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# STRATEGIES FOR THE DEVELOPMENT OF ISLAMIC CAPITAL MARKETS:
## *Infrastructures and Legal Aspects of Islamic Asset Securitisation*

Islamic Financial Services Board
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The views expressed in this publication are those of the author(s)
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## ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3rd November 2002 and started operations on 10th 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 involves, 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**

## Contents

# Preface

In the name of Allah, the Most Gracious, the Most Merciful

As the international standard-setting body for the Islamic financial services industry (IFSI), the primary objective of the Islamic Financial Services Board (IFSB) is to promote and enhance the soundness and stability of the industry. As part of its work to achieve this objective, the IFSB issues standards and guiding principles which focus on the prudential aspects of the IFSI. The IFSB also conducts research, coordinates initiatives on industry-related issues, and organises roundtables, seminars and conferences for regulatory and supervisory authorities and industry stakeholders as part of its awareness programmes.

With the noteworthy growth of the IFIS in various parts of the world, Islamic capital markets have also seen a fair amount of growth in terms of size, geographical diversification and range of products. However, given that the IFSI is still relatively young, it is not surprising that Islamic capital markets still have much progress to make in their development. Indeed, they may face many challenges, and failing to address them will limit not only their development but also the overall growth of the IFSI. In response to these challenges, with a mandate from the IFSB Council, as well as a generous technical grant from the Asian Development Bank and the Islamic Development Bank, the IFSB commissioned research to identify strategies for the development of Islamic capital markets, including the legal aspects of Islamic asset securitisation.

The results of this research are published in this book. The results provide important insights into how governments and regulatory and supervisory authorities can aid the development of the Islamic capital markets by providing infrastructure, removing regulatory and legal hindrances, and introducing specific laws and regulations to cater for the specificities of Islamic capital market products.

This book comprises chapters written by several distinguished scholars who share their thoughts and experiences on pertinent issues. The topics covered are: (i) the development of Islamic capital market strategies; (ii) the building of a liquidity management infrastructure for Islamic finance; and (iii) legal aspects of Islamic asset securitisation. Our hope is that these insights will be of great benefit to the industry.

In the Introduction, Dr Tomás J. Baliño and Dr Patricia Brenner explain the background of the research project and provide an executive summary.

In Chapter One, Professor John Board highlights issues facing Islamic capital markets based on an industry-wide survey, field visits and other sources of information. The author analyses what is considered to be the most pressing issue in Islamic capital markets: the concern over market liquidity. He provides recommendations in four broad areas that are concerned with encouraging or motivating various categories of market players: (i) encouraging more issuers of Islamic capital market instruments; (ii) motivating the development of institutional investors in such instruments; (iii) encouraging the prudent participation of retail investors; and (iv) motivating market makers in such instruments with well-designed privileges and strong enforcement.

In Chapter Two, Dr Tomás J. Baliño elaborates on the current state of Islamic money markets in selected jurisdictions, including a comparison of the Islamic and conventional money markets, highlighting the issues to be resolved and concluding with possible solutions. The author makes five suggestions: (i) increasing the number of sovereign *Sukūk* issuances; (ii) the provision of tax neutrality for Islamic financial transactions, particularly those for short-term liquidity management; (iii) the standardisation of documents; (iv) facilitating the harmonisation of *Sharī`ah* interpretation; and (v) ensuring that ancillary services and infrastructure are in place to support and enhance liquidity. This chapter is written in coordination with the IFSB's *Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets* (March 2008).

In Chapter Three, Professor Barry Rider takes a closer look at the legl issues that arise in the development of Islamic financial markets in general, and the legal aspects of Islamic asset securitisation in particular. Dealing with these issues is crucial in ensuring the soundness and stability of the IFSI, particularly in respect of the expansion of liquidity management instruments and the development of the *Sukūk* market. Professor Rider begins with a discussion of the role of law in the development of financial markets. He then offers an analysis of the relevant legal issues in Islamic law relating to the creation and development of *Sharī`ah*-compliant financial instruments. Attention is then focused on the following main aspects: (i) ownership; (ii) effective and efficient transfer of ownership; (iii) insolvency; and (iv) taxation. The chapter also examines the role and significance of prudential standards. It concludes with recommendations for resolving legal and regulatory issues, with the author emphasising the need for detailed analysis of the sufficiency, suitability and efficacy of a host of legal rules and procedures for the development of viable markets and products.

In Chapter Four, the contributors summarise their recommended actions in the areas of Islamic capital markets, the liquidity management infrastructure, and the legal and regulatory framework for Islamic financial markets.

We are thankful to the Asian Development Bank and the Islamic Development Bank for kindly granting technical assistance that has enabled this research to be published. Thanks are also due to Abdelilah Belatik, Assistant Secretary-General, Siham Ismail and Kim Shin, members of the IFSB Secretariat, Dr Tomás J. Baliño and Dr Patricia Brenner for reviewing the chapters in the book and for their efficient management of the production of the book..

***Professor Datuk Rifaat Ahmed Abdel Karim***
***Secretary-General, IFSB***

# About the Contributors

**Dr Tomás J. Baliño** is Senior Associate of the Centennial Group in Washington, DC, where he has worked on financial sector issues, including financial sector integration, Islamic finance, and monetary and macro-prudential management. Until his retirement in 2007, he was Deputy Director of the Monetary and Capital Markets Department of the International Monetary Fund (IMF). In that position, he was successively in charge of the areas dealing with monetary policy, debt management, banking supervision and crisis management, and the IMF's program on financial sector stability and development. He supervised the production of the Guidelines on Public Debt Management, and ran the Financial Sector Assessment Program (FSAP), a joint IMF/World Bank programme. Other major assignments included financial sector reform in Eastern Europe and the former Soviet Union, Korea's financial sector crisis in 1997, and carrying out the FSAP assessments for Ireland, Korea, Germany, France and Spain. He has published many articles and books on issues such as banking crises, currency boards, monetary policy and financial stability.

**Professor John Board** is the Dean of Henley Business School, as well as managing the strategic and operational development of the School. He has a long record of interaction with financial markets and regulatory bodies in the United Kingdom, Europe and elsewhere. John has a particular interest in the development of Management Education in the aftermath of the financial crisis. Before assuming the position of Dean, John was Director of the ICMA Centre, University of Reading, with a record of success in academic innovation including the UK's first collaborative programme in Islamic finance and a significant professional development programme. His recent work includes studies of the development of financial markets in the GCC, as well as work in Islamic finance. John's teaching experience includes MBA and executive development in the UK, as well as in over 20 countries including Argentina, China, Russia, Malaysia, India, Kenya, Libya, Qatar and the United Arab Emirates.

**Dr Patricia Brenner** is a financial sector specialist and a Senior Associate with Centennial Group International, based in Washington, DC. Previously she was with the International Monetary Fund (IMF) (1982–2008) where she was a division chief, led Financial Sector Assessment Program (FSAP) missions to the United Arab Emirates, Hong Kong, Georgia, Kenya, El Salvador and several Central American countries, and participated in over 60 missions around the world. Before joining the IMF, she was an Assistant Professor of Economics at Williams College and Associate Professor of Economics at Grinnell College. She holds a PhD in economics from Stanford University and a bachelor's degree in foreign service from Georgetown University.

**Professor Barry Rider** has taught law in the University of Cambridge since 1976. He was Director of the Institute of Advanced Legal Studies of the University of London from 1994 until 2003 and has taught at a number of universities around the world. He holds doctorates in law from the University of Cambridge, the University of London, Pennsylvania State University and the University of the Free State in South Africa. He is a member of the English Bar and a Master of the Bench of the Honourable Society of the Inner Temple. He has also worked as a public servant and diplomat. He is currently counsel to the international law firm Bryan Cave LLP.

# Introduction

**Dr Tomás J. Baliño and Dr Patricia Brenner**

The rapid growth in Islamic banking, and more recently of Islamic capital markets and *Takāful* (Islamic insurance) products, has motivated policy-makers to address the challenges of fostering orderly expansion of the industry and ensuring its stability. While the share of Islamic finance in the global financial system is still small, it constitutes a significant and rising share of the financial sector in many countries and regions, providing an alternative to conventional finance, and competing with it. In addition, the global expansion of institutions offering Islamic financial services (IIFS) and their growing significance in several international and regional financial centres such as Singapore, London, Paris and Hong Kong have also highlighted the need to facilitate regional and international integration of the Islamic financial services industry (IFSI), and to help in developing an internationally competitive industry. Total assets of the Islamic banking industry are estimated to have reached about US$1 trillion by 2010, while total issuance of *Sukūk* – both global and national – could reach about US$200 billion.[1] The top 500 Islamic financial institutions listed by *The Banker* recorded total *Sharī`ah*-compliant assets of US$639 billion by end November 2008, reflecting a growth of 28% from a year earlier. While the industry has withstood the impact of the global financial crisis rather well, given its limited exposure to the sorts of structured products that undermined the conventional finance industry, the slowdown in the real economy and in the real estate markets has affected the IFSI's expansion and led to the postponement of many planned *Sukūk* issues. At the same time, the liquidity crunch in the conventional finance industry and the macro-prudential linkages that underlie the current crisis have raised questions as to whether the infrastructure for Islamic finance – including the legal, liquidity and supervisory infrastructure – is sound enough to cope with potential future crisis scenarios that may affect the IFSI.

In response, the Islamic Financial Services Board (IFSB) – an international organisation set up in 2002 to develop standards and guidelines for prudential supervision of the IFSI – has developed over the past six years a wide spectrum of standards, guidance papers and technical notes in pursuit of its objectives. The standards address a wide range of prudential and governance issues in Islamic financial services covering banking, capital markets and *Takāful* components.

In addition, the IFSB has actively sought to help members exchange experiences and develop strategies to further develop Islamic finance. This has included efforts to help member countries develop strategies for the industry's growth, and also to address specific impediments to the growth of the industry, such as the difficulties that IIFS face in managing their liquidity.[2]

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[1] If total assets of the Islamic banking industry would grow at the same rate as the last three years, they could reach about US$ 1.4 trillion by end-2012.

[2] An example of this is the "Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets", which the IFSB published in March 2008 (www.ifsb.org/docs/mar2008_liquidity.pdf).

The Asian Development Bank (ADB) and the Islamic Development Bank have supported this work in various ways, including through financing of the project summarised in this book. The project had the following objectives: (i) to facilitate implementation of strengthened prudential and supervisory standards for Islamic finance; and (ii) to foster the development of Islamic money and capital markets and their regional integration as a means to support Islamic finance development, as well as to provide the essential infrastructure for effective supervision.

The ADB retained the Centennial Group to provide consulting services for this project. The late Dr V. Sundararajan, Head of Centennial's Financial Sector Practice, was the coordinator of the team until he passed away in April 2010. The rest of the team of experts that prepared the paper has comprised Dr Tomás J. Baliño (who also replaced Dr Sundararajan as coordinator), Dr Patricia Brenner, Professor John Board and Professor Barry Rider.

The book is organised as follows: this Introduction concludes with an Executive Summary that presents the main findings and conclusions; Chapter One discusses key issues in the development of Islamic capital markets; Chapter Two discusses the issue of liquidity management from the perspectives of both IIFS and the central bank; Chapter Three addresses legal issues related to Islamic asset securitisation; and Chapter Four summarises the main recommendations arising from this study. The Appendix contains four country case studies that provide additional background.

# Executive Summary

The authors analysed the responses to the Survey Questionnaire that the IFSB sent to its members in April 2010, held discussions in Bahrain, Dubai, Indonesia, Malaysia and Sudan, and drew on various other sources of information.

The main findings of the team are as follows:

- The market for Islamic financial products has grown rapidly over the last few years.
- That growth has been helped by constant efforts made by market participants to develop new products, and by national authorities and international organisations to enlarge the market, remove legal impediments, reduce or eliminate taxes that effectively discriminate against Islamic finance, and develop monetary instruments and prudential criteria that take into account the peculiarities of Islamic finance.
- Despite those efforts, significant problems remain:
    - Some operations that are feasible in conventional finance cannot yet be carried out in a *Sharī`ah*-compliant way or require fairly complicated arrangements to do so, leading to higher costs.
    - Liquidity remains a problem for some of the most promising capital market instruments, such as *Sukūk*.
    - A number of legal issues (e.g. the rights of *Sukūk* holders in case of default) have not yet been fully sorted out.
    - Differences in legal documentation and on *Sharī`ah* interpretations facilitate market segmentation both domestically and internationally.
    - In some jurisdictions, tax systems still result in Islamic financial transactions being more heavily taxed than their conventional equivalents.
    - Lack of instruments to borrow and place liquidity for the short term still leads IIFS to hold larger non-earning liquid assets (such as cash or central bank deposits) than is the case for conventional institutions, thus putting them at a competitive disadvantage.

Addressing those issues will require further time and effort. A large part of what remains to be done (e.g. creating new instruments to compete more effectively with conventional institutions) will need to be done by market participants. However, national authorities and international organisations, such as the IFSB, other standard setters and international financial organisations, should support the private sector efforts in several ways. In this connection, the authors have developed some recommendations for the consideration of the IFSB and its members, which are summarised in the Box below and presented in more detail in Chapter Four.

**Main Recommendations**

- **Development of Islamic Capital Markets**
    - Countries should review their tax regimes to ensure these do not discriminate against Islamic finance
    - Encourage more corporate issuance
    - Develop benchmarks by expanding the maturity range and volume of sovereign *Sukūk* issuance in domestic and foreign currency
    - Encourage institutional investor participation through mutual funds and pension funds
    - Promote the establishment of market makers to enhance securities' liquidity
    - Strengthen regulations and supervision of standards on market integrity and corporate governance for issuers of both conventional and Islamic securities
    - **Indices and Ratings**
        - Facilitate the provision of information to the major global index providers in order to expand the coverage of existing Islamic equity indices
        - Require ratings for new Islamic security issues
    - **Development of Retail Market**
        - Promote competition among collective investments
        - Strengthen consumer protection regulations and investor education
        - Facilitate access by retail investors to Islamic financial products
- **Liquidity Management of IIFS**
    - Facilitate the liquidity management of IIFS by developing *Sharī`ah*-compliant central bank facilities and instruments, such as short-term *Sukūk*
    - Ensure that the tax system does not impose an extra burden on Islamic financial transactions – particularly those for short-term liquidity management
    - Promote standardisation of documents, ideally making them internationally acceptable
    - Facilitate the convergence of criteria for determining which instruments and transactions are *Sharī`ah* compliant
- **Legal Framework**
    - Regarding Islamic securities, the law should ensure in a *Sharī`ah*-compatible manner: a clear framework for creation, trading and settlement; proper reporting of financial and other relevant information; effective and efficient investor protection; proper separation of legal and beneficial ownership; administration of insolvent companies and businesses; recognition of fiduciary obligations; clarity of obligations of *Sharī`ah* boards and advisers
    - Reform legislation on the creation and transfer of rights in property – particularly real property – to facilitate the creation of viable *Sharī`ah*-compatible financial instruments
    - Facilitate standardisation of legal documents and procedures
    - Promote greater certainty on the application of *Sharī`ah* to issues that are currently controversial
    - Reinforce mechanisms to monitor *Sharī`ah* compliance, and clarify the enforceability of agreements in case of disputes, and the procedures for purifying tainted property and profits
    - Implement international standards on governance, and on market and transactional integrity
    - Clarify issues on the reliability of electronic documentation

# Chapter One

# Development of Islamic Capital Markets

**Professor John Board**

# Chapter One

# Development of Islamic Capital Markets

**Professor John Board**

This chapter examines the role of capital markets and the issues facing their development in terms of Islamic finance. It first outlines the role of capital markets, then moves on to Islamic finance and the key problems that often face the development of Islamic capital markets.

The bulk of the chapter then analyses the responses to the Survey Questionnaire and summarises the key challenges and possible solutions.

## *A. Capital Markets*

Capital markets are an important part of the global financial infrastructure. In contrast to the money market, where short-term fund-raising takes place, the capital market is where corporations and governments raise long-term funds. These funds are typically required for periods in excess of one year and take the form of both debt and equity. Thus, capital markets serve the core economic functions of:

- bringing together the suppliers of capital (savers and/or investors) and those requiring capital (firms or issuers);
- offering savers methods of transferring surplus cash from one period to the future, in exchange for a rate of return that reflects both time and the economic surplus generated by the capital supplied;
- offering firms methods of attracting investment funds at the start of a project's life in exchange for a return to investors that relates to the surplus generated by the project;
- risk allocation and re-allocation meet the differing needs of investors at various points in their life cycle; and
- pricing benchmarks which can be used to evaluate risk and so can be used to guide real investment decisions.

From a government perspective, therefore, well-functioning capital markets become a core aspect of economic development.

## *B. Islamic Capital Markets*

Islamic capital markets play the same role in the Islamic financial infrastructure as conventional capital markets – that is, they are used to raise large amounts of funds in the form of debt and equity securities. Islamic capital markets do, however, have to abide by restrictions on how the funds are raised, and the instruments are structured in such a way as to be in accordance with the prohibitions inherent in *Sharī`ah*; for example, they are not permitted to attract an interest charge or to be sold short. Islamic equity capital can only be raised for companies that are *Sharī`ah* compliant, and hence are not active in, for example, conventional banking and insurance, alcohol, pork, weaponry, gambling or adult entertainment.

Islamic capital markets are not generally segregated from conventional capital markets. Instead, Islamic financial instruments tend to be listed on the same exchanges as conventional securities and are often regulated under the same set of rules. This enhances transparency for the investors, as well as providing them with the comforting knowledge that the instruments are regulated. In the Middle East and Asian regions, however, it is more common to see additional regulations for *Sharī`ah*-compliant securities imposed, along with the other, generic, regulations. One of the most advanced Islamic capital markets can be found in Malaysia, where it functions as a parallel market to the conventional capital markets and is regulated by the Securities Commission. Many other countries have also identified the importance of Islamic capital markets and have started to define regulations to enable these markets to develop.

As noted earlier, there are two principal capital market instruments: debt and equity. Equity investments naturally conform closely to *Sharī`ah* requirements, in that they already represent a sharing of risk and return between the various investors. Thus, as long as the invested-in entity does not engage in non-compliant activities, and as long as its financial ratios are within the remit, there are no particular special treatments or organisational structures required for Islamic equity markets as compared to their conventional counterparts.

In complete contrast, interest-earning debt is prohibited by the *Sharī`ah*. As a result, many well-known contract forms have emerged to provide mechanisms that are not illegal in Islam and which bring suppliers of capital and those needing it together in ways that do not require the taking of a specific equity interest in the company concerned. Inevitably, the creation and design of these *Sukūk* instruments has attracted an enormous amount of academic and professional interest – as well as no little controversy. However, in recent years, these contract forms have become much more standardised and are widely understood, and the focus of attention is now shifting towards the efficiency of issuance and the promotion of secondary trading.

## *C. Issues Facing Capital Markets*

This section lists some of the key issues facing the growth of Islamic capital markets. Many of these will be common to all market types (i.e. both conventional and Islamic types):

- *Monitoring and regulating trading:* As markets grow in size and mature, the need to oversee them in order to prevent, for example, abuses such as insider trading, front running and other activities becomes more pressing and more difficult.
- *Fragmentation and consolidation:* Modern markets are almost exclusively electronic, with no physical marketplace at which all the participants must gather to trade. As a result, regulatory oversight becomes more difficult and, indeed, it becomes harder even to define the "market".
- *Liquidity:* Given the long-term nature of the capital raised (equity is, legally, generally[1] perpetual), it is important that investors have a way of exiting their

[1] There are many examples of this, but for a recent one see the International Capital Market Association's responses to the EU Commission's Markets in Financial Instruments Directive consultation at

position at a time of their choosing, and without destabilising the entity in which they invested. To do this requires an active secondary market in which the current price offered fairly reflects the current state of the entity. Promoting liquidity, particularly in corporate debt markets, is a major source of international attention. In most conventional markets, the main holders of bonds are long-term savings institutions that tend to buy-and-hold. This means that liquidity is generally limited and is found in only a few "benchmark" bonds; for other bonds, liquidity is limited to a short period immediately after issue. There is global interest in promoting liquidity in these markets, but solutions are hard to find and, with few exceptions (e.g. Italy and the United States), corporate debt markets remain relatively illiquid.

- *Transparency:* Many academic and professional researchers view transparency (the requirement that all investors have access to information both about the company and about trading in that company's securities) as an important way of demonstrating compliance and of generating additional methods of investor protection. However, it may be argued that there is an inverse link between transparency and liquidity, so that over-promoting transparency will damage liquidity.[2] This means that many markets deliberately offer more transparency in the more liquid markets (e.g. in the top equity shares) and less for others (smaller equities and debt markets).
- *Involvement of retail investors:* It is often seen as desirable to involve retail investors in the capital markets. The benefits include mobilising the savings of individuals to assist developing the economy, a greater feeling of participation and involvement in the economy for individuals, as well as broadening the range of participants (with different investment horizons and views) in the capital markets. Generally, it has proved easier to encourage retail involvement in equity than in debt instruments – equity is simpler to understand and offers considerable upside potential for retail investors. However, greater retail involvement also brings challenges in terms of the need to ensure that regulatory structures offer sufficient protection for less-sophisticated participants, as well as the need for more emphasis on investor education to ensure that retail participants are clear about the risks involved.

However, *Sharī`ah*-compliant securities face additional challenges:

- *The need to obtain religious approval for each issue, to confirm that the issue conforms to the requirements of Sharī`ah:* This process is straightforward, and usually automatic, for equity issues. However, for *Sukūk* the approval process can demand considerable knowledge of legal and economic structures before certification can occur. This places considerable demands on the availability and expertise of *Sharī`ah* scholars, and this has been seen as an impediment to the wider acceptance of Islamic finance. As will be discussed below, some jurisdictions (in particular, Malaysia and now Indonesia) have addressed this problem by establishing Central *Sharī`ah* Boards at the country level designed to make this process as smooth and low-cost as possible, while others (many of the Middle East markets) use firm-appointed experts. There is, however, also a need to have clear procedures in place for the eventuality where an asset is subsequently deemed to be non-*Sharī`ah* compliant. The survey suggested that in some jurisdictions such

www.icmagroup.org/getdoc/059ce9ab-3abf-4e10-9210-e3ca81d56db9/MiFID-Review.aspx (last visited 18 February 2011).

