government or other public bodies.

A second challenge concerns the regulatory infrastructure. It is normal for bonds issued by governments and multinational agencies to be excluded from normal securities regulation, at least in the primary market. However, these issuers usually comply voluntarily with good market practice. But for commercial issuances, and in the secondary market, regulators need to understand how to treat *shukūk*. Many will be economically very similar to conventional bonds; however, as discussed later, this will not always be the case. Regulators also need, at minimum, to consider what additional disclosures to require. A common regulatory approach would be to encompass *shukūk* initially under the regulatory regime for bonds, to require additional disclosures on Shari'ah matters using whatever powers are available, and to develop a more tailored regime as the market develops.

A further, and very important, issue for regulators is Shari'ah governance. Should they impose any substantive requirements, or require relevant disclosures, or simply rely on market discipline? The answer may well depend on what they expect the market to be; in general, retail investors are likely to require more regulatory protection than institutional ones, who may be more capable of evaluating complex information for themselves. But also, institutional investors in *shukūk* will, to the extent that they have any concern for Shari'ah compliance, expect there to be a Shari'ah ruling (fatwa) from reputable scholars. At this level, market discipline will be helpful.

SUMMARY AND SOME KEY ISSUES

The third challenge comes when governments decide to move beyond creating an environment in which *shukūk* may be issued, to issuing *shukūk* themselves. (This is likely in practice to be a precondition of developing any viable local *shukūk* market, both for demonstration purposes and to establish a yield curve. It will also be highly desirable to support the local Islamic banking industry where one exists.) Even if the legal issues have been successfully resolved, identifying and valuing appropriate Shari'ah-compliant assets may be difficult. This will depend in part on the government's policies on the extent to which the state, rather than the private sector, holds assets. Some classes of asset – for example, defence assets – will be unsuitable for use in *shukūk*. Other assets with economic value may have been privatised. But even where the state holds usable assets, their use may in practice require the involvement of government departments well outside those concerned with either government funding or financial services policy. A power station may well be a highly suitable asset, but its use will require the cooperation of the Ministry of Power or some equivalent. This cooperation is more likely to be forthcoming if the proceeds will be devoted to some future power development. Linkage of this kind, using existing assets in a sector to fund future developments in the same sector, is not uncommon.

The need for broad support within government is one reason for the need, already mentioned, for capacity development in relevant departments. A related challenge, particularly important where the government is trying to develop Islamic finance more generally, is broader public and investor education, especially in Muslim-minority countries. The use of specifically religious labels and the Arabic language may not always be helpful here and, whether they are used or not, there is certainly a need to expand understanding of what is actually being offered.

All these challenges have been overcome in many places, but it will be much easier to overcome them if there is a general consensus that *shukūk* offer positive benefits to the jurisdiction. One common, and excellent, reason for developing a *shukūk* market is that the jurisdiction is developing Islamic finance generally, and that *shukūk* will be needed to provide Shari'ah-compliant investments for Islamic banks and other institutions. Another is that the jurisdiction has ambitions to be an Islamic capital markets hub. But a common one is that it sees advantages in *shukūk* for managing the government's own finances. This may be simply a matter of broadening the investor base. But there will also be the question of whether *shukūk* are more suited than bonds to certain types of financing. This is an issue faced too by those jurisdictions where *shukūk* are well established. It leads naturally to the next section.

Broadening the *shukūk* offering

Shukūk clearly have the potential to offer different risk–reward patterns from conventional fixed-term bonds. There are practical examples of convertible *shukūk*, of perpetual *shukūk* and of *shukūk* roughly analogous to subordinated conventional debt. One recent source of innovation in this area has been the wish by some Islamic banks to issue instruments that will qualify as regulatory capital under the Basel III regime or its IFSB equivalent. This has led to the use of different contractual models from those most commonly used elsewhere in the market, and there are some signs of this innovation being imitated by others.