[2] For a reference, see the previous footnote.

an asset would continue to be enforceable, but other jurisdictions were less clear. This sort of uncertainty can be a major deterrent to investors (particularly where there are close substitute assets that do not have such uncertainties). Procedures are therefore required for (a) monitoring ongoing compliance and (b) allowing an orderly closure in the event of non-compliance.

- *Tax issues:* Most *Sukūk* involve quite complex sets of transactions between parties, and this can lead to high tax bills. (As tax is usually levied on transactions, the multiple transactions required by the *Sukūk* structure can attract far greater tax liabilities than would a similar equity or even conventional loan interaction.) Several jurisdictions have now addressed this issue and recognise that sets of transactions within a single *Sukūk* structure should face similar tax treatment to comparable conventional financial structures.
- *Issuance costs:* In principle, *Sukūk* are regarded, simply by their complexity, as more expensive to construct and maintain than their conventional counterparts. As a result, their yield would naturally be lower than on conventional bonds or loan instruments. However, as discussed below, many respondents to the survey thought that *Sukūk* and conventional bonds had similar issuance costs. Some jurisdictions (e.g. Malaysia) provide offsetting benefits (whether in tax treatment or otherwise) to ensure a level playing field from the investor's perspective between conventional and *Sharī`ah*-compliant issues.
- *Insolvency procedures:* Investment in commercial activities is risky, and occasionally ventures will fail. In the most developed markets, well-established procedures let investors and others know what will happen in the event of bankruptcy. This is important; without such procedures, failing ventures can limp on tying up investors' assets and preventing fresh investment. In less-developed markets, often the procedures are less clear. (Indonesia was a case in point, though it has made progress.) Or the process may be clear but the implementation is less strong – for example, in India, where (a) political pressures to prevent closure of failing companies and (b) long backlogs in the legal system delay action for long periods. Islamic finance is not inherently more risky than conventional finance, but it does have a risk of failure and so clear and effective processes are equally important. These (as the questionnaire responses show) are better developed in some jurisdictions than in others.
- *Absence of benchmarks:* Conventional finance relies heavily on precedent to establish prices and measure performance. As a relatively new concept, Islamic finance is inevitably short of benchmarks. In the equity market, the problem is conceptually simpler – conventional benchmarks are relatively easily re-engineered to meet Islamic needs – and the growth of Islamic stock indices has been considerable (see below). In debt markets, the problem is more difficult. As the questionnaire responses indicate, most Islamic debt instruments are benchmarked against conventional bond yields – typically, London Interbank Offered Rate (LIBOR) or similar. The sense from the questionnaire is that this solution, while inevitable at this time, is inherently unsatisfactory.
- *Yield curve:* In the conventional capital markets, the yield curve is constructed on the back of issues with different maturities, reaching far into the future. This has to date not been possible in the Islamic capital markets due to the fact that *Sukūk* are generally issued for the short term, with the vast majority issued in the five- to seven-year bracket. Only recently have issues with longer maturities been considered, but nothing long enough to be able to construct an appropriate yield

curve for *Sharī`ah*-compliant financing. The general absence of AAA-rated government issues is further damaging this position.

- *Regulation:* The current challenges for Islamic capital markets are strongly correlated with the level of maturity in the Islamic financial markets in general. Although strong growth has been achieved during the past ten years, at an estimated US$1 trillion globally, the overall global Islamic financial market is still relatively small. To put this number in perspective, the total balance sheet size of HSBC as of 30 June 2010 was US$2.4 trillion. The growth in the market has caused a situation in which regulations have generally been lagging behind the actual state of the market. Although this is generally the case in the global financial markets, the impact is more severe for Islamic capital markets due to the fact that the pace of change is significantly higher.
- *Size of institutions:* Institutions offering Islamic financial services (IIFS) are generally relatively small compared to conventional institutions, which makes their ability to arrange and underwrite large issues on behalf of clients difficult, and in some cases impossible. To an extent, this can be overcome by partnering with conventional institutions with large distribution and structuring capabilities.
- *Product innovation:* As more appropriate product structures become available in the market, earlier product types fall out of favour. One of the prime examples of this is the application of the commodity *Murābahah.* Still one of the mainstays of interbank liquidity for IIFS, it is also considered to be a less desirable structure due to the fact that the underlying asset is purely traded for the purpose of providing funding for an unrelated project. Although it is sometimes the only available instrument, scholars prefer banks to move away from this instrument where possible in favour of other, more appropriate instrument types such as, for example, *Sukūk*. Many banks buy *Sukūk* to obtain a return on excess liquidity and have no inclination to sell before maturity. In addition, earlier issues (in particular) were generously priced, which provided yet another reason not to liquidate the position unless there is a strong requirement to release funds. As a result, the secondary market in *Sukūk*, which is one of the major capital market products, has not developed as far as it should have.
- *Investor education is a challenge in all capital markets:* Without adequate knowledge, investors, specifically less-sophisticated investors, may get drawn into financial products that are unsuitable and which they do not fully understand. Aside for the issues of morality, which are, of course, important, failures in education leading to losses tend to create political storms and invite government intervention.

The issues mentioned above were covered in a Survey Questionnaire on Islamic capital markets operations, coordinated by the Islamic Financial Services Board (IFSB). The survey results were supplemented by a series of country visits. The following sub-sections discuss the results. Thus, a key part of the inquiry was the analysis of the responses to the Survey Questionnaire submitted by market participants, lawyers and regulatory bodies in relevant jurisdictions. (The questionnaire for regulatory bodies and lawyers was different from that sent to IIFS, reflecting their different perspectives.) The questionnaires were detailed – some 62 qualitative questions and five quantitative questions for IIFS covering the following aspects of Islamic capital markets:

- legal and regulatory infrastructure;
- Islamic financial services and products (including securitisation);
- monitoring of *Sharī`ah* compliance;

- primary issuance – disclosure, benchmark prices, costs and taxation;
- organisation of the secondary market and market intermediaries; and
- professional training and investor education.

The survey covered 20 countries where Islamic products are important or potentially important. The response rate was good for a survey of this type, particularly given the level of detail requested (see Table 1.1). This was especially true of the IIFS. The response rate from regulatory and supervisory authorities was lower, but since the responses of the regulatory and supervisory authorities, legal firms and IIFS cover similar ground from different viewpoints the low supervisor response was not deemed to be a critical problem.

**Table 1.1 Responses to Islamic Capital Market Survey Questionnaire**

| Country | IFI | Legal firms | Capital market supervisors |
|---|---|---|---|
| **Brunei** | 1 | | |
| **Indonesia** | 6 | | |
| **Iran** | 1 | 1 | 1 |
| **Jordan** | 2 | | |
| **Kuwait** | 7 | | 1 |
| **Malaysia** | 21 | 2 | 1 |
| **Maldives** | | 1 | 1 |
| **Pakistan** | 16 | | |
| **Qatar** | 9 | | |
| **Singapore** | | | 1 |
| **Sudan** | 17 | | 1 |
| **Syria** | 2 | 1 | |
| **UAE** | 2 | 1 | 2 |
| **Total** | **84** | **6** | **8** |

No information was received from some countries, and therefore the chapter will not be able to cover those countries. In some other cases the responses were few, which makes it harder to draw firm conclusions.

Within each country the responses frequently showed considerable diversity, both between the views of the regulatory and supervisory authorities and IIFS, and among IIFS. This is to be expected in questions asking for opinions, but often the diversity occurred in questions of fact. In practice, we took this as reflecting a level of confusion, which, in turn, reflects the rapidly developing and changing field of Islamic finance and especially of Islamic finance regulation. In contrast, the diversity between countries is probably a key reflection of the different levels of development in Islamic finance, which is a key finding of this research.

The structure of this commentary follows the six headings already described and gives a commentary on the inter-country diversity. We have sought to summarise the views of market participants – the IIFS, the lawyers and the regulatory authorities.

### i. Legal and regulatory infrastructure

These questions examined:

- segregation of funds – a common requirement in the regulation of conventional financial firms;
- cross-border legal issues; and
- whether there is or should be special regulation for Islamic finance.

IIFS operating in four jurisdictions (two in the Middle East and two in South-East Asia) saw it as usual practice (or a regulatory requirement) to separate client funds from the firm's funds. However, responses from other countries suggested that this was either a commercial decision – especially if the firm wished to attract international investors – or the security of funds could equally be attained by using Islamic structures.

The question of whether the regulation of Islamic finance should be different from that for conventional finance has been a continuing issue. The regulatory and supervisory authorities in the most developed capital markets responded that the regulatory requirements for conventional and Islamic finance were identical. Others responded that there were differences. The IIFS were nearly unanimous in saying that regulatory requirements should take full account of the particular features of Islamic financial products. Roughly a third of IFI respondents felt that the actual standards were different, though the standards imposed on financial intermediaries (minimum entry standards and capital adequacy) were the same.

Continuing the theme of comparing the treatment of *Sharī`ah* and non-*Sharī`ah* financial products, the responses in this section indicated the existence of special, Islamic laws for banking and financial services business. Most jurisdictions covered indicated that there were special provisions in banking laws. This was also true of accounting and financial reporting obligations. However, specific Islamic legal structures for the incorporation of companies were far less common. Special taxation provisions were also less common: they applied to securitisations in only some respondent countries, and in a couple of cases to allow the underlying sales of assets or leases motivated by financial transactions to be tax exempt.

Overall, respondents felt that the regulatory environment was reasonably supportive: with a range of 1 (very supportive) to 5 (not at all supportive), most responses were in the 2–3 range. However, there was strong agreement across all respondents that greater contract standardisation would be very beneficial for the development of Islamic finance.

The responses showed considerable confusion on questions related to securitisation, with many countries showing differences of opinion on straight factual questions such as the legality of trust structures. This was particularly true of Middle Eastern and African markets. The general consensus among IIFS in a number of the respondent countries was that they have legal structures supporting trust structures (whereby legal and beneficial ownership can be legally separated). However, respondents in other countries were either less clear or were positive that such arrangements were not permitted. The regulatory and supervisory authorities' answers suggested that less than half of the respondent countries permitted trusts. As could be expected, at the more detailed legal level, the level of development of the securitisation market went hand in hand with a more developed corpus of law on true sale and related points.

Insolvency and work-out provisions are crucial factors in the success of markets for debt instruments. Regulator responses suggest that four countries had clear legal structures in those areas. There were similar responses to a wide range of insolvency/corporate accountability issues and provision of credit information.

IFI and regulator respondents were generally sanguine about the impact of a 2008 default by a US *Sukūk* issuer and did not agree that it would have a significant effect on *Sukūk* issuance by conventional issuers; nor did they think it would affect the perception of legal risk of *Sukūk*.

Acknowledging the risky nature of any investment products, including Islamic products, the respondents reported that their jurisdictions had special laws governing the sale of investment products to retail investors.

### ii. Islamic financial services and products

In almost all respondent countries, there are regulations governing access to securities-related business areas. The permissibility of banks engaging in securities-related business varies, but the more significant markets generally permitted banks to transact such business – subject, in most jurisdictions, to regulations requiring segregation of activities and separation of monies.

In most jurisdictions the banking laws have specific Islamic-finance-related provisions. This is less frequently true for securities-related business.

IFI respondents were asked which key Islamic capital markets products were available in their country. This range varied considerably, to a great extent reflecting relative levels of financial development. *Sukūk* are available in all but two jurisdictions. Islamic stocks (equities) supported by indices are also available in all but (a different) two jurisdictions. Collective investments (mutual funds) are available in the most developed markets. Other, more specialised products – such as real estate investment trusts (REITs) and derivatives – are not commonly available but exist in the more sophisticated markets.

When asked about the degree of importance in developing their Islamic capital markets, most IFI respondents saw *Sukūk* and Islamic stocks as the most important (1 = most important) (see Figure 1.1). Islamic collective investments and the Islamic indices that provide benchmarks for collective investments were generally seen as the next priority, with REITs and derivatives being seen as least important.

**Figure 1.1 Importance of Islamic Products**

| | Qatar | Pakistan | Indonesia | Malaysia | Kuwait | UAE | Brunei | Sudan |
|---|---|---|---|---|---|---|---|---|
| Islamic stocks | 2 | 1 | 3 | 1 | 1 | 2 | 4 | 1 |
| Islamic indices | 2 | 2 | 3 | 2 | 2 | 2 | 4 | 2 |
| Islamic collective investments | 3 | 2 | 3 | 2 | 2 | 3 | 4 | 2 |
| Islamic REITs | 3 | 3 | 4 | 2 | 3 | 4 | 3 | 3 |
| Islamic derivatives | 3 | 4 | 5 | 2 | 3 | 3 | 3 | 2 |
| *Sukūk* | 2 | 1 | 2 | 1 | 1 | 2 | 1 | 2 |

IIFS were asked what Islamic finance activities they actually undertake. The responses were not structured, and in some countries the responses were too few to be representative. But where there were data, there was sufficient detail to indicate the range of Islamic finance activities (see Table 1.2). The range is clearly wide, and institutions in the major markets offer a comprehensive package of financial products for their markets.

**Table 1.2 Range of Islamic Finance Activities of IFIs**[3]

| Qatar | Pakistan | Indonesia | Malaysia | Kuwait | Sudan |
|---|---|---|---|---|---|
| Retail & corporate Islamic banking | Retail & corporate Islamic banking | Retail & corporate Islamic banking | Retail & corporate Islamic banking | Retail & corporate Islamic banking | Retail & corporate Islamic banking |
| *Sukūk* issuance | *Sukūk* issuance | *Sukūk* issuance | *Sukūk* issuance | *Sukūk* issuance | *Sukūk* issuance |
| | Trade finance | | | Trade finance | Trade finance |
| *Ijārah* | *Ijārah* | | *Ijārah* | *Ijārah* | *Ijārah* |
| *Murābahah* | *Murābahah* | *Murābahah* | *Murābahah* | *Murābahah* | *Murābahah* |
| | *Wakālah* | | *Wakālah* | *Wakālah* | *Wakālah* |
| Treasury | | Money market | Treasury | | |
| | Investment in *Sukūk* | Trading Islamic bonds | Cash management & ALM | | |
| | Forex | Forex | Forex | | |
| Mutual funds | | | Asset management | | |
| Structured finance | Capital markets | | | Capital markets | |
| | | | Private equity | Real estate | |
| *Takāful* | | | | | |

(Note that there is a potential ambiguity in the table because the responses as *Murābahah* and *Wakālah* are generally used for both retail and interbank liquidity structures.)

IIFS operating in countries with substantial cross-border business were relatively highly aware of the need for contractual clarification of legal jurisdiction. Predictably, this was less of an issue for IIFS in countries where business is more exclusively domestic.

### iii. Monitoring of *Sharī`ah* compliance

*Sharī`ah* compliance for financial services, of course, relates to both the structure of the product and to the underlying business. In terms of standards for the underlying business, there was considerable unanimity across jurisdictions as to what was prohibited, with only minor differences about the acceptability of weapons-related activities. However, despite these similarities there was a widespread view that differences in screening methodologies would prove to be a barrier to cross-border transactions – and so a barrier to development of the market.

[3] This table has been prepared on the basis of the responses received from institutions offering Islamic financial services (IIFS); that is, there may be products that exist but that IIFS might have omitted in those responses.

Most jurisdictions have guidelines for *Sharī`ah* compliance. Five of them reported having set a legal requirement for IIFS to have a *Sharī`ah* supervisory/advisory board to evaluate each new financial product. Responses from IIFS confirmed that the norm for Islamic products is to require a *Sharī`ah* advisory board to evaluate each new product, and in most of the countries covered this information was provided to potential investors in offer documents. Eligibility and qualifications of advisory board members are controlled by regulations or guidelines in some jurisdictions. However, except in four jurisdictions, there are no national advisory boards at the national capital markets regulator level. The absence of formal structures to ensure consistency of *Sharī`ah* advisory board rulings can lead to differences in opinion that reduce competition and facilitate market segmentation, as instruments and operations acceptable to some institutions may not be acceptable to others. More generally, the *Sharī`ah* screening processes do not seem to be strongly subject to inspection by the national regulator. Most jurisdictions showed a wide range of responses as to the frequency of regulatory monitoring, suggesting that, to the extent that it happens, it is not seen as very significant by market participants. Regulator responses confirmed that monitoring of these processes by the regulator is rare. Furthermore, IFI responses suggest that most jurisdictions lack formal structures for maintaining and updating the *Sharī`ah* compliance of particular products.

Generally, all types of respondents felt it was fully possible to cleanse income streams to ensure *Sharī`ah* compliance, but none of the responding countries appear to have rules defining how that should be done.

Enforceability of terms on financial products which are subsequently deemed not to be *Sharī`ah* compliant appears to exist in only two jurisdictions.

### iv. Primary issuance – disclosure standards, benchmarks pricing, costs and taxation

Disclosure requirements are mainly in line with those for conventional products. All responding regulatory and supervisory authorities agreed that there were legal and regulatory requirements for disclosure applying both to initial offerings and to continuing disclosure. Most IFI respondents were reasonably satisfied as to the adequacy of actual disclosures – that is, the enforcement of disclosure requirements. Respondents were asked to rate the extent to which the requirements provide a satisfactory means of informing various types of investors, with 1 being very satisfactory and 5 being very unsatisfactory. In general, respondents scored 2.5 or lower, suggesting general satisfaction.

In terms of specific *Sharī`ah*-linked disclosures, the requirements vary; however, the most widespread requirement was for information relevant to:

- the names of *Sharī`ah* advisors/board members;
- the *Sharī`ah* compliance of a product; and
- the structural and legal features of *Sukūk.*

Information on contingent strategies to address the possibility of future non-*Sharī`ah* compliance was not available, except for one jurisdiction in South-East Asia, which indicated that the offering document should disclose such strategy. This is consistent with the response noted above that there was a lack of formal processes for ongoing monitoring of *Sharī`ah* compliance.

All jurisdictions, except one, use conventional benchmarks in pricing *Sukūk* issues. Benchmarks varied from LIBOR through local interbank rates to local (conventional) government bond yield curves. In three countries in Asia, private *Sukūk* are (like conventional bonds offered to the public) required to have a credit rating. In another jurisdiction, an *Ijārah Sukūk* is required to gain a credit rating before issuance.

In most countries the perception was that the ex-tax costs of issuing a *Sukūk* were only marginally higher than for conventional bonds, or indeed there was no difference, but in at least one jurisdiction in the Middle East costs appear to be significantly higher. Such higher costs as exist largely arose from additional documentation requirements and the costs associated with *Sharī`ah* compliance – one respondent estimated the *Sharī`ah* compliance costs to be the equivalent of US$6,000 to US$16,000. Another respondent in South-East Asia observed that tax benefits actually reduced the cost to below that for conventional bonds.

Only four countries reported having specific tax arrangements for some or all Islamic products. Two of these – in South-East Asia – have indicated that they have modified their legislation to avoid the double taxation which can arise when the underlying assets are transferred in setting up an Islamic vehicle or in executing the sales and purchases of commodities incidental to some *Sharī`ah*-compliant financial operations. The rationale for such treatment has been to level the playing field between conventional and Islamic banking, albeit in one case the development of Islamic banking is also a motive.

### v. Organisation of the secondary market

This section discusses the liquidity of the secondary markets. There are two aspects to secondary market liquidity: (a) the liquidity of medium- and long-term *Sukūk,* which – like conventional bonds – are unlikely ever to be very liquid; and (b) the liquidity of Islamic equities, which, at least potentially, could be highly liquid.

All respondents across all countries agreed that the limited range of issues and investors was a significant factor in illiquidity. While true, this does not add much to the debate since it raises the proverbial chicken and egg problem: issuers will only issue when there are buyers, buyers will only buy if there is a market where they can sell, etc. The important question from a market development viewpoint is whether there are factors such as market structure, regulation or taxation, which are under the control of the authorities and which, if improved, can encourage liquidity to develop. We return to these questions in subsequent sections. At the most fundamental level, all the responding regulatory and supervisory authorities reported having regulations to prohibit market abuse and fraudulent transactions involving Islamic securities. They also have regulations requiring disclosure of large holdings.

Malaysia showed itself as having the most developed secondary market infrastructure – with both a primary dealer system (to support its sizeable and developed government bond market) and a reasonable level of real-time information on market conditions.

A number of such possibilities were discussed in the questionnaire and responses are summarised in Figure 1.2. (1 indicates that respondents placed a high importance on this factor, and 5 indicates low importance/no importance.) The results summarised in the figure are not especially encouraging for the view that market changes could make a fundamental difference to liquidity, as with few exceptions the respondents placed no more than average importance on these factors. However, the development of collective products – mutual funds and pension funds – is seen as important.

**Figure 1.2 Improving the Secondary Market**

| | Qatar | Pakistan | Indonesia | Malaysia | Jordan | Kuwait | UAE | Brunei | Sudan |
|---|---|---|---|---|---|---|---|---|---|
| Central liquidity provider | 3 | 2 | 2 | 2 | 3 | 2 | 3 | 3 | 2 |
| More retail participation | 3 | 2 | 3 | 3 | 2 | 3 | 3 | 2 | 2 |
| Greater transparency | 3 | 2 | 2 | 2 | 1 | 1 | 3 | 3 | 1 |
| Islamic collective investment schemes | 3 | 2 | 2 | 2 | 2 | 1 | 4 | 3 | 2 |
| Islamic pension funds | 2 | 2 | 2 | 2 | 3 | 1 | 3 | 3 | 2 |

A number of respondents added comments that reiterated their view that liquidity was stifled by the small number of products and participants. This was supported by a response indicating that most respondents saw a lack of market participants, rather than a lack of competition between market participants, as a weakness of the market.

However, the tenor of comments suggested that respondents were mainly talking about *Sukūk* secondary markets. While *Sukūk* are not the same as conventional bonds, they do have many of the features of conventional bonds, which make them (a) tend towards illiquidity and (b) not very attractive to retail participants:

- bonds are essentially savings products and so compete with other retail savings products;
- lower volatility than equities and limited upside potential;
- tendency for institutional investors to buy and hold;
- large number of issues (compared to equities); and
- technical complexity.

In most conventional markets, the main holders of bonds are long-term savings institutions that tend to buy-and-hold. Thus, liquidity is generally limited to a few benchmark bonds and, for other bonds, the period immediately after issue.

### vi. Professional training and investor education

Training and education are key factors in the development of capital markets. A number of regulatory and supervisory authorities responded that these were available. However, the responses of IIFS suggest that only a minority of respondent countries had taken serious steps to provide for these needs, including through regular investor education programmes.

***Summary***

| | |
|---|---|
| Legal and regulatory infrastructure | • Should be the same for conventional and Islamic – but the structures do differ in most respondent jurisdictions.<br>• Regulatory regimes generally supportive of Islamic finance. Malaysian respondents were the most positive on this.<br>• Securitisation responses showed confusion – probably reflecting its low penetration among the responding countries. The degree of development of the securitisation markets is reflected in their legal structures.<br>• Legal structures for insolvency are clear in the more developed markets, but elsewhere they are less clear.<br>• The 2008 default of a US *Sukūk* was not seen as likely to do long-term harm to the development of Islamic finance.<br>• The great majority of jurisdictions indicated that they have laws to protect retail clients. |
| Islamic financial services and products | • Entry to securities-related business is regulated. In the most developed markets, banks are permitted to conduct securities business.<br>• All but two responding jurisdictions offered Islamic stocks and *Sukūk*. Most offered collective investments. Other products were less widely available, with no more than two jurisdictions offering the full range, including derivatives.<br>• IIFS offer a wide range of Islamic products in the major markets. |
| Monitoring *Sharī`ah* compliance | • Most jurisdictions have guidelines for *Sharī`ah* compliance, and a majority of responding jurisdictions have legal requirements for advisory boards. Some have eligibility criteria for *Sharī`ah* board members.<br>• The range of economic activities that are not permitted is very similar across all responding jurisdictions.<br>• It is possible and acceptable to separate out the non-*Sharī`ah*-compliant elements of an income stream (e.g. |

| | |
|---|---|
| | equity dividend payments), leaving a compliant income stream.<br>• Current *Sharī`ah* screening processes are not subject to much regulatory scrutiny in most countries and there is an absence of formal, regulatory processes to monitor ongoing compliance. In many jurisdictions, financial transactions that turn out to be non-*Sharī`ah* may not be enforceable. |
| Primary Issuance | • Disclosure requirements are in line with those for conventional products.<br>• Most IFI respondents felt that actual disclosures were reasonably adequate.<br>• Most jurisdictions require disclosure of the *Sharī`ah*-compliance process, but it is rare to require details of ongoing monitoring or for the offering document to disclose contingent strategies to address the possibility of post-sale *Sharī`ah* non-compliance.<br>• Conventional benchmarks are almost universally used for pricing *Sukūk* issues.<br>• Most jurisdictions did not have special tax rules for Islamic products. However, four have special tax arrangements to avoid disadvantageous taxation of Islamic products, and one indicated that development of the Islamic segment was an additional reason for those arrangements. |
| Organisation of the secondary market | • The main current problem is non-availability of Islamic assets and a scarcity of investors.<br>• All jurisdictions have basic rules to prohibit market abuse and securities fraud.<br>• Developing Islamic collective investments – mutual funds and pension funds – is seen as the best way to develop the secondary market. |
| Professional training and investor education | • Essential – but few jurisdictions have made significant progress. |

### vii. Issues facing Islamic capital markets

This section returns to some of the "issues" first raised in earlier sections in light of the questionnaire responses above and discussions on the team's site visits.

The striking feature of the responses summarised above and expressed very vocally at the site meetings is that very great progress has been made over the last five years in many jurisdictions. In particular:

- Tax issues connected with Islamic financial products have been recognised in all jurisdictions and have been largely addressed to the satisfaction of market participants in the majority of them. For those countries that may still have tax reforms to enact, there are now ample precedents for the changes required; all that remains is the political will to implement them.
- The main recent developments in Islamic capital markets are applicable to the Islamic financial industry as a whole and are associated with an increasing demand for standardisation globally. Although some scholars are sceptical about this, as they fear it will diminish the role of *Ijtihad* and therefore hamper innovation,[4] these are challenges that will need to be overcome to further enhance the Islamic financial industry as a whole. Increased standardisation will reduce transaction costs, and enhance transparency in the markets. The current move by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to subject scholars to clearer guidelines and the IFSB's *Sharī`ah* Governance Guidelines should both, therefore, be seen as a welcome attempt to assist the industry as a whole to move forward.
- Complexity of product has also been addressed, not by simplifying the products but simply by using them repeatedly. This means that the structures become commoditised and, rather like conventional bonds or equities, "off the shelf". This has major, and beneficial, implications for the cost and usage of the instruments. The market for securitised debt gives a good example (despite the recent, serious problems at its more exotic end). At first the process of securitisation was very complex, requiring detailed (and expensive) legal opinions on true sale and bankruptcy remoteness. Over time the process became standardised and the legal costs associated with issues were reduced substantially. Complexity of documentation is being actively addressed by international organisations, often in collaboration with conventional agencies. While far from complete, these projects demonstrate awareness of the need for standardisation and are being progressed as swiftly as is feasible. It is to be expected that, once introduced, such documentation will be widely adopted over a short period.

The above discussion reflects the steady progress that has been made over the last decade. Simply stated, *Sharī`ah*-compliant securities – both their structure and their regulatory needs – are now well understood. In addition, as the promotion of *Sharī`ah*-compliant banking in all its forms is seen as a major national benefit, there is generally considerable government willingness to make such further changes as may be required.

It is reassuring indeed that the major Islamic-only issues have been so successfully addressed and that the largest outstanding issue remains that of liquidity – a common concern across all markets. This problem is discussed in detail in the following section of the report. Some of the "Islamic concerns" discussed above (e.g. bankruptcy laws) are

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[4] See, for example:
www.gulftimes.com/site/topics/article.asp?cu_no=2&item_no=390152&version=1&template_id=48&parent_id=28 (last visited 17 February 2011); and
http://blogs.reuters.com/faithworld/2008/11/12/sharia-scholars-oppose-more-regulation-on-islamic-finance/ (last visited 17 February 2011).

discussed further in this section – the reason being that, like bankruptcy law, they affect liquidity in both conventional and Islamic markets.

### viii. Liquidity – a cause for concern

The lack of liquidity in the Islamic capital markets remains one of the main concerns for banks, investors and fund managers. The authors regard this as the single most pressing issue – but also one of the most intractable. A lack of liquidity generally results in:

- higher volatility in pricing – as small changes in supply or demand will induce disproportionately large changes in price;
- wide spreads as dealers demand larger premia for the risks they undertake, although the current trends are starting to show that bid/ask spreads for *Sukūk* are coming more in line with spreads for comparable instruments in the global financial industry; and
- the inability of investors to exit their positions at fair prices. This will clearly cause a cycle in which new investors are deterred from entering the market because of their fear that exit will also be difficult.

All of these concerns lead to higher costs for issuers, lower real investment and, consequently, slow the real growth of the economy, to the extent that it relies on this type of financing.

It should be noted that liquidity is generally regarded as "satisfactory" in a relatively small number of markets worldwide:

- large stocks (often the largest 200-odd) on large equity markets (e.g. London, New York, Tokyo);
- a number of government bonds across a relatively restricted part of the term structure; and
- corporate bonds in a small number of countries (principally in the US).

However, liquidity remains a significant concern for smaller-capitalisation equities worldwide, all equities on smaller exchanges (including those in many parts of the Islamic world), corporate bonds and *Sukūk* worldwide, and some government bonds.

As noted above, the size of the *Sharī`ah* market is, in global terms, small (irrespective of the rates of growth) and this will hinder participation rates. Equally, for a variety of reasons, these markets tend to be in countries that are either emerging or are recently emerged. In turn, this means that investor awareness of securities markets in general may be limited.

As noted, illiquidity is very difficult to address and there are very few instruments in the hands of either governments or regulatory and supervisory authorities to increase it. However, some of the possibilities are discussed next.[5]

[5] The discussion is couched in terms of Islamic debt instruments. Islamic equity instruments present a slightly different situation, since Islamic equities are a sub-set of conventional equities rather than a separate asset class. Many equities that are *Sharī`ah* compliant will have substantial and liquid markets involving both conventional and Islamic investors. That said, many of the equities in, for example, Gulf Cooperation Council states are relatively illiquid not because they are *Sharī`ah* compliant but because they are small or otherwise unable to support liquid markets. For these, the discussion on encouraging market makers, attracting institutional investors, etc., is equally as valid as for debt instruments.

### Increasing *Sukūk* issuance

Before deciding to issue a *Sukūk*, an issuer answers two questions:

1. Why issue debt securities – as opposed to using retained earnings, issuing equity or going to a bank?
2. Why issue *Sukūk* rather than conventional bonds?

The first question is beyond our scope but has to do with the target capital structure for the issuers, taxation and the relative costs of capital. The decision between *Sharī`ah* and conventional may be driven by ethical considerations – some issuers may choose to issue *Sharī`ah*-compliant securities in all circumstances irrespective of the relative cost. However, experience of issuers suggests that most see cost of capital as the key issue, since they have obligations to their stakeholders to achieve the best possible arrangement. But many issuers prefer *Sukūk* finance if it is available at a cost that is not dissimilar to the cost of conventional bonds. Therefore, for *Sukūk* to become more widely used – which is essential for greater liquidity – they must involve a similar to all-round cost (running cost plus issuance cost) to conventional bonds. Thus, the issue is whether this is possible.
Running costs of *Sukūk* can be lower, at least in the short term, because they can have a lower yield than conventional bonds, for a number of reasons:

- They access a group of investors who have a strong preference for Islamic investments and therefore do not have access to conventional bonds. This includes retail investors directly, or (equally importantly) as indirect investors through collective investment schemes (CIS). There are major opportunities for drawing a large population of retail investors who currently have few investment choices into *Sharī`ah*-compliant CIS – mutual funds and insurance companies. In this context, it is also worth noting the continued interest among the governments of non-Islamic countries in tapping the Islamic investor market through issuance of *Sukūk*.
- *Sukūk* may be given special advantages – for example, the Malaysian government assists *Sukūk* though advantageous taxation. That government has also given a major push to *Sukūk* issuance through the use of *Sukūk* to finance its government-backed (and guaranteed) residential mortgage vehicle, Cagamas.

Issuance costs are currently reckoned to be higher for *Sukūk* than for conventional bonds. While survey respondents said that the difference in cost was not high, any difference in costs – and debt market costs are measured in very small increments – will deter issuers. We note elsewhere that, other things being equal, the overhead of establishing and monitoring *Sharī`ah* compliance would make costs of issuing *Sukūk* higher than for conventional bonds. However, the expectation is that this will even out over time. It is worth noting that in the early years, (conventional) securitisation was extremely expensive. The legal costs involved in establishing a true sale were very considerable. Each transaction was, in essence, a totally new venture and so could not draw much on the work already done for previous transactions. In some ways the problem for securitisations was the same as that for *Sharī`ah* compliance: both require an unarguable opinion from experts who may be in short supply and who may not fully understand the financial implications of their opinions. Over time, with securitisations the supply of experts increased, the requirements became more standardised and costs fell. The fall in costs led to a virtuous circle, where more issuance led to further economies of scale and further reductions in cost. It would be quite surprising if a similar process did not occur for *Sukūk* issuance.

Thus, standardisation associated with increased transparency and greater understanding of the underlying instruments will ensure that more participants will be attracted to the market. This will drive down the costs associated with issuance of Islamic products. Standardisation and reduced costs will have a positive effect on the development of the Islamic capital market. There are further all-round advantages if issuers avoid making small issues. Among conventional issuers there has been a tendency to issue multiple small bonds each with specialised characteristics. As well as incurring higher issuance costs per unit (many issuance costs are not variable with the size of the issue), small issues are more likely to be highly illiquid. In recent years, most sovereign issuers have become aware of this and now re-open existing bonds to issue more rather than starting an entirely new bond. Many regulatory and supervisory authorities assist this by allowing shelf-registration, whereby a bond issue is approved up to a maximum amount to be issued as a series of tranches when market conditions are most favourable. It seems possible to do the same for *Sukūk*.

Issuers need good pricing benchmarks if they are to be confident that the yields they offer on new *Sukūk* are appropriate. The lack of benchmarks can best be addressed by an increase in the number of government issues, either in local or foreign currencies. Government bonds form the basis of a capital market by providing the necessary benchmarks, whether conventional or Islamic. Often governments regard the government bond market as something that is only useful if the government wishes to borrow money. A number of Islamic countries are in fiscal surplus and so there is no financing need to develop the government bond market. However, this misses the key role of the government bond market, which is (as the risk-free standard) to be the benchmark for the rest of the capital market. Indeed, some countries – for example, Norway and Australia – maintain their government bond market solely for this purpose. Government bond markets can best help the further development of an international Islamic capital market by issuing a range of AAA locally rated,[6] local currency, USD- or EUR-based securities across a range of maturities. The availability of a wider range of instruments will stimulate the secondary market and reduce volatility as well as transaction costs. As well as locally issued instruments, there is strong interest among international organisations and governments (including those of some non-Islamic countries, such as the UK, France and Germany) in issuing *Sukūk* to tap the growing wealth in Islamic markets.

### Encouraging the development of institutional investors

In developed markets, institutional investors – mutual funds, pension funds and insurance funds – are dominant in the capital market. The funds they manage are massive and have been a key factor in the development of liquidity. While there has been some development in Islamic mutual funds, as shown by the questionnaire responses, there is a major gap in defining the concept of an Islamic pension fund. Among the Islamic countries, Malaysia has successfully developed a range of institutional investors and Indonesia is working towards that goal. These funds invest in both bonds and equities, and there is no reason for them not to become substantial investors in Islamic assets. Currently the global Islamic fund management industry is still relatively small – estimates[7] at the end of 2009 suggest

[6] Local (domestic) credit rating agencies generally give domestic government bonds an AAA rating, indicating that in local currency terms their credit status is very high. International agencies will give a country a rating based on its estimated ability to repay foreign currency debt – which is often less than AAA.
[7] *Islamic Finance Opportunities: Country and Business Guide* (KFH Research Ltd), October 2010.

671 funds managing a total of US$52.3 billion[8] [9] – but the longer-term potential is very considerable.

Institutional investors may be locally developed or may be part of major, international groups. Either way, there are a number of factors that encourage their participation (or if absent, will certainly deter it):

1. *Market integrity:* Institutional investors tend to be deterred by markets that are perceived as not clean in the regulatory sense – that is, where market abuse is common. Such markets tend to attract only the most speculative type of participants – especially hedge funds – which are willing to accept the high risks for the promise of very high returns. Many of the respondent countries already have regulations prohibiting market abuse, though international experience suggests that enforcement can be difficult to achieve to an acceptable standard. This is a challenge for developing markets irrespective of the type of asset – that is, conventional or Islamic.
2. *Bankruptcy clarity:* As mentioned, procedures are not always clear in developing markets, and particularly so with respect to Islamic finance assets which present particular problems. It had been believed that Islamic assets might have special features that made them less subject to failure, but some high-profile defaults and the general atmosphere of international finance have shown that those assets were subject to the same fears as conventional assets. Thus, *Sukūk* issuance slumped in 2008 along with issuance of conventional debt and became focused on the most secure issues – sovereign debt of the most stable issuers, Malaysian issues, accounted for 54% of issuance in 2009.[10] Responses to the questionnaire suggested that bankruptcy procedures were less than perfect in a number of Islamic jurisdictions – even in jurisdictions that have applied UK law to transactions, such as Dubai; the assets involved in the transactions are outside the remit of UK law. A related issue arises with respect to ongoing monitoring of *Sharī`ah* compliance and definition of procedures in the event that non-compliance is detected (either ongoing or retrospectively).
3. *Corporate governance standards:* These norms are critical for institutional investors who are typically substantial but still minority shareholders/bondholders. Standards are a problem throughout all markets, developed and developing, but the problems tend to be worse (or perceived by investors as worse) where there are a large number of firms which a founding family controls or where there is substantial government involvement. These are both features of many markets in Islamic countries. Progress is inevitably difficult – many countries issue codes of best practice which are widely ignored. But a significant part of the solution is to highlight current standards and make issuers aware of the standards in other jurisdictions, as well as impressing on issuers the gains from lower capital costs that flow from better governance. To this end, institutes such as the IFSB and Hawkamah have helped in raising the level of awareness of corporate governance. This action has included, in the case of the IFSB, issuing standards of corporate governance and in the case of Hawkamah, carrying out assessments of corporate governance in the Middle East North Africa (MENA) region.
4. Infrastructures for settlement and payments should be robust and not subject to failure, confusion or fraud. Fortunately, this is increasingly easy to achieve as low-

[8] "Battle for the Islamic Investor", *The Banker*, August 2010.
[9] For comparison, one conventional fund manager (Fidelity) manages US$232 billion.
[10] "Why Islamic Finance Has Not Yet Reached Critical Mass", *The Banker*, May 2010.

cost systems for trading, depository and settlement are now easily available off-the-shelf. There is consequently little reason to continue with legacy systems or to develop (much more expensive) custom systems. Infrastructure development can, however, incur opposition from intermediaries who profit from the inefficiencies of the old infrastructure, but this must be resisted.

5. *Benchmarks:* Institutional investors need benchmarks to measure their performance and by surpassing those benchmarks to sell their products. Benchmarks also allow a wide range of new products – for example, index-funds which appeal to investors seeking lower risk with lower costs, and Islamic Exchange Traded Funds offering retail investors coverage of a whole market or sector (without the use of derivatives). Islamic stock indices have only been around since 1999 and, until recently, developed slowly. Now all four major global index providers – MSCI, FTSE, Standard and Poor's, and Dow Jones – offer an ever-widening range of Islamic equity indices covering markets and sectors.

## Encouraging retail participation

Retail participation is good for social and economic reasons, as described above. Prudent encouragement of retail participation should be part of policies designed to develop markets. There is clearly a significant potential retail market for investment assets as shown by the appetite for Islamic retail banking products. A number of factors are important for developing retail markets:

1. Encourage competition for the investors' business. For many retail investors, CIS are the wisest option and this should be accepted. We have discussed the framework for encouraging institutional investors, but to successfully attract a strong retail following, funds need to display innovative strategies in developing new products. For this to happen requires: (a) a regulatory infrastructure that encourages competition among collective investments, including the admission of foreign competitors into the market; and (b) regulatory processes that make it relatively easy to launch new products, especially if these are not dissimilar to existing products. For example, requiring every new product (as opposed to a new line of products) to go through an expensive *Sharī`ah* advisory board process is likely to stifle innovation.
2. Enact appropriate investor protection regulations. The survey indicated that basic provisions such as separation of funds are common, but that other retail investor protections (such as suitability rules and best execution requirements) were less common.
3. Ensure adequate investor education – investors who do not understand risk will make bad choices (especially if encouraged by dishonest intermediaries), bringing the industry into disrepute and inviting government restriction. Ensuring adequate investor education is ultimately the responsibility of the regulator – which must act to ensure that sales material, etc., gives a fair and true picture of what is being offered to retail investors. Currently, this function is not well developed in most Islamic countries.
4. Make access easy. Once a sufficiently well-informed investor has decided to commit funds to an investment, there should be no barriers to execution. This implies ease of transacting and ease of payment without unnecessary regulatory barriers or excessive costs of intermediation.

5. Ensure that there is adequate information available for retail investors to make informed decisions. In practice, real-time information is likely to be priced beyond the reach of all but the most committed retail investors – and anyway, real-time information in illiquid, over-the counter (OTC) markets is usually partial and difficult to interpret. Consequently, the real-time information will more likely be accessed by intermediaries acting as agents for retail investors. It is, however, helpful to retail investors and encourages retail interest if less frequent information is available at very low prices – for example, in daily newspapers or on websites.

## Product development

Financial institutions have proved themselves able and incentivised to develop new products in conventional markets. There is no reason to believe that this will not be true in Islamic investments. If local incumbent banks and intermediaries do not innovate, then there will be pressure from foreign firms that have track records of developing innovative products. The main restraint on product development in conventional markets has been the need to gain regulatory approval. In the most developed markets the regulatory approval process generally gives fairly broad permission for firms to innovate within certain classes of investment without the need to gain specific regulatory approval for each product. For example, if the regulator has approved a new product class such as REITs, then a firm does not require separate regulatory approval for each issue as long as it conforms to the features of the class. However, in some markets regulatory approval for each separate issue is required. This slows down the process of innovation, but does not offer significantly increased investor protection: arguably, it would be better for the regulators to give very deep consideration (including consultation) before approving the whole asset class, rather than going through a box-ticking exercise for each separate issue.

*Sharī`ah* approval is not asset class-based but issue-based. It could therefore be a barrier to product innovation as the need for issue-based regulatory approval has proved to be. For equities issues this process is straightforward, and usually automatic. However, for *Sukūk* the approval process can demand considerable knowledge of legal and economic structures before certification can occur. This places considerable demands on the availability and expertise of *Sharī`ah* scholars, and this has been seen as an impediment to the wider acceptance of Islamic finance. As already noted, some jurisdictions (in particular, Malaysia and now Indonesia) have addressed this problem by establishing Central *Sharī`ah* Boards at the country level designed to make this process as smooth and low-cost as possible, while others (many of the Middle East markets) use firm-appointed experts.