SUMMARY AND SOME KEY ISSUES

In principle, there are other types of innovation to which the available *shukūk* structures appear well suited, particularly infrastructure financing involving real elements of project or asset risk. But these have so far made little headway in the market. A common claim is that few investors are interested in taking such risks, though others argue that this is unproven in an environment where the default setting of investment banks and other advisers is to market instruments as close to conventional bonds as possible. This unresolved issue of investor demand is highly relevant to standardisation issues, as discussed below. What can be said with more certainty is that country risk, in a broad sense, is a key issue for investors in all *shukūk*. However, it becomes a greater one if the investors are taking project or asset risk, because in these circumstances they become exposed to a wider range of potential government decisions. For this reason, infrastructure financing is often dependent on government commitments to some level of use and pricing.

Shukūk are often discussed in the context of green/ESG/SRI investing. (The fact that all these terms, and more, are used with slightly different meanings is itself significant, and will be discussed later.) In this context, there is a strong link between such ethical investing and the goals of Sharī'ah. Discussions of this link are, however, less clear on how far it is realised in practice in features of *shukūk* themselves, in the Sharī'ah constraints on them, or simply in the ethical principles of *shukūk* investors. In so far as it comes from structural features of *shukūk* themselves, the benefits must lie in the ability to create non-traditional risk–return profiles, including possible links to the attainment of particular goals. The Sharī'ah constraints are helpful in excluding some types of investment, but there appears to be consensus that they are not in themselves sufficient for *shukūk* to meet the criteria of many who would consider themselves as ethical investors.

It is at this point that the differing ethical preferences of investors enter, as indeed they do in the conventional investment world. These preferences are in practice articulated in slightly different criteria (green/ESG/SRI, etc.). For example, a “green” investor would be likely to focus mainly on environmental impacts. But investment in, say, schools, while it might well meet SRI criteria, might not meet “green” ones. Again, some of the ESG criteria focus on issues of governance, payment of fair wages, etc. and can be met by, say, tobacco companies, whose product would be anathema to many investors. While it will never be possible to eliminate the differing priorities and ethical views of investors across issues such as fossil fuels, animal testing, working conditions, defence, tobacco, governance, etc., there is a pressing need for some standardisation of criteria, and perhaps of verification, so that it is at least possible to understand what is embraced in a particular claim. This, however, is an issue for conventional finance as much as for Islamic finance, and it is therefore likely that any rationalisation of the various criteria may need to be led from the conventional side if it is to succeed in the market. Some rationalisation is already beginning to occur in the climate and environmental areas, but it is much more limited in other areas of ethical investing.

One specific area where the *shukūk* offering may be broadened is in microfinance. In principle, the possibility of combining *shukūk* financing with charitable or philanthropic funding to allow various forms of microfinance to be economically viable is a highly attractive one and could be a distinguishing feature for Islamic finance. However, this is an area where, despite much discussion, there have been few practical results. Cost is an issue here, but so are the Sharī'ah limitations on how charitable giving may be used, and the bureaucracy around the charitable/philanthropic sector in some countries.

SUMMARY AND SOME KEY ISSUES

Deepening the market

For jurisdictions with an established *shukūk* market, three further issues are prominent: how to achieve active trading, preferably on-exchange; how to extend involvement to retail investors; and how to encourage smaller businesses to issue *shukūk*. These issues are to some extent linked. They are also to some extent shared with the conventional market, in that much conventional bond trading is OTC, few countries have retail bond markets, and most corporate issuances are by larger entities.

There appears to be some consensus that it is likely to be retail investment that brings more *shukūk* trading on-exchange. Retail investment is also likely to be a condition for issuances by smaller companies, since larger investors cannot take tranches of a small issuance that are to them material enough to justify the research and monitoring costs, without also giving themselves problems of liquidity. However, retail investment, though possibly a necessary condition for smaller issuances, is not a sufficient one. The key issue here is cost, for businesses that, because of their size, have bank financing as a realistic alternative option.

In general, both the cost and the time to issue *shukūk* are greater than are required to issue a conventional bond. The differences come partly from the lack of standard documentation, but also from the need to identify and value assets, and to obtain Shari'ah approvals. Any form of issuance is likely to be more expensive, in terms of the transaction costs, than taking bank financing. Hence (and absent government or other subsidy), issuances are likely to be attractive only if bank financing is not available or is unduly expensive.