## Encouraging market makers

Market makers fulfil two important roles – at issuance and in the secondary market. At issuance time, they offer a distribution and stabilisation service. In developed markets, sovereign bonds are usually issued through an auction process supported by specialised market makers – primary dealers who are obliged to bid for new issues. (Sometimes the auction includes a special retail tranche.) This ensures that there is adequate demand and that issues do not fail – the primary dealers effectively underwrite the issue. The primary dealers then distribute the issue to their clients and effect stabilisation to ensure that the price does not fluctuate sharply during the distribution process. New bonds usually change ownership several times during this time. This rapid turnover assists the process by ensuring there is adequate liquidity to support the distribution and assist the primary dealers (PDs) in price stabilisation.

For corporate issues the process has many similarities. However, the auction is carried out informally and the entire issue is allocated to a small number of securities firms (often just one). The firms base their bids on a book-building exercise where investing institutions are asked to indicate their level of interest and price. As with sovereign bonds the issue is distributed by the securities firm, which will also run the market for the issue in the initial period.

It is important to note that during this process the securities firms distributing the issue are actively managing their capital and risk exposure. The tools they use to do this are:

- money market instruments, allowing them to borrow against securities holdings – through repos and other collateralised loan structures; and
- derivative instruments, allowing them to manage their exposures and hedge themselves against market movements.

Without these tools, securities firms would need to hold much higher reserves of capital and carry much greater levels of risk, which would substantially increase the costs of issuance. This raises the need to devise suitable financial instruments to provide that service to PDs of *Sukūk*.

It is also important to note that in conventional markets it is normal for market makers to satisfy buyers even if they do not currently own the stock – that is, they sell short and borrow stock to complete settlement. Short selling allows market makers to:

- Meet orders which they would not otherwise be able to satisfy. This has the effect of reducing volatility in the market. Without short selling, market makers would have to turn orders away if they did not own the stock and the result would be upwards price pressure.
- Maintain continuous two-way quotes for the market. Without short selling, market makers could only provide ask quotes when they had stock in their inventory.
- Reduce their capital employed – by relying on stock borrowing or repo facilities, rather than carrying inventory.

Islamic standards prohibit selling what is not owned, so short selling would not be permissible for market makers in Islamic products. This is necessarily an obstacle, for the reasons given above, but it is not an insuperable barrier. Many markets have historically prohibited short selling and have managed to support a certain level of market making. As an example, primary dealers in the Indian government bond market were, until relatively recently, prohibited from short selling by the Reserve Bank of India. There were frequent complaints from investors about failure of market makers to provide liquidity on all occasions, and market makers frequently complained of the inconsistency between their obligation to provide two-way quotes and the prohibition on short selling. However, the market worked reasonably successfully, had decent liquidity (though it has considerably more now that short selling is permitted) and the Government of India was able to finance substantial deficits through issues of bonds.

Once the initial period is over and most of the issue has been placed with long-term investors, the level of activity usually falls significantly. Long-term investors are precisely that: they buy bonds with the intention of holding them until maturity or at least for a long period – "buy and hold" is the norm. Some sovereign bonds will become benchmark bonds and will remain relatively liquid, but most bonds will become illiquid. Benchmark bonds are selected by the market and are usually the largest bond in each maturity band or the bond that has the most frequent issuance. Some central banks have conducted a process of consolidation to remove smaller issues – which are illiquid – replacing them with benchmark bonds of the same maturity.

The situation in corporate bonds is again similar but usually more extreme. Again, there are benchmark corporate bonds that define the yield spread over sovereign bonds and are fairly liquid. But by and large, corporate bonds are not actively traded. This is true even in the United States, where the corporate bond market is more highly developed than elsewhere.

This lack of liquidity has a number of consequences:

- Investors who wish to alter their risk profile will generally trade the most liquid bonds rather than the least liquid. Except when there is a ratings event, investors are largely indifferent between bonds of similar maturities and ratings. Indeed, investors, where possible, will avoid trading bonds at all. Good bonds are scarce, and all but a handful of bonds have high transaction costs. Investors will prefer to manage the risk profile of their bond portfolio by trading derivatives – either OTC or on exchange.
- There is a role for market makers to provide liquidity and facilitate execution of investor orders. Market makers may be formal: certain firms commit to the role and agree to provide quotes at all times (usually in a certain size and often subject to restrictions on spreads). Or they may be informal: certain securities firms will generally make markets and provide quotes, but have no obligation to do so. Usually, PDs have some responsibility to maintain the secondary market and provide continuous liquidity. In the corporate bond market, formal market-making arrangements are very rare. (Formal market-making arrangements in equities used to be relatively common but are now almost all confined to the least liquid equities.)

Informal market makers need no incentives – when they see a profitable opportunity, they will make markets; otherwise, they will not. Formal market makers have an obligation to provide liquidity even when they might choose not to do so. To get them to sign up to the commitment requires an incentive. It follows that formal market makers are only possible when there is some market authority able to grant privileges and enforce obligations – a central bank or a stock exchange (or, conceivably, a national regulator, but this has not been done so far).

To illustrate, PDs are obliged to bid for new sovereign issues – even when they would choose not to. In order to get securities firms to volunteer to be PDs, they are offered privileges. The privileges vary from country to country but usually include some or all of the following:

- Exclusive access to the auctions. This guarantees them a profit on the attractive issues (when they sell on to long-term investors), which offsets losses they may make on other issues that are less attractive to investors.
- Exclusive access to some sources of central bank finance. To make efficient use of their capital (and so reduce costs of issuance), PDs make extensive use of short-term borrowing collateralised against their holdings of bonds. PDs are usually given

exclusive access to a repo window at the central bank, which allows them guaranteed funding. Funding is at market rates; indeed, the central banks use the repo rate as a key tool of monetary management.

- Exclusive access allowing them to borrow stock to cover short positions. PDs are usually required to offer a market-making function in the after-market. This requires them, on occasions, to sell stock that they do not (yet) own. In order to meet their delivery obligations they need to borrow stock. The central bank usually controls access to the register and gives PDs special access to stock borrowing.
- Tax advantages, such as exemption from capital gains taxes and transfer taxes for transaction undertaken in the course of their market-making business.

As noted, informal market makers can withdraw from the market when they please. However, there is some reputational risk to doing so. Securities firms work to build up their customer basis and part of this is to demonstrate commitment to providing liquidity. Nonetheless, most informal market makers are said to have drawn back from conventional bond markets in 2007–2009, and evidence suggests they have only returned on a much smaller scale than before 2007.

An encouraging development is the creation of the International Islamic Liquidity Management Corporation (IILM), which was announced by the IFSB in mid-October 2010. On 25 October, 14 signatories (12 central banks and two multilateral organisations) signed an agreement to participate. The IILM, which was established in October 2010, has recently completed the appointment of a CEO and *Sharī`ah* Board (January 2011). The IILM will have an authorised capital of US$1 billion, but only US$80 million will be called up at the start.

According to the IFSB, "the IILM will issue high quality *Sharī`ah*-compliant financial instruments at both the national level and across borders in an integrated manner thereby enhancing the soundness and stability of the jurisdictions in which they operate". In practice, the IILM will issue short-dated securities denominated in major reserve currencies. The aim is to produce the beginnings of a money market for Islamic products by providing IIFS with acceptable instruments for investment of short-term funds. As noted above, short-term instruments are vital for the risk management operations of banks and so are supportive to the development of market making. With the exception of Malaysia, which has developed its own Islamic money market, such markets are not well developed in other Islamic countries. It is hoped that the IILM will provide support for the development of such markets. In addition, the IILM will provide an important benchmark for shorter-dated Islamic instruments.

IILM is not in itself a market maker; rather, it is an entity that could support the development of market making. However, it faces challenges if it is to make a wider impact than the Bahrain-based and Gulf-focused Liquidity Management Corporation (LMC). Established in 2005, the LMC, created to facilitate the investment of the surplus funds of IIFS in quality short- and medium-term *Sharī`ah*-compliant instruments, had total assets of just under US$300 million at the end of 2009.[11] Although profitable, it would need to develop further in order fully to fulfil the role it set out to undertake in the market. To avoid marginalisation, the IILM therefore needs to gain wide acceptance. To be seen as truly

[11] www.lmcbahrain.com/financial/FS2009(Eng_Published).pdf

international, it needs to attract a significant volume of business from across the Islamic world and it needs to leverage its influence beyond its initially small size.

For policy-makers and regulatory and supervisory authorities, there is an important point: increasingly, liquidity may conflict with development of the national market. Increasingly, liquidity is accessed across borders. If there are to be national markets, then these markets must interact to maximise liquidity. This can be achieved either by technical means of linking technology; or by physical means (establishing regional “hubs”); or simply by encouraging international participation. All of these measures are likely to increase concentration in some “winner” markets and, therefore, to decrease liquidity in others – even if overall levels of participation increase. Consideration of this point raises, for the first time in this chapter, the possible conflict of national interest (defined as each country wishing to have its own markets, where local firms raise funds from local investors) and commercial interest (firms should have access to as much funding as they need at the lowest possible cost – irrespective of its geographical source).

There is no immediate answer to this question – there are few international success stories of highly liquid markets from which to draw – and, in consequence, no immediate legal or regulatory changes that can guarantee success. Moreover, differences in *Sharī`ah* interpretations add a major complication in the case of Islamic financial instruments. Developing liquidity is a long-term “game” that relies on investor confidence, wealth and knowledge. Markets can (and largely have) done what they can to ensure the first and third, while governments try to increase the second and help markets improve the other two.

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# Chapter Two

# Building a Liquidity Management Infrastructure for Islamic Finance

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**Dr Tomás J. Baliño**

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Liquidity management has been a problem for institutions offering Islamic financial services (IIFS), since they are unable to use many of the earning assets that conventional banks rely on for that purpose. This puts IIFS at a competitive disadvantage, by increasing their financial costs. In addition, their assets often have a long duration, which can lead to problems in a liquidity squeeze.

Two major determinants of the liquidity holdings are (i) the degree of development of the money market in which to place or borrow funds as needed, and (ii) the facilities that the central bank offers for that purpose.

As regards borrowing in the market, the situation ranges from cases like Sudan's, where there is no money market, to Bahrain or Malaysia, where specific institutions have been set up to facilitate the liquidity management of Islamic institutions.

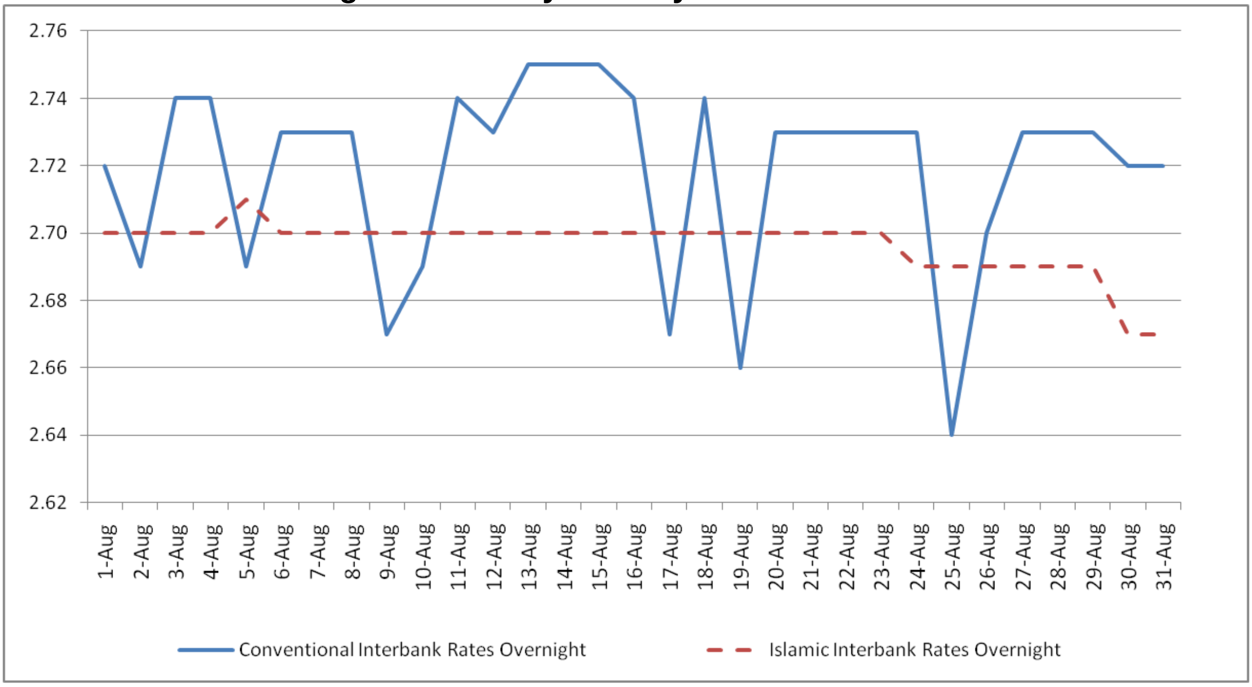
The types of instruments used in the interbank money market depend on the maturity, cost and riskiness of each instrument, in addition to the differences in *Sharī`ah* interpretations that IIFS may have. For instance, in Malaysia, the Islamic interbank market relies mostly on *Mudārabah* for shorter maturities (overnight to one week) owing to its lower cost compared to commodity *Murābahah*, which is the instrument of choice for longer maturities because it gives greater certainty as to the yield of the operation. Some operations rely on *Wakālah* arrangements, which entail lower transaction costs but tend to be more risky – a reason why banks prefer to reserve them for select counterparties.

During the authors' country visits, some IIFS noted that the small size of many institutions makes others reluctant to lend to them, particularly because *Sharī`ah* considerations make securitisation more complicated and costly than would be the case for conventional banks.[1]

Figure 2.1 compares daily data of yields for Malaysia's interbank transactions for the month of August 2010, for conventional and Islamic banks.

[1] Smaller institutions tend often to be perceived as riskier. While conventional institutions can guarantee repayment by posting collateral in the form of securities, this is harder to do for Islamic institutions and would entail costs (e.g. sales and purchase of commodities in a commodity *Murābahah* contract) which are too onerous for the short-term typical of interbank liquidity transactions.

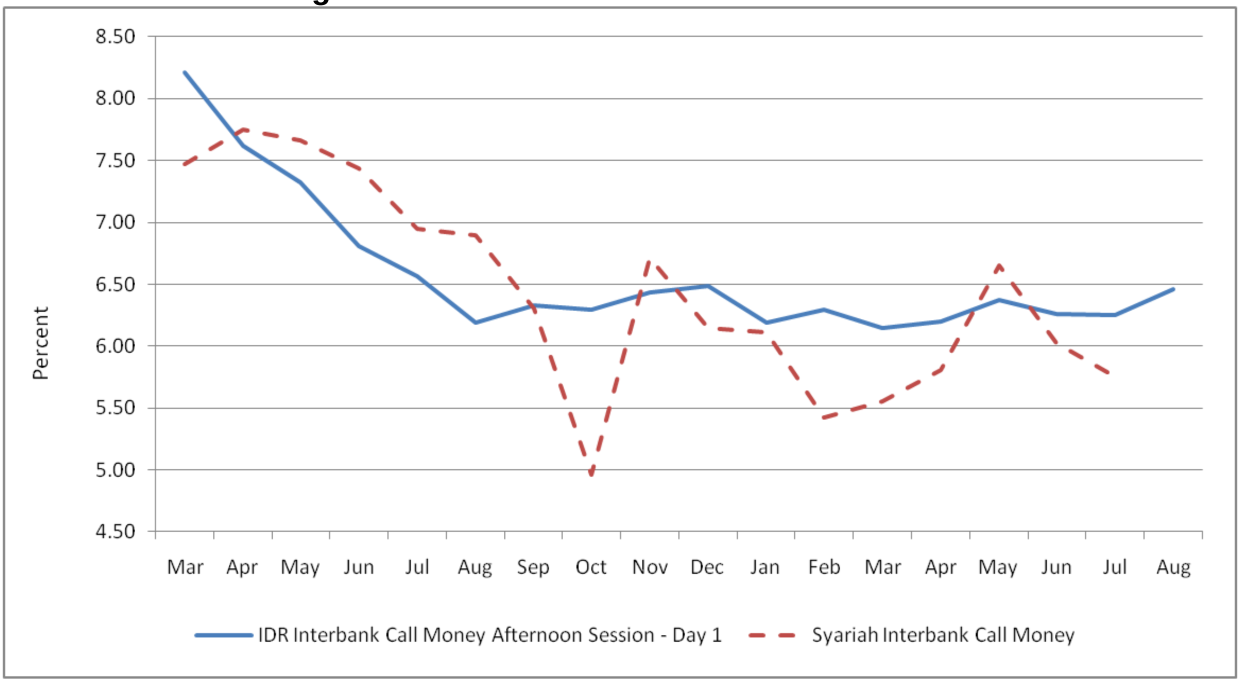
**Figure 2.1 Malaysia Daily Interbank Rates**




*Source: Bank Negara Malaysia*

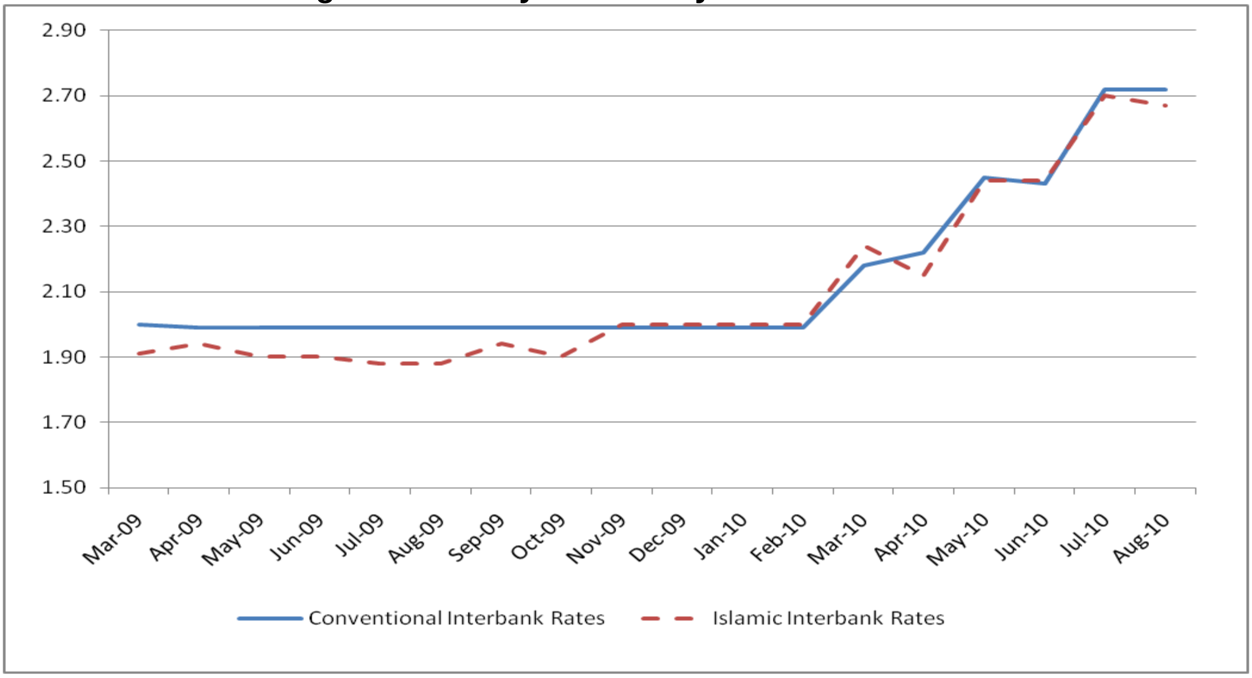
A similar comparison is provided for Indonesia and Malaysia, using the latest available monthly data for 2009/2010 (Figures 2.2 and 2.3).

**Figure 2.2 Indonesia Interbank Market Rates**




*Source: Bank Indonesia*

**Figure 2.3 Malaysia Monthly Interbank Rates**




*Source: Bank Negara Malaysia*

The figures suggest that, as could be expected, conventional and Islamic interbank rates move broadly together, albeit there may be significant differences at some points in time. However, Islamic rates appear more stable. Table 2.1 sets out some statistics for those rates. First, it presents comparative data for Malaysia and Indonesia, for both the conventional and the Islamic interbank markets, spanning the same period as the figures above. In both countries, the Islamic interbank rate was lower than the equivalent rate in the conventional segment, albeit somewhat more volatile (particularly in Indonesia). The same table shows that, in Malaysia, daily interbank rates for the month of August 2010 again were lower on average in the Islamic than in the conventional segment of the market, with insignificant volatility in both segments.

**Table 2.1 Selected Statistics for Interbank Market Rates**

| Interbank Rate Statistic | Malaysia | Indonesia |
|---|---|---|
| **Monthly Data** | | |
| Conventional Market | | |
| Mean | 2.15 | 6.58 |
| Standard deviation/Mean | 0.12 | 0.09 |
| Islamic Market | | |
| Mean | 2.11 | 6.45 |
| Standard deviation/Mean | 0.13 | 0.13 |
| **Daily Data** | | |
| Conventional Market | | |
| Mean | 2.72 | n.a. |
| Standard deviation/Mean | 0.01 | n.a. |
| Islamic Market | | |
| Mean | 2.70 | n.a |
| Standard deviation/Mean | 0.00 | n.a. |

*Sources: Bank Indonesia, Bank Negara Malaysia*

The above results suggest that Islamic banks do not face higher borrowing costs than conventional institutions in the interbank market.[2] However, this does not result in Islamic banks holding lower non-earning liquid assets than conventional banks. Table 2.2 presents data for a sample of banks in Malaysia, the United Arab Emirates (UAE), Kuwait and Bahrain. The sample included the five largest banks in both the conventional and the Islamic banking system in each country for which Bankscope had at least four years of data. The numbers shown correspond to the difference between the mean of the non-earning liquid assets that each class of banks held as a percentage of their total assets.

**Table 2.2 Comparative Liquidity of Islamic and Conventional Banks**

| Difference in Mean Liquidity (*) | | | | | |
|---|---|---|---|---|---|
| **Country** | **2005** | **2006** | **2007** | **2008** | **2009** |
| Malaysia | 22.51 | 5.36 | 11.32 | 12.63 | 9.71 |
| UAE | 0.40 | –0.93 | 1.11 | 1.11 | 1.11 |
| Kuwait | n.a. | –3.15 | –1.36 | –1.62 | –2.23 |
| Bahrain | 1.33 | 2.31 | 0.47 | 0.91 | 0.38 |

*(*)Difference in mean liquidity between IFIs and conventional banks (percentage points).*

*Source: Bankscope*

The data show that for all the countries in the sample, except Kuwait, Islamic institutions kept higher non-earning liquid assets almost every year (UAE in 2006 being the only exception) than their conventional peers. Of course, multiple factors affect a bank's desired level of liquidity, such as its business model, type of clientele, etc. However, it is highly likely that the difficulty in placing and obtaining liquid funds for short periods of time has been a significant factor in the observed differences between Islamic and conventional banks.

In well-developed financial systems, an active secondary market for short-term, high-quality assets (typically issued by the government or the central bank) facilitates the liquidity management of conventional banks, which can trade outright those assets or use them as collateral or repos. However, IIFS have a much more limited range of instruments available to them than conventional institutions. In addition, the fact that the Islamic segment has fewer and often smaller institutions than the conventional one further limits the possibilities of IIFS in this area.

[2] These results are merely suggestive: further research would be needed to confirm them for longer time periods and for other countries, for which data were unavailable to the expert team.

Both in their responses to the survey and during the experts' visits, market participants noted that *Sukūk* with the appropriate characteristics would go a long way in addressing the problem of liquidity management. However, the conditions for that do not yet exist. Existing *Sukūk* have longer maturities than those appropriate for short-term liquidity management. Moreover, their supply is still insufficient, and their buyers follow a buy-and-hold strategy, as a result of which *Sukūk* generally are not actively traded.

Central banks in countries with significant Islamic financial systems have sought to facilitate the liquidity management of those banks and to better integrate them in the country's overall monetary policy framework. Those actions help in achieving a level playing field for both conventional and Islamic institutions, including in the way monetary policy affects them. Also, some central banks have sponsored the establishment of institutions that endeavour to facilitate IIFS' liquidity management (e.g. Bahrain's Liquidity Management Centre).

As detailed in Appendix, Bank Negara Malaysia (BNM) has been at the forefront in accommodating the peculiarities of IIFS. Its strategy has been to develop a range of *Sharī`ah*-compliant instruments broadly comparable to those available to conventional banks. Thus, IIFS can deposit daily excess short-term funds (7–21 days) with BNM using the *Wadī`ah* principle and earn a market rate. For longer maturities, BNM accepts funds using commodity *Murābahah* transactions. It has also introduced Islamic monetary notes, which are based on *Ijārah* (using BNM buildings as the underlying asset) and commodity *Murābahah*. These notes are tradable, thus helping to develop the secondary market as well. It is now planning to add securities underpinned by a basket comprising 51% *Ijārah* and 49% commodity *Murābahah*.[3]

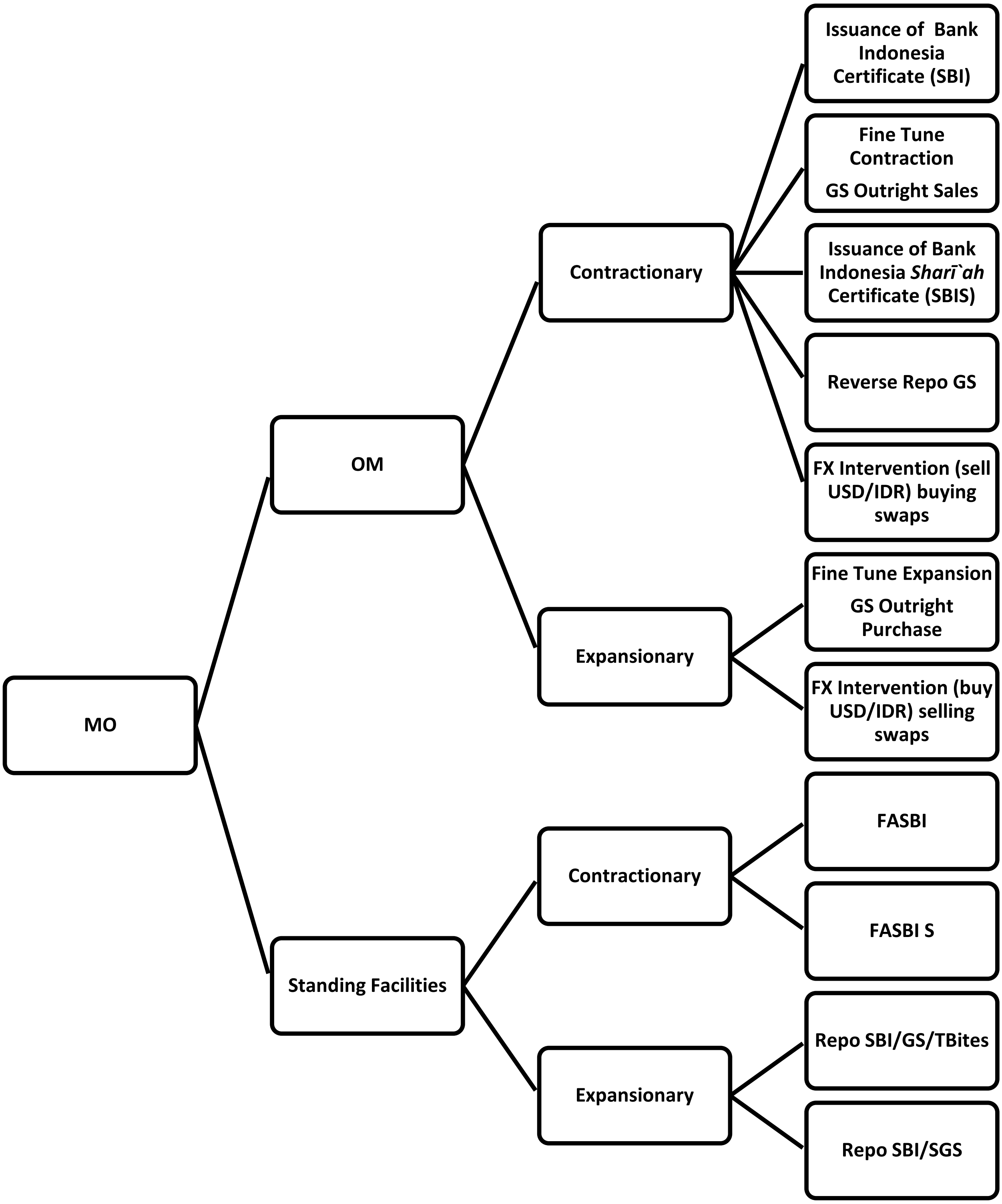
Islamic banks can also hold other Islamic securities issued by the government: Malaysian Islamic Treasury notes – issued weekly with maturities up to one year, and Government Investment Issues—which are longer-term securities (three–ten years).

Bank Indonesia offers Islamic banks its Bank Indonesia *Sharī`ah* certificate (SBIS), which is the *Sharī`ah* equivalent of its Bank Indonesia certificate for conventional banks. The SBIS is issued under the *Ju'ala* principle; it has a minimum maturity of one month and a maximum of one year. The *Ju'ala* principle (to remunerate work) is applied to compensate Islamic banks for helping the central bank meet its obligation to implement monetary policy with all the banks. Thus, the instrument can be used in transactions with Bank Indonesia – including repos – but is not tradable.

Figure 2.4 and Table 2.3 illustrate Bank Indonesia's range of monetary instruments for both conventional and Islamic banks.

[3] This would help in overcoming the limitation resulting from basing the securities only on *Ijārah* on the Bank's real estate property.

**Figure 2.4 Bank Indonesia's Monetary Instruments**




*Source: Bank Indonesia*

**Table 2.3 Bank Indonesia Standing Facilities**

| Instruments and Description | Deposit Facilities | | Lending Facilities | |
|---|---|---|---|---|
| | FASBI | FASBIS | FASBI | FASBIS |
| Liquidity impact | Tighten liquidity | Tighten liquidity | Expand liquidity | Expand liquidity |
| Frequency of transactions | Daily regular | Daily regular | Daily regular | Daily regular |
| Tenor | Overnight | Overnight | Overnight | Overnight |
| Minimum nominal bid | Rp 1,000 m. | Rp 1,000 m. | Rp 1,000 m. | Rp 1,000 m. |
| Nominal multiples | Rp 100 m. | Rp 100 m. | Rp 100 m. | Rp 100 m. |
| Transaction mechanism | FRT | FRT | FRT | FRT |
| Settlement | T+ 0 | T+ 0 | T+ 0 | T+ 0 |
| Cost | BI Rate – 50bps | BI Rate – 50bps | BI Rate + 50bps | BI Rate + 50bps |
| Bidders | Banks, brokers | Banks, brokers | Banks | Banks |

*Source: Bank Indonesia*

Nonetheless, and probably owing to the comparatively small size of the Islamic banking segment, Islamic instruments represented only about 1% in 2008, and 2% in 2009, of the total volume of the monetary policy instruments for which Islamic equivalents exist.

In both countries, instrument design has been helped by the existence of national-level *Sharī`ah* councils that enhance clarity of the rules that apply to each type of transaction. For instance, In Malaysia, this extends to the judiciary, which must abide by the opinion of the appropriate National *Sharī`ah* Council, depending on whether the issue relates to banking or securities.[4]

Table 2.4 presents the instruments that IIFS in some other jurisdictions can use to obtain or place liquidity with the central bank.

[4]There are two National *Sharī`ah* Councils in Malaysia, with competence in different sets of issues: one for banking issues – attached to BNM, and one for securities issues – attached to the Securities Commission.

**Table 2.4 *Sharī`ah*-Compliant Central Bank Instruments in Selected Countries**

| | |
|---|---|
| **Bahrain** | Government *Al Salam* and *Al Ijārah Sukūk*, the former with a maturity of 91 days and the latter with 182 days' maturity (short-term) and three–ten years (long-term). |
| **Qatar** | *Wakālah* agreement with central bank, mutual deposits: IIFS can compensate positive and negative excess balances with Qatar Central Bank to avoid interest payments. |
| **Sudan** | Government investment (*Ijārah*) and *Mushārakah* certificates, tradable (outright) with central bank. |
| **Kuwait** | *Tawarruq* (reverse *Murābahah*) to absorb longer-term liquidity. |

*Source: TN-1: Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets (www.ifsb.org/docs/mar2008_liquidity.pdf).*

Notwithstanding the efforts of central banks and their own, IIFS still face several problems in liquidity management, even in those countries that have been more active in addressing IIFS's special needs:

- Each operation usually entails several individual transactions, requiring paperwork and additional costs for formalising them. The problem becomes worse to the extent that instruments are not standardised. In addition, these transactions often attract taxes, albeit some jurisdictions have adopted special provisions to avoid such taxation.[5]
- Costs are not easy to lower for liquidity management, even though some practices can lower transaction costs. (For example, Malaysian market participants reported that it is cheaper to use the local palm oil market for *Murābahah* transactions than commodities traded in overseas markets.) While these additional costs may not have a major impact on longer-term transactions, this is not the case for liquidity management where operations have very short (including overnight) maturities.
- Some types of operations to effect a financial transaction (e.g. *Wadī`ah*) may lower the cost but increase the risk.
- Differences in *Sharī`ah* interpretation mean that some institutions – even in the same country – may not wish to use some instruments, further restricting the number of available counterparts in the money market.
- Insofar as doing a transaction in a *Sharī`ah*-compliant manner is more costly than doing it in a conventional way, only IIFS will be willing to do it, which segments the market.
- Central bank facilities usually do not address foreign currency liquidity needs.
- The need for different types of operations and differences in their acceptability limits market depth and makes markets hard to integrate, particularly across countries.

Market participants provided useful comments in meetings with the experts and in their answers to the survey. Those comments can help in designing measures to improve the

[5] For instance, Malaysia and Indonesia have adjusted their tax system to avoid taxation of incidental transactions required to carry out a *Sharī`ah*-compliant financial transaction.

functioning of the secondary market and primary issuance of Islamic financial instruments. Some of the most common and important remarks were the following:

1. Standardisation of the documentation of the different *Sharī`ah*-compliant transactions would significantly help to lower costs. Ideally, such standardisation should be done at the international level, in a way similar to what has happened with the Eurobond market.
2. More transparency would help in enhancing liquidity.
3. Differences in *Sharī`ah* interpretations have also impeded development of the primary and secondary markets.
4. Lack of sufficient issuance of *Sukūk* has fostered a buy-and-hold investor behaviour, and diminished the liquidity of this instrument. In particular, several participants noted the need for benchmark issues that would facilitate pricing.
5. Participants held different views about the sources of the transaction costs in the secondary market for *Sukūk*, which most respondents felt were too high. High bid-ask spreads, taxes, commissions and fees, and lack of market makers of an active exchange market, were frequently mentioned as significant cost sources.

Both the comments received and the analysis of the team suggests several actions that national authorities and international bodies can take to further develop the Islamic finance market. They are:

- Increase the supply of sovereign *Sukūk*, denominated both in domestic and in foreign currency.
- Ensure that the tax system does not impose an extra burden on Islamic financial transactions.[6]
- Promote standardisation of documents, ideally making them internationally acceptable.
- Facilitate the convergence of criteria for deeming a transaction *Sharī`ah* compliant.
- Ensure that ancillary services and infrastructure are in place to support and enhance liquidity, including elements such as electronic platforms, and bond pricing arrangements

Central banks can help in these endeavours. As regards the supply of sovereign *Sukūk*, several members of the Islamic Financial Services Board have recently established the International Islamic Liquidity Management Corporation (IILM), which will issue these instruments in foreign exchange.[7] This would not only directly increase the overall volume of *Sukūk*, but would also help address the current scarcity of suitable assets that central banks can use to support their own issuance of domestic sovereign *Sukūk*. Central banks can also help in the standardisation process, by clearly specifying the documentation that financial instruments must have in order to be acceptable for transactions between the central bank and banks. Similarly, they can identify those instruments that they will deem to be *Sharī`ah* compliant, if the central bank is required to make such type of determination for purposes such as investor protection or for eligibility for some monetary operations. This approach could still leave IIFS to make their own determinations as to what legal documents to require, and their *Sharī`ah* boards would retain the ability to make their own decisions as to *Sharī`ah* compliance. However, it would not only provide some guidance to

[6] In some jurisdictions this would require eliminating taxes on operations – such as sales of commodities – that are incidental to an Islamic financial transaction, such as *Murābahah*.
[7] See www.ifsb.org/preess_full.php?id=150&submit=more

IIFS and their clients but also enhance the liquidity of instruments that meet the central bank's criteria, giving them a competitive edge.

International organisations and forums can help in the development of the market in several ways. In particular, they can assist in achieving convergence of standards for documentation across borders, helping to create an integrated Islamic financial market. Forums for discussion, seminars and international working groups are ways in which this can be materialised. They can also sponsor the creation of instruments that can be useful in multiple jurisdictions. Again, the just-announced establishment of the IILM is an example of what can be achieved in this area.

# Chapter Three

# Legal Aspects of Islamic Asset Securitisation

**Professor Barry Rider**

# Chapter Three

# Legal Aspects of Islamic Asset Securitisation

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## *A. Overview*

We address the legal and regulatory issues in eight sections which are, of course, interrelated. We are concerned to provide guidance on the legal and regulatory hurdles that exist within Islamic law and the general legal environment, which may not be exclusively Islamic, to the development of Islamic capital markets. By "development" we mean we are concerned with facilitating their depth and breadth in terms of the products available for trading, and fostering the capacity of intermediaries and market professionals to provide a two-way market, promote stability, and service clients to appropriate standards of competence and integrity. All this is within the context of promoting and maintaining adequate liquidity in secondary markets and ensuring financial and risk soundness. We also explore how the law can encourage diversity and depth of ownership.

Section B. seeks to set these issues in the general context of relevant legal considerations and, in particular, to draw attention to the matters, perhaps outside Islamic law, which need to be considered along with the development of Islamic principles. The ability to list and trade Islamic financial products on a market presupposes the existence of laws that permit and facilitate the creation of tradable obligations that may be negotiated, resulting in an effective transfer of rights. There are real, and to some degree, unresolved issues in *Sharī`ah* as to the ability to trade in debt. There is a divergence in the schools as to whether it is permissible to sell debt, particularly as a species of property. This is especially an issue where the transaction involves the creditor selling to a third party, which would normally be the case in a market environment. Hanafis, Shafi'i and Hanbalis are concerned that the transaction may be *Gharar*, in that the seller cannot deliver the subject matter of the contract. On the other hand, there are those who argue that, provided there is no element of *Riba*, such a transaction is acceptable. If the debt is one for money, then the *Sharī`ah* in regard to money transactions would apply. Consequently, the transaction must be spot. The *Sharī`ah* also requires that the transaction should not be at a discount on the debt; in other words, there should be parity. Having said this, in Malaysia such transactions do occur.

Section C. focuses on the regulatory approaches and models that are most likely to provide markets with the liquidity and efficiency to ensure that Islamic financial products that have been admitted to trading retain their value and become internationally negotiable.

Section D. addresses, primarily by way of background, the relevant legal issues in Islamic law relating to the creation and development of a viable market in *Sharī`ah*-compliant financial instruments and services. As in the first section of the part, it also addresses wider issues that are pertinent to the creation – and, in particular, the subsequent transfer – of rights. In so doing, perceived weaknesses are identified.

Section E. is concerned with the legal and regulatory issues pertaining to the securitisation of rights in Islamic law and, in particular, the *Sukūk*. We examine the nature of securitisation and the legal inhibitions that exist in certain Islamic jurisdictions. On the assumption that securitisation of rights that are *Halāl* is acceptable in Islamic law, we examine the various devices that are employed to structure contractual rights in underlying property so as to produce tradable interests. The constraints that Islamic law places on the manner and form of contract are considered, in addition to the wider impact of principles of *Gharar*. Of particular significance in practical terms will be the ability under domestic laws to effectively and efficiently transfer rights pertinent to the subject matter of the basic contracts. For example, the ability to divide and negotiate interests in land or other property, whether real or moveable, and the willingness of the relevant law to recognise changes in ownership, are of crucial significance. Again in practical terms, the flexibility of the local law in facilitating transactions at different times, albeit related or perhaps serialised, is of importance. Traditional requirements under *Sharī`ah* for all related transactions to be synchronised create potential problems.

Section F. presents examples of effective Islamic financial market regulation, while section G. is concerned with an examination of the salient legal rules and their application in Malaysia, Dubai and Indonesia. This draws on the questionnaires that have been returned and additional information. In particular, we examine the response of these legal systems to the issues that we have already highlighted as significant in terms of the markets. We also examine the particular issues relating to sovereign issues.

Section H. examines the role and significance of prudential standards, in regard not only to markets and products but also to the establishment and operation of institutions offering Islamic financial services (IIFS) and intermediaries. The concluding section i. provides recommendations in the legal and regulatory areas for the further development and enhancement of Islamic capital markets.

## *B. The Role of Law and Regulation in the Development of Sound and Stable Markets*

### i. The role of law and regulation in context

History records many examples of markets developing as a result of economic and social interaction without the direct intervention of law. Indeed, without strong economic justifications and the social and political factors that support the coming together of willing buyers and sellers, markets cannot be created by law. Attempts to establish new markets, whether in commodities or financial instruments, by legal measures unsupported by an underlying and at least partly recognised economic imperative have generally failed. Therefore, it is important to recognise the limited role that the law can play in the initial establishment of markets. Markets come into being and function as a result of an interplay between the economy and the social and political system within which a regimentation of the processes of negotiation and execution (and settlement) is found to be desirable. Convenience, location and security weigh rather more in this balance than law. Having said this, history also records that law does have a role to play in regularising and facilitating the sound and proper operation of markets. For example, in England laws came into existence, and were subsequently promulgated by statute, to outlaw what were considered to be unacceptable practices whereby commodities bound for established markets were diverted or intercepted.[1] There are many other examples in the ancient legal systems of other societies, including in China, Japan and the Middle East.[2] Thus law, in its various forms, has a much more significant role in assisting in the *development* of markets, rather than their creation.