One major interest at present is how far technology can reduce the costs associated with *shukūk*. There are clear possibilities to use distributed ledger technology (DLT) to record transactions, to track securities and to record changes in assets where these may occur. These will reduce continuing costs and, where they affect trading, may make market finance (whether through equities, *shukūk* or conventional bonds) a little more attractive compared with bank financing. They may also assist in repeat issuances of programme *shukūk*. Various proof-of-concept trials have been done, but DLT has yet to find operational uses where it is able to show a clear economic advantage. So far as Islamic finance is concerned, it is arguable that those first operational uses will be in higher-volume businesses such as trade finance.

The other technology which may be promising is AI, where there are possibilities in due diligence and in Shari'ah analysis. This is a technology with which important law firms are already engaged. However, while it may have value in some parts of legal and Shari'ah analysis, particularly searching for precedents and identifying and incorporating standard documentation, it is still a long way off being able to identify underlying facts and to perform the necessary analysis to reach a conclusion on them, in either legal or Shari'ah terms.

Overall, none of the new technologies is yet at the point where it seems likely in the near future to have a decisive impact on costs (in either the *shukūk* or the conventional bond market). The greater volume of the bond market suggests that the impact of technology may be felt there first, though it will be vital for Islamic finance markets at least to keep pace.

SUMMARY AND SOME KEY ISSUES

The role of standardisation and regulation

The *shukūk* market has long seen a three-way tension between innovation to allow it to address a wider range of possibilities, protecting its distinctive character, and providing points of entry for new issuers and indeed new investors. Proposals to protect *shukūk* from becoming economically too close to conventional bonds generally come with additional governance requirements and/or additional structural constraints, both tending to involve costs. On the other hand, providing points of entry for new participants generally requires reductions in cost and the use of well-understood structures and risk profiles.

Against this background, the standardisation of at least some *shukūk* structures and documentation has long been an aim of policymakers and industry participants, but has proved frustratingly slow. There are a number of reasons for this, some better than others. However, there are now some signs of progress, and the possibility that the IIFM may soon have a set of standard documentation for an *ijarah shukūk*.

This will be voluntary standardisation, which will succeed to the extent that market participants find that its use has a positive impact on the speed and cost of the issuance process. It nevertheless has the potential to be enormously valuable, after a long period in which efforts at voluntary standardisation have foundered, partly on the desires of law firms to maintain distinctiveness.

In the area of regulatory standardisation, the IFSB has produced standards, notably but not exclusively on disclosure, and AAOIFI has produced a standard on *shukūk* governance. One general tension in the area of regulatory standardisation is that compliance costs, or limitations on the structures that may be used, may still further increase the costs of issuance and the time to market. Regulatory, as opposed to voluntary, standardisation rarely has as its objective a reduction in industry costs. One overall question here is whether attempts to force a distinction between *shukūk* and conventional bonds may in fact inhibit the growth of a market which would, in any event, develop its own distinctiveness over time.

One particular area where regulatory intervention has been suggested is so-called fatwa shopping – that is, choosing a group of Shari‘ah scholars likely to give the answer the client wants. It is, however, difficult to identify how great an issue this is, especially in a largely institutional market where potential investors are both able and willing to take their own advice on Shari‘ah matters. From a regulator’s point of view, it is difficult to intervene in any case where well-qualified scholars have given a fatwa, unless it is clearly at odds with Shari‘ah standards established for the jurisdiction. The situation is, as in some other areas, different if the *shukūk* is targeted at retail investors, who cannot be expected to take their own Shari‘ah advice, or indeed take a view of the competence of those who have given a fatwa. Regulators in retail markets may need to play a more active role, but this means both that they will need to have their own Shari‘ah advice available and also that there is a greater degree of market fragmentation, with some products being unable to be sold cross-border.

SUMMARY AND SOME KEY ISSUES

A third area for standardisation has already been referred to above. The broad area of ethical investing is in principle a promising one for *ṣukūk*; however, partly reflecting the different priorities of investors, there are a range of standards and designations, some of them vulnerable to “greenwashing”, and in totality highly confusing. There is beginning to be some convergence in the climate and environmental area and concentrating initially on disclosures. There is less convergence, however, on broader areas of ethical investing. It is not clear how far regulators can bring further clarity to this scene at present, or whether voluntary market standardisation should be the initial focus, but there appear to be opportunities to make common cause with elements of the conventional market.