Having recognised this in the more complex economies of today, for markets – particularly in financial instruments – to operate as markets in any real sense it is necessary for the relevant legal system first not to inhibit their existence and, second, to provide a supportive legal environment. There are situations as a result of economic and/or political determinations where a market or any regularised exchange of certain commodities, and instruments representing those commodities, are strictly prohibited by law. Indeed, such prohibition may extend to the very holding of such property or engaging in transactions in relation to such. While in most jurisdictions such prohibitions relate to well-defined commodities such as certain types of drugs and other proscribed property, the operation of law at both a domestic and international level can result in a much wider prohibition of, in particular, financial instruments issued or derived from certain sources, such as states that are subject to economic sanction. Obviously, where a market operates internationally, or where transactions involve property rights created or derived from property in other jurisdictions, the potential for issues to arise in this context is so much greater. In regard to Islamic markets, whether financial or

[1] See, generally, B. Rider, C. Abrams and M. Ashe, *Guide to Financial Services Regulation*, (1987) CCH, Ch. 1; and G. Gilligan, *Regulating the Financial Services Sector*, (1999) Kluwer, Pt. II.
[2] See B. Rider, H. Yan and L.H. Xing, *The Prevention and Control of International Financial Crime*, (2010) People's Bank of China, Financial Publishing House, Pt. I.

commodity, there is, of course, a much more salient issue as to essential lawfulness, in that the commodity or relevant rights therein must be *Halāl*.[3]

Assuming lawfulness in both the secular and religious sense, which at this stage we will take together, it is also a pre-requisite for the creation and operation of a market that the processes by which the property or rights are first brought onto the market and made available for negotiation are lawful and acceptable. This is a different (albeit often related) issue to that of the essential lawfulness of the right or commodity in question. In the context of commodities, the property must be merchantable – that is, capable of sale and purchase; and in the case of rights, including financial rights, they must be recognised as a form of property that can be the basis of an effective transaction transferring title. Again, this can involve complex legal issues, particularly in Islamic legal systems. The process by which a sale and purchase is negotiated, consummated and executed must also be acceptable to the relevant law. The parties to the transaction and their agents must have capacity within the law and be allowed to transact, albeit perhaps subject to certain constraints. Finally, there must be lawful settlement and effective transfer of the relevant property physically or in the nature of the rights. The significance of all this should not be underestimated. For example, to establish a viable market in securities in several small jurisdictions in the Caribbean the transference of any right in the security of a local public company other than through the securities exchange was prohibited whether the security was listed or not. As we shall see, an expedient measure adopted in the laws of most developed economies to promote investor protection, but also to support liquidity, is to require that all transactions in certain categories of securities are through or with a professional intermediary. Failure to comply may amount to a criminal offence and invalidity of the transaction. Therefore, we need to consider the lawfulness of the rights in question not only in terms of their creation, but also in terms of their negotiability.

The second role of the law in the context of the establishment of markets is to provide a sound, efficient and predictable legal environment. This is vital not only for the creation of a market, but also for its continuation and development.[4] The laws that are necessary for achieving such an environment must address a host of issues. In the context of financial markets, these would include laws providing for the effective and efficient creation of contracts and their enforcement, the creation and transfer of property and rights in property, the establishment and operation of incorporated business vehicles with the ability to issue various forms of securities that directly or indirectly relate to the enterprise of the entity and its property, the preparation and dissemination of reliable information that would allow decisions to be reached in regard to the relative value of such rights, the protection of those who purchase and sell such rights in terms of fraud

[3] See, generally, M. Ayub, *Understand Islamic Finance*, (2007) Wiley Finance, Ch. 1; and Siti Faridah Abd Jabbar, “Islamic Finance: Fundamental Principles and Key Financial Institutions”, 30 *Company Lawyer* (2009) 23.

[4] See V. Sundararajan in S. Archer and R.A.A. Karim (eds.), *Islamic Finance: The Regulatory Challenges*, (2007) Wiley Finance, Ch 3. See also *Islamic Financing for Infrastructure Projects*, (2000) Dubai International Financial Centre, p. 26.

and misrepresentation, and the proper and orderly handling of insolvency and bankruptcy. Furthermore, these laws need to operate within a system for the administration of justice that provides predictability as to the consequences of a legal act and the proper enforcement of rights. There are obviously also wider issues relating to the fiscal environment, such as the predictability and assessment of tax and other charges, the ability to borrow and secure loans, and the availability of conventional banking services. Without these and, indeed, the broader constitutional and public law protections that are associated with notions of the rule of law, markets will be difficult to establish and will certainly have difficulty flourishing.

We have referred to law in our discussion without distinguishing between the sources of law, the hierarchy of rules, and the different forms that law might take in seeking to impose obligations or accord rights. While in most states the constitution, wherever this may be found, will indicate the accepted sources of legal authority and will often establish hierarchy, in the case of Islamic jurisdictions this is not always as clear as it might appear.[5] Legal systems that seek to establish their legitimacy in terms of authority and even content in a higher law, above and beyond human invention, often seek to provide for this in their state constitutions. The implications, however, of a conflict between law derived directly from the constitution and that articulated, by whatever accepted means, from the higher and a priori source are not always delineated with precision. This can have serious implications for the predictability and certainty of laws made by human agencies. Given the trans-national quality of Islamic law and the fact that most markets will at least aspire to have an international dimension, the potential for debate is real.

In the majority of legal systems, the more detailed and specialised the issues that law is required to address, the more likely the legal rules will be cast in the form of regulations rather than primary legislation. This, of itself, introduces further legal issues in terms of legal competence for the relevant secondary legislation and its essentially administrative quality. While there is usually no great issue as to the subordinate nature of such rules and regulations, there may well be a hierarchy within this secondary tier. Of course, in some jurisdictions with common law systems, or which look to common law heritages in default of their own legal provisions (some of which are Islamic), there is a further complication or sophistication, depending upon one's perspective, to take into account. The legal significance of international legal obligations and, in particular, what has come to be called "soft law" such as Basle II and III and many of the initiatives on stability and integrity, needs also to be considered. While in many, but certainly not all, jurisdictions international agreements, whether bilateral or multilateral, do not automatically become part of the domestic legal system, they may well become interpretative tools or standards against which "hard" domestic legal obligations are measured and applied.

[5] See, in particular, Lu'ayy Minwer Al Rimawi, "Legal Aspects of Arab Securities Regulation with particular reference to Disclosure as a Tool of Investor Protection", (2004) PhD Thesis, London School of Economics, University of London.

What is clear is that in regard to the role of law in the creation and development of financial markets, the situation even within a single jurisdiction, discounting the trans-national issues of composition and operation, is both highly complex and dynamic. To properly evaluate the suitability of laws in a specific jurisdiction, in terms of fostering the development of an adequately liquid and efficient financial market, even in basic traded rights, requires a depth and breadth of contemplation that is rarely perceived, let alone undertaken.[6]

Finally, before leaving these introductory remarks, it is important to appreciate that the very nature of a legal obligation is not fixed and may vary within a single legal jurisdiction, let alone from one to another. This, again, has important implications in Islamic law, where different norms of law may well result in qualitatively different obligations.[7] The consequences of these obligations may vary from one school of thought to another in Islam. The interrelationship of these obligations even in a non-Islamic legal system may have serious legal and regulatory consequences. In the United Kingdom, Singapore and the United States, where the financial regulators make it clear that providers of *Sharī`ah*-compliant financial services are required to comply with the general laws to exactly the same extent as non-Islamic institutions or service providers, and where compliance with Islamic law is not as such a matter for the regulator,[8] there remains a risk of *Sharī`ah* non-compliance becoming a real legal issue. For example, investors solicited on the basis that a particular investment opportunity is *Halāl* or certain transactions have been undertaken in compliance with *Sharī`ah* will afford investors a legal action, under the general law, if this is not in fact the case. Such conduct would also justify intervention by the regulator on the basis that this amounts to soliciting or providing services on the basis of a false and/or misleading assertion.[9]

### ii. Law and securities markets (including primary regulatory/ supervisory policies – investor protection)

In the common law jurisdictions during the last century there was an ever-increasing body of regulatory law. Much of this relates directly or indirectly to the creation and operation of financial markets. In the civilian jurisdictions where the notion of administrative law was not so unusual, there has also been a significant dependency in developing the financial sector on this type of law. Consequently, in most developed

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[6] See TN-1: "Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets", (2008) IFSB.

[7] See, generally, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence*, (2006) Adam.

[8] See, for example, *Islamic Finance in the UK: Regulation and Challenges*, (2007) FSA; and *Guidelines on the Application of Banking Regulations to Islamic Banking*, (2010) Monetary Authority of Singapore. See also F. Atbane, "The Authorization of *Sharī`ah* Compliant Banks in the UK", 27 *Company Lawyer* (2008) 2.

[9] Indeed, such action has been considered in Malaysia under s. 354 of the Capital Markets and Securities Act 2007 on the basis that investors have been misled. See also, for example, the case of *MIDF Amanah Investment Bank & 9 Ors v Pesaka Astana (M) Sdn Bhd and 8 Ors* (2010) whereby the Malaysian High Court decided that the adviser and arranger of a *Bay` Bithaman Ajil* Islamic private debt securities issued by a company should be as liable as the issuer for any false and misleading information in its Information Memorandum, and for failure to exercise necessary due diligence on the issuance.

economies the bulk of the relevant law relating to the creation and operation of financial markets will consist of regulations promulgated directly or derivatively under the authority of primary legislation. Most of this secondary law will be drawn up and administered by specific regulatory authorities, themselves deriving authority from primary legislation. It is also not uncommon to find that within this mass of law, the authority to draw up and administer rules and regulations will be in effect delegated by the primary regulator to lesser and often sector regulators. The character of such rules and regulations, viewed from a legal standpoint, might be different from the higher regulations promulgated by the primary regulator or regulators. In some cases, these lesser rules may appear rather more as standards or principles which depend for their effect on disciplinary action based rather more on the law of contract than on the primary legislation that enables this process to occur. Indeed, as has occurred in the United Kingdom – with its principles-based approach to regulation,[10] even the rules and regulations promulgated directly by the primary regulator may well not resemble in form or character conventional legal rules.

While there are clear advantages in specialised authorities being given the legal authority to design and administer laws that address the specific and particular issues within their mandate, there has been an unwelcome tendency, as we have indicated, for the sheer bulk of these regulations to increase, and continue to increase, to a point of such complexity that any perceived benefit resulting from special knowledge is lost. In many cases, the role of the regulator as a facilitator of the markets has been replaced with an excessive concern to police. Indeed, the criticism that has been made of the failure of some of the most sophisticated and well-resourced financial regulators to recognise and act appropriately in the build-up to the most recent international financial crisis has, if anything, given further impetus to this trend. Regulators institutionally and as individuals do get blamed when things go wrong, and while in practice it is difficult for those who have suffered losses as a consequence of mere negligence to sue, in some circumstances this is a real threat and one that regulators are today mindful of. Consequently, the tendency to bury potential problems in a plethora of regulation becomes almost irresistible.

The willingness of new regulatory authorities and their professional advisers, particularly in developing economies, to borrow regulation from other jurisdictions compounds the problem. Not only might it be disproportionately cumbersome, but also ill fitting and unnecessary.[11] There are many examples, especially in the developing world, of regulatory systems having been imported that are inappropriate to the needs and aspirations of the recipient jurisdiction. To make matters worse, little regard is given, in this process, to the efficacy or otherwise of the relevant laws and, in particular, to their drafting, in the jurisdiction for which they were designed. There is an assumption that if

[10] See S. Bazley and A. Haynes, *Financial Services Authority Regulation and Risk Based Compliance*, (2007) Tottel; and A. Hudson, *The Law of Finance*, (2009) Sweet and Maxwell, Pt. III.
[11] See, generally, *The Regulation of Financial and Capital Markets*, (1991) Singapore Academy of Law; and B. Rider, "Insider Trading: An English at 75 et seq. Comment in New Zealand", in C. Rickett and R. Granthams (eds.), *Essays in Insider Trading and Securities Regulation*, (1977) Brookers.

it has been found necessary by the US Securities and Exchange Commission (SEC) or the UK Financial Services Authority (FSA) in their markets, it must have some relevance elsewhere. The fact that regulations carry a cost both in terms of the inhibition of enterprise (which may or may not be justified on the facts) and in its administration is often ignored. The situation becomes even more problematic as a result of international consultants "cutting and pasting" regulations from several jurisdictions. For example, it is possible to find in the laws of more than one jurisdiction a hotchpotch of US, UK, Australian, New Zealand and Canadian law.[12] We have already emphasised the importance of such law operating effectively within the general legal environment of the host state, but if one adds to the brew the dimension of *Sharī`ah* the potential for uncertainty, at least in prediction of application, becomes highly problematic.

While it is desirable for those who are responsible for the development of financial markets to learn from the experience in other jurisdictions, it is equally important for them to have the ability to reach independent decisions as to the appropriateness and viability of particular legal obligations. Of course, as we have already indicated, there are certain basic legal building blocks that will be necessary in all markets. However, exactly how these are constructed and the nature of their obligations might, and probably should, vary. For example, a failure to properly prepare financial statements and to disseminate them under the relevant law may in one state be subject to the imposition of criminal convictions and in others to civil penalties. Indeed, even something that is considered, by many governments and inter-governmental organisations, as serious as insider dealing is treated differently in terms of enforcement in different parts of the world. Attitudes to the appropriate form of enforcement change even within jurisdictions. In Britain, for many years, it was argued that the best way to deal with insider abuse was through self-regulatory rules such as to be found in the then City Code on Take-overs and Mergers and the Stock Exchange's Model Code.[13] Views changed with the criminalisation of insider abuse in 1980 and the full panoply of the criminal justice system was invoked.[14] However, by 2000, it was thought that this did not work, given the high standard of proof required by the traditional criminal law, and a more-or-less parallel system of civil enforcement was introduced.[15] More recently, the view has been taken that this does not in fact work and there is now a return to reliance

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[12] See B. Rider "Blindman's Bluff – A Model for Securities Regulation", in J. Norton and M. Andenas, *Emerging Financial Markets and the Role of International Financial Organisations*, (1996) Kluwer.

[13] See B. Rider "Self-regulation: The British Approach to Policing Conduct in the Securities Business, with Particular Reference to the Role of the City Panel on Take-overs and Mergers in the Regulation of Insider Trading", *Journal of Comparative Corporate Law and Securities Regulations* (1978) 319; and also B. Rider, "The Control of Insider Trading – Smoke and Mirrors", *International and Comparative Corporate Law Journal* (1999) 271.

[14] See B. Rider, *Insider Trading*, (1983) Jordans; and B. Rider and M. Ashe, *Insider Crime*, (1993) Jordans; and from a comparative perspective, B. Rider and H.L. French, *The Regulation of Insider Trading*, (1979), Macmillan.

[15] See B. Rider, "Civilising the Law – the Use of Civil Proceedings to Enforce Financial Services Law in the UKI", in D. Feldman and F. Meisel, *Corporate and Commercial Law: Modern Developments*, (1996) Lloyds of London Press.

on the criminal law.[16] Other jurisdictions, such as Hong Kong, have had a similar experience.

Having advocated flexibility, at least in the framing and enforcement of obligations, it needs to be recognised that the growth in international (and regional) standards, and the soft law to which we have already referred, serves to curtail the scope for domestic ingenuity. The international requirement to introduce, for example, anti-money laundering laws is in practical terms non-negotiable. While the substantive and regulatory provisions that are required by the international community may be justified in disrupting serious and organised crime, the impact of the obligations that need to be imposed on ordinary financial business are significant and potentially costly. There are also issues in the inter-play between the substantive obligations and the general law. For example, even in highly developed systems of regulation it is unclear as to the extent to which the obligation to know your customer impacts on the law of negligence in giving investment advice or handling a customer's account. In those jurisdictions which have the "suitability doctrine", whereby advice must be appropriate to the circumstances of the customer, the more that is known about an individual, the greater will be the scope of the duty of care. This presents a real cost for professionals and intermediaries that may not always be proportionate to the perceived general benefits. The interreaction of criminal and civil law obligations is another area of potential concern and risk.[17]

Finally, before leaving these issues, it needs to be pointed out that in many jurisdictions for a variety of historical, political and perhaps legal reasons, responsibility for overseeing issues relevant to the creation and operation of the markets is not confined to one agency, whether exercising direct authority under legislation or in some delegated capacity, such as the FSA in the UK. While the vast majority of states recognise today that self-regulation within the financial sector cannot be a comprehensive solution given the pressures of greed and self-interest that inevitably exist in the context of markets,[18] in Islamic jurisdictions there is perhaps more faith in self-control and self-discipline. Having noted this, it would not be practical, or from an international standpoint acceptable, not to provide for some form of supervisory authority with the force of law. Although some states have advocated a "one stop" financial regulator with oversight over the financial sector as a whole, this has rarely if ever actually been achieved. Of course, while there is a clear distinction in theory between economic policy, fiscal control and financial regulation, in practice the distinction may be less defined. In reality, governments change their minds where the institutional mandates and lines are drawn. The recent decision of the British

[16] See B. Rider, K. Alexander, L. Linklater and S. Basley, *Market Abuse and Insider Dealing*, (2nd ed. 2009), Tottel.

[17] See, generally, B. Rider and M. Ashe (eds.), *The Fiduciary, the Insider and the Conflict*, (1995) Sweet and Maxwell.

[18] See, for example, B. Rider, "Policing in the City", 41 *Current Legal Problems* (1988) 47; B. Rider (ed.), *The Regulation of the British Securities Industry*, (1979) Oyez; and B. Rider and E. Hew, "The Regulation of Corporation and Securities Laws in Britain – the Beginning of the Real Debate", 19 Malaya Law Review (1977) 144.

government to give back to the Bank of England responsibility for policing financial institutions is a good example of this. Even where a super-regulator has been established, it is often the case that their remit will not be encompassing of even the legal issues attaching to their mandate. For example, corporate law and its administration will invariably be left to another body, as in Malaysia, for example. Insurance may or may not be included. The operation of the criminal law will almost certainly not be included, but be left to the Law Officers and police. As a result, there is a strong likelihood of several sources of legal authority in regard to the institutions of and players in the markets. These bodies, with differing constitutions, mandates, natures and budgets, may or may not be effectively coordinated. It would certainly be rare for there to be a unified political structure for their accountability. Furthermore, while not in any Islamic jurisdiction, but certainly in markets to which IIFS must have regard, such as the US, the system of regulation is greatly complicated by a federal/state division of responsibility.

### iii. The structure (and mix) of legal regulation

We have already highlighted the problems that may arise as a result of complexity within even a wholly domestic and parochial legal system. While to some extent the more simplistic – and possibly under-developed – the legal system is, the less tension might exist, it is also the case that where a conflict or uncertainty does arise there may be an absence of legal apparatus to resolve it. Consequently, there is a trend to comprehensive treatment within a legal structure of identified issues and, thus, a tendency to complexity. Let us take the relatively simple illustration of an established company that wishes to see its shares traded in a regular and orderly manner on the stock exchange in its own jurisdiction. Let us also put aside all the laws and regulations concerned specifically with the operation of the market and look at the issues that need to be addressed over and above these.

Assuming proper incorporation and general compliance with the law, the board of directors will need to ensure that the correct procedures within the company's own constitution and the relevant corporate law are complied with. For example, it may be that certain classes of shares are not freely transferable or are in some manner encumbered. The issue of shares that are to be listed, or at least regularly traded, on the market will need to comply not only with the obligations, essentially of a contractual nature, imposed by the relevant stock exchange, but also with the corporate law. The prospectus or offer document will need to contain the detailed information required by the relevant laws and listing agreement. Those responsible for its issue may, under the terms of the corporate law, be held to a higher standard of care and diligence than would normally be the case in a sale contract. This might give rise to the prospect of criminal as well as special civil liability. However, there will also be issues between the company and those who subscribe to its shares in the market, which again are likely to be governed in part by the relevant corporate law, but also by the general law particularly relating to misrepresentation. The extent to which the directors and others who authorise the release of this information might be made personally liable will be determined not only by specific provisions in the company law but by the wider law. The general law will also determine the extent to which others, such as subsequent purchasers from initial subscribers in the market, who rely upon this information, may have claims should it be materially false. From this very simple and brief example, it is obvious that those who operate in the financial markets, even where specific and special laws have been enacted, are likely to be subject to other obligations arising by virtue of their contracts, or their alleged wrongdoing.

Indeed, there has been litigation and discussion in a number of jurisdictions, including the US, Australia, South Africa, Malaysia and England, as to the nature of the listing agreement between an issuing company and a stock exchange. As a contract, the question has arisen as to whether a breach of one of its terms, such as the obligation to ensure that there is continuous and timely disclosure, might be enforced by injunction. The issue has also arisen as to whether such a contractual obligation can provide a basis for a regulator – or even in the US, an investor – to step in and seek to ride on it, either as a third party or on the argument that the contract stands in the place of direct regulation. In similar circumstances it has been held by courts in New Zealand, Hong Kong and the UK that the existence of an obligation, albeit a contractual obligation to a third party, can constitute the basis for a criminal prosecution under the general criminal law. The arguments are invariably complex, have little to do with specialised financial law and are decided upon general principles of law.

Mention has already been made of the potential impact on legal determinations of rules that are not law as such – for example, international standards and rules drawn up by self-regulatory bodies. A court may always look to such sources for interpretation or as standards of appropriate behaviour. Indeed, rules that are long-standing and have been consistently complied with may be considered, particularly in common law jurisdictions, as market practice and therefore as the legal customs and usage of the market. In such circumstances, they may be implied into contracts or be used as the appropriate standards of conduct in a given situation. We have already seen that a representation that a particular product complies with Islamic law might, if it does not, constitute an operative misrepresentation or be actually a contractual term. Such would afford a regulator grounds for intervening and, in appropriate cases, utilising enforcement powers. Indeed, a dishonest assertion that a product is *Sharī`ah* compliant when it is not might well constitute a criminal offence.

There is, however, in the context of the financial markets another dimension to which reference needs to be made. This is compliance. In the financial sector the role of compliance procedures has attained a unique significance. It is important to distinguish in this discussion compliance from governance. While good governance encompasses an obligation on those responsible for institutions to ensure that there are viable and effective compliance systems in place that are adequately administered, compliance operates at a wholly different level within the organisation. Creating an effective compliance system involves identifying risks and then designing procedures that will avoid, control and contain the impact of such risks occurring. In the context of the financial sector, compliance will principally be concerned with legal, regulatory and reputational risks. The procedures that are put in place will often have contractual force either being incorporated into contracts of employment or for services, or constituting the standards for due diligence or appropriate employee behaviour.

While the existence of in-house controls within financial institutions is nothing new, the promotion of these into complex compliance systems in many countries is relatively recent. This is also the case in regard to the integration of compliance into the regulatory systems that have been developed to ensure observance of standards in the financial services sector. For example, under the various international anti-money laundering standards and most domestic law, financial institutions are required, under threat of criminal penalties, to have designated and qualified officials responsible for policing the internal anti-money laundering procedures and the reporting to the authorities of suspicious transactions. In some cases, specific legal responsibilities are cast on such officials. In developed systems of financial regulation, it is common to find this emulated in regard to a host of other issues ranging from the control of market abuse and insider dealing to customer relations and fair dealing.