Actions for the development of *ṣukūk* markets

This section proposes some actions to develop *ṣukūk* markets in the region.

In the **short term**, for **jurisdictions new to *ṣukūk* markets**, there are a number of enabling steps that need to be taken.

1. Since a sovereign or quasi-sovereign issuance is the natural first step, the authorities in the jurisdiction need to confirm that any tax or legal obstacles can be removed or circumvented (e.g. by the use of a long lease with a shorter leaseback).
2. From the point of view of capital markets regulation, if the issuance is to be listed locally, it should be confirmed that there is no obstacle to applying an appropriate regime to it. Bond regimes are in general reasonably appropriate, and drawing on an existing regime will normally be better than trying to create a new one. A tailored regime recognising the specificities of *ṣukūk* is highly desirable but can follow later as the market develops.
3. The natural structure for an initial issuance is *ijara* (leasing) because it is a well-trodden path and poses relatively few issues. Advice on such an issuance is readily available commercially. The IFSB can also offer technical assistance to its member regulatory authorities.
4. The need for capacity building is often underestimated. A decision to issue *ṣukūk* will involve a substantial number of people around government, and building a basic level of understanding among them is not a trivial enterprise. In some jurisdictions, staff tend to move through government posts fairly quickly, so maintenance of capacity can also be an issue. Multilateral development banks (MDBs) have particular expertise in running capacity development programmes, and this is an area in which they can be very helpfully engaged.
5. Closely aligned with capacity building is public education and awareness. Even if *ṣukūk* are not expected to be traded in a retail market, there will be a need at minimum to communicate about a decision to become involved with *ṣukūk*, and for this to have at least tacit acceptance. Again, MDBs may be able to assist.

SUMMARY AND SOME KEY ISSUES

For both **new and established markets**, a second relatively **short-term** issue is **standardisation**. The most pressing need here is to develop standard documentation for a relatively few well-understood structures in order to reduce the costs of issuance. This will help to extend not only the geography of the market but also the scale at which *shukūk* can be a viable option. The IIFM's work on *ijārah* is very helpful and should be brought to completion. It should be followed by other documentation standards including, perhaps, a perpetual *shukūk* based on one of the investment contracts.

For markets with established **Islamic banking industries**, there will be a need for high- quality liquid assets that banks can hold to meet their regulatory requirements. Central banks should consider issuing short-term *shukūk* in parallel with their conventional bill issuances.

There is also the issue of **asset availability**, especially for sovereigns and quasi-sovereigns. It is likely to affect established markets at least as much as new ones, because most jurisdictions will have at least some low-hanging fruit that can be used for earlier issuances. It is later that the problems of asset availability impinge seriously. There are two lines of action here. The first, for governments that expect a continuing programme of *shukūk* issuance, is to construct an asset register itemising the major (civilian) assets owned by the government, how title is held, approximate valuation, etc. This is, of course, desirable for other reasons, too, and is another area in which MDBs may be able to assist. The second is to develop the use of so-called asset-lite structures. Some caution is necessary here, however. While there is certainly scope to explore the use of a wider range of assets, including some intangible assets, too great a rupture in the link between *shukūk* and real assets risks the familiar criticism that these are simply bonds in very thin disguise. There is, however, room for the academic community in particular to explore further the possibilities of using new types of asset and assets under development (see below).

For the **longer-term** development of the market, three principal themes emerge.

The first is **broadening the *shukūk* market** away from structures that do no more than imitate conventional bonds. This needs to be a matter of “pull”, rather than “push”; that is, defining and using new structures, rather than seeking to restrict the use of existing ones, which risks restricting the market and closing off natural points of entry. There has already been gradual development of *shukūk* with new profiles, including convertibles and the regulatory capital *shukūk* issued by some Islamic banks. However, there is a need for research in two areas in particular.