The compliance industry in the more developed financial markets has become a vitally important element in the way in which financial regulators operate. By regarding compliance officers as gatekeepers or monitors, they are able to focus their monitoring and supervisory resources far more keenly in the hope and expectation that effective compliance procedures will throw up the most egregious cases. Of course, whether this is in fact the case remains to be seen. The level of development of compliance services in many Islamic jurisdictions would not normally allow the regulators to make such assumptions.[19] The development of both the ethos of compliance and the resources to achieve it should be important goals.

### iv. Regulation of structure and operation of markets

The majority of financial markets were not created by law. They came into existence and operated as a result of other imperatives, and such law as is imposed is invariably designed to be facilitative, whether by promoting efficiency and/or confidence. Therefore, law tends to follow the economic and political realities of markets. Consequently, the legal rules that have been developed more-or-less reflect the peculiarities of the market in question. Of course, with the internationalisation of players and financial paper and with the development of technology, particularly in regard to trading and settlement, there is a greater degree of standardisation both in terms of approach and actual contents. Standardisation and even, in some respects, uniformity has been deliberately promoted to facilitate greater efficiency between markets and the better protection of investors. This has occurred over many years within the US and more recently within the European Union. However, it is interesting to note that, in the context of the Single European Capital Market, the goal of harmonisation, let alone

[19] See C. Nakajima and B. Rider, “Corporate Governance and Supervision: Basel Pillar 2”, in S. Archer and R.A.A. Karim, *Islamic Finance: The Regulatory Challenges*, (2007) Wiley Finance.

uniformity, was long jettisoned in favour of approximation and now, simply, equivalence. In large part, this reflects the diversity of markets and the reality of national domestic legal environments. On the other hand, as we note later, European banking regulators have recently espoused the cause of harmonisation of prudential standards in the wake of the banking crisis.

While there is little value in categorisation itself, it is possible to discern relatively distinct, albeit often interrelated and overlapping markets, from the legal perspective. The first is where persons trade securities directly with each other on a face-to-face basis. Although this most usually occurs in regard to securities of companies that have not attempted, for whatever reason, to establish a public market, it may also occur in regard to substantial interests traded between significant investors. In some jurisdictions, particularly in the developing world, the issuer of the securities may itself assist sellers and purchasers by putting each other in touch. The important point, however, is that in legal terms there is a direct and personal contract between known and identified parties. It is in this situation that the parties, by inserting into the contract stipulations requiring, for example, full disclosure, can best protect themselves. Indeed, in such contracts the courts may well be prepared to find that there are special circumstances importing into the transaction obligations of fair dealing and disclosure of material facts. For example, the courts in Australia, New Zealand, the US and, to some degree, in England have been prepared to find that where one of the parties can reasonably be taken to be relying on the candour and integrity of the other party, because they occupy a privileged position in regard to, for instance, access to information relating to the value of the securities in question, a duty of fair dealing arises. Failure to discharge the obligations imposed by this duty will enable the other party to assert an operative misrepresentation and seek the appropriate remedies. Civil law jurisdictions are also more likely to require good faith in the negotiation of a transaction in such circumstances. Islamic law in direct personal transactions also recognises a duty of disclosure, particularly in regard to what in the common law tradition would be described as “latent or hidden defects”. Indeed, this is also a principle found in Roman and Roman Dutch law. Consequently, direct personal transactions may well involve legal issues that do not generally arise in regard to other types of transaction. In most jurisdictions, the involvement of an agent representing one of the parties in a direct personal transaction would not necessarily impact on the nature of the transaction, as in contemplation of law, the agent is the person for whom he acts and effectively drops out of the contract on agreement. Of course, if intermediation goes further than this and involves, for example, an intermediary acting as principal, then the position may well be rather different.

The second category of transactions that can be better described as a market involves a process of organisation whereby prospective purchasers are put in contact with prospective sellers, or vice versa. However, the prospective transactions do not normally involve securities that are listed or quoted on a formal market, such as a stock exchange. We have already mentioned that in some countries and exceptional situations the corporate issuer may perform this function to promote the maintenance of value in its securities and as a service to its investors. Such markets are sometimes referred to as over-the-counter markets. However, with developments in technology, in practice there is little in common between, for example, NASDAQ and the circulation in Fiji of buy and sell lists. An institution or association may assume the role of facilitating this market by coordinating and collating offers for sale and purchase, and even providing assistance in settlement. In the more sophisticated markets, a dealer or specialist function may develop, but essentially the market remains one of direct, albeit not always personal, negotiation. Where those who have taken it upon themselves, or who are designated perhaps by legislation, to assume additional responsibilities than the mere circulation of offers, the market starts to resemble a traditional stock exchange in many respects. In the more developed markets, there will be agreements, resembling listing agreements, with the issuers whose securities are traded, and transactional information will be gathered and disseminated. Technology has in many ways enabled disparate traders and investors to operate much in the same manner as parties on a traditional stock exchange.

Contractual rules in regard to these markets operate much in the same way as in regard to direct personal transactions, with the important exception that as the parties will not normally be in a face-to-face situation and almost certainly not in a position to negotiate with each other, there is little opportunity for the courts to imply special contractual terms or find representations. Having said this, there is always the possibility, as we have already noted, that market customs might be implied into a contract provided they are known, recognised and generally complied with. It is also conceivable that regulations promulgated by the organiser of such a market might be impliedly incorporated as terms of any transaction taking place in the context of such a market.

The third category of markets is those that would be recognised as stock exchanges. Of course, the organisation of such markets varies, but the distinguishing feature is that the issuers of the securities traded on the market will have agreed, by virtue of a contractual agreement or some other legally binding commitment, to observe certain obligations to the market. The paramount obligation will be to ensure an adequate and proper flow of information into the market to avoid the creation of a false or unfair market. The listing agreement will determine the securities that are admitted to trading or quotation on the market or, more usually, one of the lists operated by the market. It follows from the obligations imposed by the market that corporate issuers assume a much greater responsibility to investors and would normally be of a higher investment quality. Transactions on such markets will often be between professionals acting on behalf of other investors or as dealers in their own right as principal. In such a structured market, it is more usual to find procedures designed to assist the dissemination of information and to ensure orderly and smooth trading. The market as a market assumes a greater responsibility for ensuring adequate liquidity. This is not only desirable in terms of value, but to ensure the maintenance of confidence by those who place securities in the market and those who invest. There are many mechanisms that are employed to facilitate liquidity, but the most important is the intermediation of market makers. Market makers perform a jobbing function, by ensuring that in the securities in which they specialise, there will be a two-way market at a price. In other words, they carry or are prepared to carry an inventory, and the reward for doing so is the privilege of being able to act as principal within the market.

Different legal systems do not always treat transactions that take place on stock exchanges in the same way. In some systems where there is dealer intermediation or marrying of parties, the eventual contract between the seller and buyer, albeit through their brokerage agents, will be regarded as a single contract. In effect, all but the eventual parties will drop out and – save where there is contingent liability remaining, such as for an unpaid call, on the securities – be absolved from the prospect of liability. As we have seen, in most systems of law the brokers' role as agent will be to facilitate the giving of good title and – as lawyers say – quiet enjoyment, or due payment, and that will be all. The application of Islamic law in this context has been little tested and while it is invariably assumed that the relevant principles of agency would result in a similar result, it is arguable that at least certain types of agency in *Sharī`ah* impose somewhat more onerous obligations.

One issue that has arisen is the responsibility in law for a broker to offer advice to a customer. The simple answer is that this is governed by the terms of engagement. However, in recent years the development of legal obligations to treat customers fairly, combined with obligations to know much more about the customer's circumstances, have led to uncertainty. Indeed, in Islamic law, it has been argued that there may be an obligation on even an execution-only agent to advise against a particularly poor decision. Of course, to posit an obligation on market professionals to offer competent advice, whether separately contracted for or not, raises serious issues as to the capacity and competence of the industry, the management of risk and, particularly in Islamic law, the appropriateness of remedies and resolution. What should, however, be clear is that even if there exist comprehensive special laws and regulations relating to the operation of markets and the conduct of market professionals, there remains a significant and largely uncharted area of potential legal risk within the general law of the jurisdiction concerned – or possibly a more convenient jurisdiction to the person with a complaint.

An important further element in our discussion of markets is the form and efficacy of settlement. Even in the highly developed and regulated markets in the United States there have been serious issues in regard to effective settlement, which have been seen in the past as disrupting the proper operation of the exchanges and casting doubt on the integrity of the industry. Indeed, there have been similar problems in jurisdictions as different as Hong Kong and Japan. It must be remembered that at the end of the day, the seller will wish to obtain as soon as possible his price, less the costs of transacting business, and the purchaser will wish for good and provable title to the securities that he has bought. In the more sophisticated markets, transfer of title and financial settlement has been greatly facilitated by technology and, in particular, the immobilisation of securities. However, this process has not been without its legal problems. For example, generally speaking – at least in the common law jurisdictions, there is a significant difference in the legal implications of the theft of securities and merely obtaining them by fraud. It is the difference between a void transaction and one that is valid and can pass good title to another, before being voided. There are also significant issues related to insolvency of the parties, intermediaries and even the depositary. The transfer of contingent liability for tax and other charges is also a potential problem. The requirement in some jurisdictions for notarisation of a transfer is yet a further complication.

In many Islamic jurisdictions the laws relating to the transfer of rights in property, assuming that such rights are recognised and acceptable, are dated and do not address the concerns indicated above. Indeed, in some instances the law unduly protects the initial holder of a right and requires either a process of notarisation or some other form of official certification before the property is effectively transferred. In some instances, there are restrictions imposed by law on to whom such a transfer may be made.[20] While it is increasingly unusual to find restrictions on foreign ownership of securities in the more developed jurisdictions, this is far less unlikely in some Islamic jurisdictions. Furthermore, there are in some jurisdictions, such as China and Indonesia, significant restrictions on the transfer of state-owned property.[21] This has particular relevance in the context of sovereign *Sukūk*.[22]

Our discussion so far has focused on traditional equity and debt corporate securities. There are, of course, a plethora of less traditional securitised rights that are encountered on the world's markets. We have long progressed from the simple put and call option, to rights that are derived from structured interests in other rights, which may or may not eventually result in a right to acquire or sell a particular security. The use of composite rights may or may not have a proper economic function, notwithstanding their utility in market operations. The lawfulness of such securities in Islamic law is not free from controversy. Indeed, there are many in Western jurisdictions that have profound reservations as to the appropriateness of such devices, particularly after their use in the securitisation of suspect and poor-grade mortgages in the US.

Speculation and, in particular, short selling has come in for much criticism from *Sharī`ah* scholars. Basically, the sale of future property is generally forbidden in Islam, not least on the basis of *Gharar*, or uncertainty. All forms of gambling – *Maisir* – are also outlawed. It is also the case that in regard to debt securities, which are typically traded as *Sukūk*, if the debt is a money debt, then transactions will be regarded as money transactions and be governed by the *Sharī`ah* accordingly. Consequently, transactions will need to be spot and generally at parity. The trading of debt at a discount is forbidden by most scholars, although in certain circumstances it has been permitted in

[20] For example, in a number of Islamic states such as the Maldives and the Gulf Cooperation Council (GCC) countries, foreigners are generally not permitted to own land.
[21] Even in Malaysia there are issues as to whether the land is under federal or state authority – see Federal Lands Commissioner Act 1957, the National Land Code, the Sabah Land Ordinance (Cap. 63) and the Sarawak Land Code (Cap. 81).
[22] *Sukūk* literally means certificates, but technically it refers to trust certificates that are treated typically similar to conventional bonds. *Sukūk* is the plural of *sakk.*

Malaysia by the *Sharī`ah* Council of the Malaysian Securities Commission.[23] However, it is notable that, in recent years, scholars in the Gulf area who disallowed it, permitted inclusion of amounts receivable as a minority component in a larger package of securities. The end result may not be that much different: all debt-obligations are now sellable if re-packaged with a majority component of a permissible portfolio of assets.

Perhaps a rather more important issue in regard to the development of Islamic markets is public securities – in other words, non-corporate securities. Of course, it may well be that a government will utilise a corporation to issue securities to a market much in the same way as a company raises capital. In such cases the only difference – which may in certain respects be quite significant – is the issue of sovereign ownership. Governments and in some cases intergovernmental organisations may, however, choose to issue debt securities directly to a market. Bonds and rights relating to such will generally be issued pursuant to an undertaking similar to a listing agreement with the relevant market. However, it is not unusual for public securities to be made available on different markets at the same time.

Another important issue in the development of markets is the degree of access that potential direct investors have.[24] This involves a number of issues relating to physical and, increasingly, electronic access to intermediaries, information and perhaps the market itself. There is also the question as to how widely spread investment opportunities actually are in a particular market. Hitherto, for a number of reasons, including the difficulty and cost of structuring *Sukūk*, instruments have high denominations and will be beyond the reach of many investors. Furthermore, given the high unit cost of investment, this may inhibit prudent investment diversification and thereby be contrary to the legal obligations – for example, for those managing collective investment schemes and trust funds. Furthermore, the nature of *Sukūk* and the sort of investors that have so far characterised the market have tended to be long term, often waiting to redemption, resulting in a lack of liquidity. Obviously, in addressing such issues the law can only go so far. However, the ability to more cheaply structure bonds and provide lower unit costs would be beneficial. This depends, however, in many cases on the relative inflexibility of local property and transfer laws.

Finally, it is probably worth pointing out that different issues arise in regard to markets depending upon whether the securities are coming onto the relevant market as a new public issue, or having been issued are simply being traded or admitted to a list.

### v. Regulation of market professionals

We have already seen the importance of ensuring that markets are properly supported by adequate laws and regulations to promote efficiency, continuity and confidence. The

[23] See Resolutions of the Securities Commission's *Syariah* Advisory Council, (March 2002) Securities Commission of Malaysia.

[24] See, in particular, *Islamic Financial Services Industry Development: Ten Year Framework and Strategies*, (2007) Islamic Development Bank, IFSB and Islamic Research and Training Institute.

importance of regularising the operation of markets has been recognised in many early legal systems, for a variety of reasons. Markets provide an important – and, on the whole, reliable – interface between demand and supply and through their operation achieve an economic valuation of the commodities or rights traded upon them. An important role for the law is to ensure that the processes by which this is achieved are proper and would be considered as fair by those relying on the market to determine value. There are also early examples of legal systems seeking to impose regulations on individuals and associations who operate in these markets in a professional capacity. For example, in the 17th century the City of London required "stockjobbers" to be licensed, and to show competence, integrity and compliance with various administrative obligations. There are much earlier examples in regard to those who dealt with commodities coming on to established markets.

The regulation of market professionals in the modern world serves many purposes. The privilege of access to the markets, whether as a principal or agent, has usually to be bought in terms of membership of a recognised association or by authorisation from a regulator. In either case, obligations will be placed on the individual or company to ensure that they are a fit and proper person to operate in the markets, in whatever capacity, and that they are financially sound and have adequate competence. Similar obligations, in most developed systems, are imposed on all those who engage by way of business in the investment services and banking industries. Indeed, with the concentration of businesses in the financial sector and the multiple functions that they perform, the conventional divide between bank supervision and the oversight of other financial intermediaries has become blurred, albeit after the recent financial crisis some governments are keen to see a clearer line between the two at least in terms of institutional supervision. As we shall see in practice, the divide is between those businesses engaged in retail activity and those concerned primarily with other financial businesses and sophisticated investors.

We have noted that reliance on purely self-regulation, even when re-enforced by contractual provisions, in ensuring the soundness and integrity of businesses involved in the financial services industry has been jettisoned in the vast majority of jurisdictions. Notwithstanding arguments to the effect that self-regulation promotes responsibility and professionalism, the interpenetration of financial businesses, and especially the internationalisation of ownership and control, renders the efficacy of domestic ethical and even cultural values suspect.[25] On the other hand, Islamic institutions are better placed than most, because of the all-pervading nature of *Sharī`ah*, to aspire to ethical values. Whether this is enough in the context of international markets remains to be seen. In practice, it is hard to see how any market that wishes to attract foreign investment or service other than domestic interests could operate without effective legal regulation of those who, by way of business, operate in its financial sector. We have already noted the impact of various legal and non-legal obligations at the international level and the trend to standardisation.

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[25] See, for example, B. Rider and E. Hew, "The Role of the City Panel on Take-overs and Mergers in the Regulation of Insider Trading in Britain", 20 *Malaya Law Review* 315.

So far we have discussed the desirability – or rather, the inevitability – of regulating, by law, those who engage in investment-related business in the financial sector. Perhaps a more controversial issue is the extension of such regulation to players in the market who arguably are performing service or deposit-taking functions. In other words, should those who engage with the market as substantial investors be subject to supervision? A distinction is made in most systems between institutions that invest and engage in investment-related activity on behalf of others and those that simply act on their own account, or that of a very few identified and sophisticated participants. Consequently, structures that solicit funds to invest collectively as a single institution are generally subject to regulation. A significant problem in this context, however, is that the structures employed in institutional investment are essentially those of the trust. The trust is a common law device and, while the reality of a trust structure can be created by statute, it is less easy to import the body of fiduciary law that supports it. The position is potentially far more complex in Islamic jurisdictions where notions of fiduciary responsibility outside agency and the *Waaf* are less developed.[26]

It is perhaps appropriate here to refer also to the particular issues that are thrown up by sovereign investors. Issues have arisen as to the extent to which sovereign investment funds and agencies, which tend to be substantial players in certain markets, should be subject to the laws of other states. While legal issues may arise for the sovereign within a jurisdiction, these are normally resolved at a political rather than purely legal level. An example of the issues that may arise, however, in an international context relates to article 8 of the Kuwait Investment Authority Act. This provision renders it a serious criminal offence for any person to disclose, other than on the express authority of the Kuwait government, any information relating to the investments of the Kuwait Investment Authority (KIA). On the other hand, regulatory authorities such as the US Securities and Exchange Commission and the UK's Financial Services Authority consider that the KIA and its agencies are not entitled to sovereign immunity in their investment activity, as this is a commercial activity of the state. Consequently, there would be a legal obligation on officers of the KIA and its agencies to report, in compliance with the relevant legal provisions, substantial interests in securities. Such issues remain unresolved.

### vi. Disclosure/reporting/dissemination of information

Financial markets operate, or should operate, on the basis of reliable and relevant information. Investment decisions should be sensible and based on rational criteria. The better able the market is to obtain, digest and evaluate information, the more economically efficient that market is said to be. Indeed, laws aimed at discouraging taking advantage of inside information or even information that is not widely available are designed in part to encourage the flow of information into the market. The legal

[26] See B. Rider, "Islamic Financial Law – Back to Basics", in *The Changing Landscape of Islamic Finance*, (2010) IFSB; and Siti Faridah Abd Jabbar, "The Governance of *Shari`a* Advisers of Islamic Financial Institutions", 30 *Company Lawyer* (2009) 312.

obligation on issuers of securities to disclose all material information at the time of issue is there to allow subscribers to come to a sensible decision, in their own interests, as to whether the investment is worth the risk. Indeed, the English common law considered promoters were under a duty of good faith disclosure notwithstanding the general principle of *caveat emptor* (let the buyer beware).

Of course, whether all investment decisions can be so nicely justified in terms of disclosure is highly questionable. Investment decisions in the real world are reached on the basis of many factors and perhaps rarely on the fundamentals of worth. Having said this, however, transparency is itself an imperative for reasons far beyond informing prospective investors. Commentators have identified three distinct roles for disclosure: first, as we have identified, as a mechanism for affording those who have a choice the opportunity of reaching an informed decision; second, in assisting the operation of some other mechanism which may or may not have an informational quality. The example that is often given is section 16(a) of the US Securities Exchange Act 1934. This provision requires directors, officers and holders of 10% or more of the securities of the corporation to report their interests on a timely basis[27] to the SEC and to the public. Section 16(b), which is known as the short swing profit rule, requires the surrender by such insiders to the company of any profit that is obtained by the often artificial matching of buy or sell or sell or buy transactions within a six-month period. The purpose of this law, which had been adopted in other jurisdictions, is to discourage short-term speculation by insiders, irrespective of whether they have in fact had access to privileged information. While this draconian rule operates independently of section 16(a), for it to work effectively the obligations imposed by section 16(a) are presupposed. If the disclosure obligation is removed, the short swing profit rule becomes toothless – as it did in Japan.[28] The third role for disclosure, identified by commentators, is its role as a sanction or denunciation. While in financial regulation we are today concerned with all three roles, it is clearly the first role that has most significance in the development of viable and efficient markets.

When considering disclosure as a means of providing information, in the context of the financial markets we discover three types of disclosure. First, there is promotional disclosure, which is usually achieved through an offer document or prospectus. We have already pointed out that the content of this document may be governed by corporate law, rather than specialised financial laws, and may be influenced by the regulatory and essentially contractual requirements of the market to which the relevant securities are being admitted. Errors and misstatements may or may not be governed by the law setting out content; but even if they are, liability is also likely to arise under the general civil and criminal law. Second, there is the periodic reporting obligation that is imposed on companies and certain other business forms. This will almost certainly be governed by the laws allowing for the incorporation or establishment of the enterprise, although expanded by the requirements, contractual or regulatory, of the market

[27] Similar obligations exist under the corporate and securities laws of many states. For example, there are similar disclosure rules in regard to regulated entities in Dubai.
[28] See B. Rider, I. Tajima and F. Macmillan, *Commercial Law in a Global Context*, (1998) Kluwer, Ch. 18.

authority. Errors and misstatements may again involve issues of liability in the general law. Third, and for investors perhaps most importantly, there is timely disclosure. This involves an obligation usually imposed by the listing agreement, or directly or indirectly by law, to disclose material items of information as and when they occur, subject to the indulgence of the market authority where premature disclosure might harm a legitimate interest of the enterprise. While traditionally this obligation on listed issuers and their managements has been imposed as a term of the listing agreement, because of the significance of this in providing topical information and uncertainties in the enforcement of this duty, in many jurisdictions the obligation is now imposed by substantive law. Timely disclosure may also be indirectly promoted by anti-insider dealing laws, particularly those that are based on the notion that insiders must either abstain from dealing or disclose relevant price-sensitive information.