1. It is frequently argued that *shukūk* investors are basically fixed-income investors, like those who invest in conventional bonds. This argument is a powerful force for conservatism in the *shukūk* market, because no potential issuer wants to offer a novel risk–reward profile and find that the issuance fails to meet its target. But this also means that the argument is largely untested. There is scope for research, probably by academics, to test the willingness of larger investors to contemplate novel risk–reward profiles. This will need to be rigorous enough to be a convincing basis for behaviour.
2. There is also scope for research on developing novel structures. One area of particular need is infrastructure finance, where the apparently promising *istisna'a* contract has failed to live up to the hopes placed in it, partly because of the reluctance by some investors to accept construction risk but also because of the difficulty of providing any return to investors during the construction period. Structures more conducive to funding build–operate–transfer schemes need to be researched.

SUMMARY AND SOME KEY ISSUES

Another structural area for research lies in the ability to link *shukūk* returns to the achievement of social goals (including financial inclusion and microfinance). This links with the next theme, and some experiments have been made, on a relatively small scale. The idea is to link returns to, say, the results achieved by a school, or the amount of carbon sequestered by a forestry project, so that a successful project operator experiences a lower cost of capital. *Shukūk* holders would of course receive a lower return from a successful project, but the underlying concept is that so-called impact investors may be willing to forgo some element of return in exchange for (validated) achievement.

There is also a need to explore more fully what can be done with some of the very rarely used contracts, such as *muzara'ah*, *musagat* and *mugharasah*. While these are, at least in origin, agricultural in nature, the region does have agricultural projects requiring investment and it would be helpful to test whether these contracts offer something distinctive as a basis for *shukūk* in a modern environment.

It is also a little surprising that the issuance of regulatory capital *shukūk* by Islamic banks has so far been focused on a small number of jurisdictions. Since any such issuance requires at least the tacit approval of the banking regulator, it perhaps suggests that some banking regulators may not yet be comfortable in approving such issuances. The IFSB will explore whether there is scope to issue a Guidance Note discussing the structures that can be used, and how regulators should confirm that they meet the Basel/IFSB loss absorbency requirements.

The second theme concerns the values underlying the *shukūk* market, how they can be expressed, and their link with wider themes of ethical investing. There is clearly work to be done here, some of it in cooperation with conventional markets.

So far, significant work has been done to articulate the consonance between the values of Islamic finance and various expressions of social good, especially the sustainable development goals (SDGs). However, it is also clear – for example, from research done by the General Council for Islamic Banks and Financial Institutions (CIBAFI) – that the SDGs (or other expressions of values) are only occasionally fully embedded in the business models and strategies of Islamic finance firms. More still needs to be done.

The issues in the capital markets are, however, a little different from those in banking. Ethical preferences are articulated largely through the behaviour of investors, and the basis for their decisions is often some form of certification, or scoring or ranking. As already noted, there are many “standards” in this area, addressing different criteria and sometimes producing counterintuitive results.

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It has also been noted that in the environmental and climate areas, some convergence is beginning to be seen. This has so far been largely market-led, as one might expect, but regulators are beginning to become involved. The natural first points of involvement will be with the disclosures made by companies with instruments listed on an exchange, perhaps requiring the disclosures recommended by the Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD), and at prospectus level in ensuring that any claim to meet, for example, the Green Bond Principles is soundly based. Given the respective market sizes, it is likely that this process will be driven by the conventional markets. The question for Islamic finance will be whether there are specificities that would require corresponding standards in Islamic finance to be different. It is arguable that there may be – for example, around the role of Shari'ah governance in providing assurance. This is an issue for the relevant standard setters to consider – presumably, the IIFM in the case of the market-led standards, though the responsibility is less clear in the case of the TCFD disclosures.

In the broader area of impact investment and contributions to the SDGs, convergence is slower. This is partly because investors legitimately have different preferences – for example, for health projects ahead of education, or vice versa. More fundamentally, it is because of the difficulty of weighing together all the factors embraced within the concept of ESG. It has been remarked in the context of some attempts to establish an ESG scorecard that a company may be well governed, may treat its employees well and use little energy, but still produce a fundamentally objectionable product.

There may be more scope here to establish at least a disclosure standard for *shukūk* relating to claims of social responsibility, and in this area Shari'ah principles and values may indeed be helpful (e.g. by excluding at least some socially undesirable end uses). The key here will be to require clarity about exactly what claims of social responsibility are being made and whether there are any implicit negative claims (e.g. about staff working conditions).

The third, and perhaps the most difficult, theme is about driving down **costs**, both initial and continuing. The seminar established clearly that, for fund-raising below around USD 200 million, bonds will generally be more expensive than bank financing, and *shukūk* will be more expensive than bonds. There may be other good reasons to choose *shukūk* – for example, to diversify an investor base – but both these cost gaps need to be addressed.

Much hope has been pinned on technology, though it has yet to make a decisive impact on either the bond or *shukūk* (or, indeed, on the equity) markets. There is a real prospect that DLT, in particular, may drive down the costs of trading, settlement, securities depositories, etc. It will not greatly change market structures, if only because the major exchanges are well-enough resourced to be able to acquire the technologies they need. But it may well shift the cost balance, especially in respect of continuing costs, somewhat in favour of market as opposed to bank financing. Similar technology may also reduce continuing costs for *shukūk* based on a changing pool of assets. It is unlikely to justify its cost where assets change relatively infrequently (e.g. a company vehicle fleet), but may do so for more rapidly changing assets (e.g. the cars financed by a bank under *ijarah* contracts).

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AI has also been discussed. There is general consensus that there are some parts of the legal process that can be assisted by AI, and this will carry over to Sharī'ah governance as well. The technology is likely to be driven by the secular legal profession, across a range of applications, and will, at least initially, focus on precedents, both legal and as to facts, rather than full analysis. Given the relative rarity of *ṣukūk* – and, indeed, bond – issuances by “big data” standards, the technical drive will come from elsewhere.

Standardisation is the most critical initiative for cost reduction. As already discussed, it needs to go beyond standardisation of structures to standardisation of documentation, and in forms usable in as many jurisdictions as possible (in particular, both civil law and common law jurisdictions). It should also incorporate structures for framework prospectuses, to allow *ṣukūk* to be issued in tranches with much lower documentation requirements. (This is not uncommonly done, especially by sovereigns, but documentation has not been standardised.)

Standardisation should also reduce the costs of Sharī'ah review for each issuance and, almost as important, the time taken for this. Standard and well-accepted documentation should allow Sharī'ah review to be focused on a limited number of issues specific to the individual case.

A final issue is developing liquidity in the *ṣukūk* market, which is expected to have knock-on effects in reducing the illiquidity premium that has been considered to exist before, and allowing a retail market to develop. A retail market will, in turn, increase the attractions of *ṣukūk* for smaller issuers. However, the problem of liquidity is one that many have tried to solve over the years without success. Part of the solution no doubt lies in increased volume of issuances, to reduce the incentive for large investors, such as Islamic banks, to buy and hold. Other approaches, including the presence of market makers and, in some markets, equivalents of securities borrowing and lending facilities, have been tried, but with limited success.

ANNEX A

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IFSB–AMERC of IOSCO Joint High-Level Seminar

Development of *Şukūk* Markets in the Middle East and Africa:
Growth Potential and Policy Considerations”
26 September 2019 | Abu Dhabi, United Arab Emirates

PROGRAMME

TIME	SESSION
08:00 – 09:00	Registration
09:00 – 09:20	<p>Welcome Remarks</p> <ul style="list-style-type: none"> • Michael Gifferty, President, Gulf Bond <i>Şukūk</i> Association (GBSA) <p>Opening Remarks</p> <ul style="list-style-type: none"> • Dr. Obaid Al Zaabi, Chief Executive Officer, Securities & Commodities Authority (SCA) • Dr. Bello Lawal Danbatta, Secretary-General, Islamic Financial Services Board (IFSB)
09:20 – 09:50	<p>Keynote Address</p> <ul style="list-style-type: none"> • Paul Muthaura, IOSCO Chair of Africa / Middle-East Regional Committee (AMERC)
09:50 – 10:40	<p>Session 1: Islamic Finance and <i>Şukūk</i>: Key Concepts, Global Significance and Outlook</p> <ul style="list-style-type: none"> • Trends in issuances from the region • Prerequisites of an efficient Islamic capital markets ecosystem • Case study on the potential and outlook of Islamic capital markets for AMERC – the case for <i>Şukūk</i> • Features of different types of <i>Şukūk</i> that raise additional considerations for investor protection and supervision
09:50 – 10:40	<p>Presentation on “An Overview of Islamic Finance and <i>Şukūk</i> including Key Regional Trends” by Dr. Mohamed Damak, Global Head of Islamic Finance, S&P Global Ratings</p> <p>Moderator: Peter Casey, IFSB Consultant</p> <p>Panelists:</p> <ul style="list-style-type: none"> Dr. Mohamed Damak, Global Head of Islamic Finance, S&P Global Ratings Gregory Man, Partner, Norton Rose Fulbright Nadjima Hannoucene, Head of Islamic Finance, Natixis

TIME	SESSION
10:40 – 11:00	Coffee Break and Networking
11:00 – 11:50	<p>Session 2: <i>Shukūk</i> in Addressing Developmental Goals: Prospects and Challenges</p> <ul style="list-style-type: none"> Enhancing the effective utilization of <i>Shukūk</i> in meeting development needs, including addressing budget deficits and infrastructure financing gaps – what is needed? Linking <i>Shukūk</i> and long-term economic development initiatives and sustainable development goals Strengthening the link between ethical finance and <i>Shukūk</i> – identifying potential projects that meet developmental goals What roles can national regulators and sovereigns play to ensure <i>Shukūk</i> is at the fore of ESG? Case study on the experience of a successful green <i>Shukūk</i> issuance to meet developmental objectives <p>Moderator: Sohail Zubairi, Senior Advisor, Dubai Islamic Economy Development Centre (DIEDC)</p> <p>Panelists: Fawaz Amin Abu Sneineh, Managing Director, Head of Debt Capital Markets & Issuer Services, First Abu Dhabi Bank Maya Marissa Malek, Managing Director, Amanie Advisors LLC Leong See Meng, Senior Vice President Corporate Strategy & Communications, Cagamas Berhad</p>
12:00 – 12:50	<p>Session 3: Technological Innovation and its Potential for Growth of the Islamic Capital Market</p> <ul style="list-style-type: none"> Emerging developments in financial technology and its potential in the Islamic capital markets The application and potential for crowdfunding, P2P platforms, robo-advice and block chain technology and others, in the Islamic capital markets – in particular, in transforming the <i>Shukūk</i> market Can such technological developments be applied to support local markets? Addressing the key regulatory challenges – promoting innovation in the Islamic capital markets while ensuring investor protection <p>Moderator: Khalid Howladar, Founder, Acreditus</p> <p>Panelists: Fraser Brown, Senior Executive Director – Banking & Insurance, Financial Services, Regulatory Authority, Abu Dhabi Global Markets Talal Tabbaa, Co-Founder, Jibrel Network Xuan Jin, Counsel, White & Case</p>
12:50 – 14:00	Lunch and Networking

TIME	SESSION
14:00 – 14:50	<p>Session 4: Strengthening Legal and Regulatory Frameworks to Enhance Investor Protection and Stability of <i>Shukūk</i> Markets: Key Policy Aspects and Way Forward</p> <ul style="list-style-type: none"> • Key policy issues that need to be addressed from a market, legal and regulatory perspective to ensure investor protection • Issues around Sharī'ah governance and standardization in <i>Shukūk</i> markets • Regulatory efforts by international standard-setting bodies and critical areas of focus for enhancing stability and resilience of <i>Shukūk</i> markets specifically, and capital markets in general • Integration with global capital markets and regulatory harmonisation across jurisdictions <p>Moderator: Dr. Bello Lawal Danbatta, Secretary-General, IFSB</p> <p>Panelists:</p> <p>Ijlal Alvi, Chief Executive Officer, International Islamic Financial Market (IIFM)</p> <p>Dr. Umar Oseni, Acting Chief Executive Officer, International Islamic Liquidity Management Corporation (IILM)</p> <p>Basheer Ahmad, Senior Manager, Markets, Dubai Financial Services Authority (DFSA)</p>
14:50 – 15:00	<p>Closing Remarks</p> <ul style="list-style-type: none"> • Dr. Obaid Al Zaabi, Chief Executive Officer, SCA