The medium of disclosure in primary and continuous disclosure will in large measure be financial statements. The importance of timely disclosure is that the medium will invariably be narrative and, thus, far easier for the market to digest. Indeed, the complexity of accounting information is such that in many jurisdictions there has been a significant initiative to simplify corporate financial statements in the hope that they will be meaningful and accessible to investors. Indeed, international standardisation has as one of its goals simplification to foster effective comparability. On the other hand, some have contended that even simplified financial information is largely unintelligible to the ordinary investor and it would be better for the best financial information available to be trickled down through market professionals who are able to comprehend it. While this intellectual argument, most eloquently put by Professor Homer Kripke of New York University (NYU),[29] may have purchase in jurisdictions such as the United States, it presupposes a relatively sophisticated class of market professionals who have the desire to act in this manner and the capacity and competence to do so. In developing and many embryo Islamic markets, this is an assumption that cannot be readily made. Professor Kripke's view that of far greater assistance in the determination of investment decisions is comparative information and so-called soft information – the views of management and, in particular, forecasts – does have merit in a developmental context. He also doubts the practical utility of integrity disclosure. Much of the information required in primary and secondary disclosure mechanisms relates to essentially ethical and integrity-related matters. Professor Kripke questions the use of this information for the purposes of coming to an informed investment decision.

The informational needs of Islamic investors, while no less than investors in other markets, may, however, go further.[30] For example, given the importance of establishing not only that business is *Halāl*, but that it is operated in compliance with *Sharī`ah*, it

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[29] H. Kriphe, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*, (1979) Law & Business Inc.; and J. Friedland, *Reforming the Law and Structure of the International Financial System*, (2004) Praeger.

[30] See, for example, Securities Commission of Malaysia, Release: Information required for the *Syariah* Compliance_Review of pre-IPO stage; and Siti Faridah Abd Jabbar, "*Sharia* Compliant Financial Instruments", (2009) 30 *Company Lawyer* 176.

would not be so easy to dismiss the significance of integrity disclosure. However, it is important to note that from a legal standpoint in the verification and testing of information there are important issues in the assessment of purely financial information as compared with certain types of integrity-related disclosure. At the end of the day, it may amount to a distinction between fact and opinion. Many legal systems hesitate to apply the full rigour of the law to the making of opinions, because they do not purport to be factual. On the other hand, the representation that the maker of a statement had a belief or held an opinion, which he did not at that time in fact have, could be an operative misrepresentation.

### vii. Regulation of issues (primary markets)

The important point to appreciate as a matter of law in regard to new issues is the obligation cast upon the issuer, whether a company or public authority, to ensure, according to the relevant legal and regulatory requirements, that adequate disclosure is made to those who are likely to subscribe.[31] Where there is an initial public offering, then the obligations to disclose all material information will be sufficiently onerous to reflect the fact that little or nothing else is known about the investment. In the case of subsequent issues, there will be at least some track record and knowledge in the relevant market concerning the enterprise and its assets.

Given the practical significance of drawing tradable investments onto new markets, their promoters have occasionally failed to recognise the importance of ensuring that there is a sufficient level of liquidity in the market to ensure the maintenance of value in new issues. This has been a particular problem in regard to some of the large privatisation issues, particularly when associated with indigenisation or popular capitalism. If the market is not able not only to digest the issue at an appropriate level of subscription, but also to provide a two-way market in the new securities, those who have invested with high aspirations and, perhaps, ideals will feel cheated. The viability of the secondary market is critical to the success of the primary market.[32] While achieving this involves many factors other than the law, there are clearly lessons to be learned. The structuring of the primary offer to ensure adequate opportunity for market makers is critical. Careful control over staging is also important. Where subscribers apply for far more securities than they can afford, in the hope of selling them off on allocation, and utilising the premium that might be expected on an over-subscription to cover the costs of acquisition, or at least the desired holding, there is an obvious danger of market collapse. Indeed, requiring retention of securities for a minimum period may be desirable.

[31] See, for example, *Guidelines on the Offering of Islamic Securities*, (2004) Securities Commission of Malaysia.

[32] The establishment (25 October 2010, Kuala Lumpur) of the International Islamic Liquidity Management Corporation by 12 central banks, the Islamic Development Bank and the Islamic Corporation for the Development of the Private Sector is, in this regard, of considerable potential significance.

### viii. Regulation of trading

The relationship of stability and integrity in the markets, while often assumed, is difficult to establish empirically. Indeed, the debate is similar to that about whether insider dealing actually harms the markets. It has been argued that permitting insiders to deal on the basis of the informational advantages that they may have as insiders not only draws the information into the market, but allows other investors by following known insiders to share in the benefits. As the relevant information will finally be discounted by the market, the argument also goes, it is only speculators who trade during the period that the information has not been absorbed who lose out. It is also contended that in narrow markets which are dominated by insider interests, the only sensible investment policy is to follow their trading patterns, assuming that such can be discerned and that they are not engaged in manipulation. In fact, in such markets the danger is really one of manipulation rather than traditional insider dealing. Of course, whatever the academic arguments, it is probable that in most societies direct and indirect investors, such as the beneficiaries of pensions, would consider that it is unfair for insiders to bet on certainties or at least privileged information. Whether this concern is based on principles of integrity or simply jealousy, as the empirical evidence in regard to informant-led enforcement in the US would suggest, matters not. What is at stake is the public's regard for the fairness of the markets.[33] Consequently, albeit perhaps not entirely rationally for the development of sound markets, addressing issues of integrity is important.

The desirability of avoiding unstable or volatile markets is deeper than cosmetic. Where the price of securities fluctuates excessively, investors become disillusioned and are inclined to regard the market as little more than a casino. Valuations, for a variety of important needs, become uncertain and precarious. Loans become under-secured and the operation of margin and capital adequacy rules becomes problematic. On the other hand, there is a danger in promoting stability or – to adopt the wording of certain European Union Directives[34] – smoothness, when the underlying market needs to adjust. Indeed, again the example of insider dealing is apposite. Early attempts in some Commonwealth jurisdictions to address insider dealing through provisions designed to prohibit the creation of false and contrived markets faltered on the basis that the insider dealing was certainly not falsifying the market; the insider was perhaps the only one dealing in an informed manner!

Another issue that is occasionally raised in the context of stability and integrity of markets is that of money laundering.[35] Laws that are designed to identify and interdict the proceeds of crime or monies used to foster terrorism have had a profound impact on the way in which business is conducted in the financial services industry. Indeed, when

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[33] See B. Rider, "Insider Trading – A Question of Confidence", *Law Society Gazette*, 6 February 1980.

[34] See, generally, R. Alexander, *Insider Dealing and Money Laundering in the EU: Law and Regulation*, (2007) Ashgate.

[35] See B. Rider, "The War on Terror and Crime", in D. Masciandaro (ed.), *Global Financial Crime*, (2004) Ashgate; B. Rider and Michael Ashe (eds.), *Money Laundering Control*, (1996) Sweet and Maxwell; S. Savla, *Money Laundering and Financial Intermediaries*, (2001) Kluwer; and K. Hinterseer, *Criminal Finance*, (2002) Kluwer.

the raft of compliance and related procedures that are required under these laws is considered, the actual impact on business is probably greater than that of the laws specifically directed at the financial services business. While the interdiction of the proceeds of crime and corruption and the disruption of terrorists and organised crime are laudable objectives, it is debatable whether in the context of financial markets these measures contribute to the maintenance of confidence or, for that matter, integrity.[36] Indeed, there is a real issue in many developing countries as to whether the plethora of rules, regulations and procedures that are required to support these laws are cost effective. As few such jurisdictions perceive the same level of criminality within their own jurisdiction as compared with, for example, the US, they might well question the proportionality of the burden contrasted with the regulatory or enforcement benefit to them. In fact, there are serious doubts as to the cost effectiveness of such laws and systems, measured in terms of the amounts of criminal or terrorist finance actually identified let alone interdicted, in most developed jurisdictions.[37] Such issues are of direct concern in the development of Islamic markets, as senior analysts in organisations such as EUROPOL have identified Islamic finance as intrinsically attractive to those who wish to launder criminal and subversive funds. While such a view is misconceived, the ability of Islamic markets to demonstrate full compliance with the international standards and the requirements of jurisdictions such as the US and UK is, in practical terms, vital.

Whether the existence in a particular market of suspect funds, perhaps the proceeds of drug trafficking or corruption, actually adversely impacts on the character of that market is a matter for debate. The reality is that, given the vast amounts of money that are produced by serious crime, all markets are to some extent exposed, at some stage in the laundering process, to this. The problem is compounded by the reluctance of even developed legal systems, such as the US system, to draw a line other than in terms of the ability to prove facts to a court of law, beyond which money that might at some distant point be associated with crime loses its taint. In fact, the potential problems for those who handle wealth are significantly increased by the adoption of similar laws to deal with the wealth of politically exposed persons (under the United Nations Convention against Corruption) and under numerous embargo and sanctions regimes.[38]

Where it is arguable that the existence of suspect funds does impact on the stability of the markets is when the risk to such funds, and to those who handle them, are considered. Under the laws of almost all states, proof that securities have been used in a crime or are derived from the proceeds of a crime – in most cases, either in that

[36] See, for example, B. Rider, "The Financial War on Terror", 5 *International and Comparative Corporate Law Journal*, (2007).
[37] See B. Rider, "Corruption – the Sharp end of Governance", in S. Ali (ed.), *Risky Business*, (2010) Caribbean Law Publishing Co.; B. Rider, "The Financial War on Terrorism", in *Combating the Financing of Terrorism*, (2003) Centre for International Security Policy/NATO; and B. Rider, "Financial Regulation and Supervision after 11th September 2001", 10 *Journal of Financial Crime* (2003) 336.
[38] B. Rider "Proving Probity – A Discourse on the Dark Side of Development", in S. Schlemmer-Schulete and K.Y. Tung, *Liber Amicorum Ibrahim F.I. Shihata*, (2001) World Bank and Kluwer; B. Rider (ed.), *The Enemy Within*, (1977) Kluwer, Pt. IV; R. Scott and D. Steel (eds.), *Banking on Corruption*, (2000) SALS.

jurisdiction or anywhere else – would place those funds at risk of seizure by the authorities. Furthermore, any person who has assisted in the retention, removal or disposal of those funds, knowing or suspecting that they are tainted, might well be subject to a criminal charge. Indeed, in most jurisdictions a mandatory obligation, sanctioned by the criminal law, is imposed on persons working in the financial services industry and many other wealth-related activities to report to the authorities any suspicions of money laundering that arise in the course of their work. This obligation also extends to the proceeds of corruption and monies suspected of being associated with terrorism. Consequently, the net of risk is thrown widely over those operating in the financial services industry. While it is true that few financial institutions or individuals in the financial services industry have in fact been successfully prosecuted for money laundering outside the US, many have fallen foul of the related offences relating to the failure to maintain proper records, operate effective compliance and surveillance procedures, and report suspicious activity. The criminal fines and civil penalties have in many instances amounted to millions of dollars.

It must also be recognised, according to a special study[39] commissioned by the European Union under its AGIS Programme on internal threats to banking and financial institutions, that where markets are recognised as being facilitative of money laundering and related dubious financial activity, there is a real risk of criminals penetrating financial institutions and corrupting the industry. Indeed, the European Union commissioned this study from police and intelligence agencies largely as a result of the statement of the then chairman of the UK's FSA that organised crime was actively penetrating financial institutions in the City of London. While there is no compelling evidence that this has occurred on any scale in the Islamic finance space, there have been concerns as to the interface between traditional IIFS and so-called underground financial systems. The extent to which organised crime and terrorist organisations utilise such networks is a matter for debate. However, there is little doubt that this is a real issue and remains a key concern of many law enforcement agencies and, in particular, revenue intelligence agencies around the world.

A much more serious issue, however, in terms of legal and regulatory risk, is the exposure of financial institutions to the threat of civil asset tracing actions.[40] The US government has long utilised civil proceedings to trace and seize the proceeds of crime or monies subject to a sanction. This procedure suitably modified to accommodate the requirements of domestic law has been adopted in many other jurisdictions. The civil law allows states to reach overseas and seize monies in a manner that the traditional criminal law would not normally permit. It is for this reason that so much emphasis is placed on civil recovery procedures in the United Nations' Convention against Corruption and by the World Bank in its Stolen Assets Recovery (STAR) programme.

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[39] *Report to the DG Justice and Home Affairs of the European Commission on the Penetration of the EU Retail Banking Sector by Criminal Organisations*, (December 2008) AGIS Programme, EU.

[40] See B. Rider, "Old Weapons for New Battles – The Role of Stewardship in the Development of the Common Law in its Fight against Corruption and Self-Dealing", (2009) *Anti Corruption Studies*, ICAC, Government of Hong Kong.

Under US law, the Federal Courts have recognised the ability of the US Justice Department to claim against an American bank operating in New York, on the basis that it has a correspondent relationship with a bank in Jordan. There was evidence that the proceeds of a fraud in the US and Canada, after attempts at laundering, ended up in that bank. The US Justice Department's argument that the American bank could make itself whole by helping itself to funds in correspondent accounts – leaving the bank in Jordan to attempt to sue the account holders holding the suspect funds – was accepted by the US courts. This case alone underlines the importance of this area of law to the issues discussed in this report.

Apart from such civil enforcement actions, there is perhaps the wider threat of civil actions based on the law of restitution. Over the last decade in a number of common law jurisdictions the courts have greatly extended the range and scope of legal tools for the tracing and seizure of the proceeds of civil wrongs and, in particular, breaches of fiduciary obligations. For example, the courts in Hong Kong were prepared to contemplate holding a major bank liable as a constructive trustee in regard to funds that it was alleged resulted from insider dealing in New York.[41] The scope of liability has been significantly extended to hold those who dishonestly assist in a breach of trust or other fiduciary relationship involving property. Thus, an accountant who established companies in the UK on behalf of a fraudster, and who failed to ask the questions that an honest and reasonable person would ask as to the circumstances, was held personally responsible for the losses incurred by the fraudster's employer.[42] The very real prospect of such liability is a risk for those engaged in the financial services industry, and clearly this has implications for their stability.

It should not be forgotten that one of the four statutory mandates of the FSA in the UK is the reduction of financial crime, and this is specifically defined to include insider dealing, market abuse and the handling of the proceeds of crime.[43] Consequently, there can be no doubt that these issues are pertinent in any discussion of the development of financial markets.

### ix. Regulation of risks

Following on from our discussion above on stability and integrity-related risks, it is important for financial institutions to be aware of the potential risks and to be able to address them in terms of avoidance, minimisation and control. It is also important for the supervisory authorities to be able to assist in this process and to ensure, in its prudential monitoring, that relevant procedures and systems are sufficiently robust and sound. Indeed, authorities such as the US SEC and the UK's FSA attracted considerable criticism, justified or not, for their alleged failure to address issues of misconduct leading up to the financial crisis. The FSA's risk-based approach to regulation attracted criticism

[41] *Nanus Asia Co. Inc. v Standard Chartered Bank* [1990] 1 HKLR 396.
[42] *Agip (Africa) Ltd v Jackson* [1991] Ch. 547.
[43] Financial Services and Markets Act 2000, sections 2(2) and 6; and see, generally, B. Rider et al., *Market Abuse and Insider Dealing*, (2nd ed. 2009) Tottel, Ch. 6.

on the basis that certain risks had either not been recognised or were not given adequate weight – in particular, during bank examination.

Indeed, well before the crisis it was recognised that in the context of even Basel II the assessment and management of risk was almost an uncharted sea. For example, the General Counsel of the UK's FSA, Mr Andrew Whittaker, observed in May 2003: "There is, so far as I am aware, no authoritative guidance, from the Basel Committee or elsewhere, on the appropriate systems and control needed to manage legal aspects of operational risk." Speaking in the context of the management of legal risk by lawyers, Mr Whittaker, on another occasion, stated: "When talking about legal risk, people mean different things. There is no standard definition of legal risk and it may not be very helpful to produce one."[44]

In the context of *Sharī`ah*-compliant institutions, the *Sharī`ah* board might be expected to achieve certain limitations on otherwise unacceptable conduct on the part of those charged with management. As was observed by Lord President Salleh Abbas in the Malaysian Supreme Court, "There can be no doubt that Islam is not just a mere collection of dogmas and rituals but it is a complete way of life covering all fields of human activities, may they be private or public, legal, political, economic, social, cultural, moral or judicial. This way of ordering the life with all the precepts and moral standards is based on divine guidance through his prophets and the last of such guidance is the *Qur'ān* and the last messenger is Mohammad S.A.W. whose conduct and utterances are revered."[45]

A risk-based approach to regulation, while being obviously open to criticism given its inherent subjectivity, nonetheless is probably the most sensible model for developing markets given the practical limitations within which they operate. Having said this, in view of the discussion hitherto, a rather wider and more exacting process of threat identification and risk assessment is desirable. It goes without saying that this must comprehend a good deal more than issues of integrity and competence and focus in particular on solvency, continuity and resilience. In new markets there is a tendency for this to be considered as part and parcel of the process of designing compliance. Indeed, in some Islamic jurisdictions, compliance expertise and training has been offered on this basis. This is misconceived and is in danger of confusing two quite different processes, requiring very different skills and expertise. The identification and quantification of risk is a different, albeit related process to the design, implementation and monitoring of compliance procedures and systems. Indeed, in the context of some of the integrity-related issues that we have already discussed, the existence of an effective compliance process itself may give rise to legal and regulatory risks. For example, there are cases that have come before the English and Australian courts in which a bank with effective compliance has been placed on the horns of a dilemma. In one case, the court accepted that a bank by virtue of its suspicions as to the source of certain funds in an

[44] Quoted in C. Nakajima and B. Rider, "Corporate Governance and Supervision: Basel Pillar 2", in S. Archer and R.A.A. Karim, *Islamic Finance: The Regulatory Challenges*, (2007) Wiley Finance.
[45] *Che Omar bin Che Soh v Public Prosecutor* [1988] 2 MLJ 5.

account might be constituted a constructive trustee. In such circumstances, it is under a civil law obligation to protect the best interests of those beneficially entitled to the monies. On the other hand, the criminal law renders it a criminal offence, in the circumstances, to inform anyone other than the authorities as to the suspicion. There are numerous other examples of similar potential conflicts.[46]

In developing sustainable Islamic financial markets, adequate attention will need to be given to the skills required for risk management as well as the more traditional role of compliance. It is not clear that in every jurisdiction these resources exist to the extent and level that prudence would dictate.

### x. Regulation of substantial transactions (including takeovers)

Corporate mergers and acquisitions potentially have economic and other benefits. However, it is also the case that there is ample evidence throughout the world that such transactions also have the potential for serious harm and wrongdoing. Incumbent management of a target company in a takeover situation may be more concerned about protecting their own interests than the wider interests of shareholders and other stakeholders. They may be tempted to engage in conduct that is designed either to raise the price of the securities in question unjustifiably, or in some other manner to render the acquisition less attractive to the offeror. Major transactions also provide opportunities for market abuse and insider dealing. An offeror may be tempted to encourage the price of the target company's securities down by circulating information or by manipulative trading. The opportunities for controversy and self-dealing are legion. Indeed, it is probably fair to say that in many jurisdictions it is in the context of such substantial transactions that most evidence of abuse and, in particular, insider dealing and manipulation has occurred.

Where changes are required in the capital structure of a company or the rights of shareholders, the matter is usually regulated by the relevant corporate law. The general law will also be relevant in regard to contracts and misconduct. However, because of the potential impact on the stability and operation of markets, it is common to find additional regulations in special laws. In the US, for example, where contests for corporate control have tended to be either by proxy battles or tender offers, there has long been comprehensive regulation at both state and federal levels. In the UK and most developing markets, the approach has tended to be one of takeover – that is, the

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[46] See *Bank of Scotland v A. Ltd* (2001) EWCA Civ. 52. Note also the current litigation, *Shah v HSBC Private Bank*, Court of Appeal, England and Wales, 25 February 2010. Similar issues arise in regard to "Chinese walls" and attempts to segregate potentially conflicting functions and sensitive information. See B. Rider, "Conflicts of Interest – an English Problem?", in G. Gerrarine (ed.), *The European Securities Markets*, (1998) Kluwer; B. Rider, "The Fiduciary and the Frying Pan", (1978) *Conveyancer* 114; C. Nakayima, *Conflicts of Interest and Duty – A Comparative Analysis*, (1999) Kluwer; C. Nakayima and E. Sheffield, *Conflicts of Interest and Chinese Walls*, (2002) Butterworths; and B. Rider and M. Ashe, *The Fiduciary, the Insider and the Conflict*, (1995) Sweet and Maxwell. See also *Prince JeFri Bolkiah v KPMG* [1999] 2 AC 222; and, in particular, *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd* (2007) FCA 963.

purchase of the target company's shares either in the market or by public offer. From the early 1960s, attempts were made in the City of London to curb abuses and provide for the more-or-less equal treatment of all shareholders, particularly in terms of disclosure and price, in the target company by essentially a self-regulatory process—the City Code on Takeovers and Mergers. This was extended to apply to substantial acquisitions involving interests from 15% to 30%, 30% being the trigger point at which the Code requires a mandatory offer on the same terms as earlier acquisitions to all shareholders. The Code has in effect become a legal requirement and is enforced by legal sanctions. It has provided a model for many other jurisdictions, although many have enacted it as law and operate different (usually reduced) trigger points.

Within the company laws of many jurisdictions there are also rules relating to the sale of office to facilitate a change of control and the purchase of control at a premium over and above the average price of the relevant securities in the market. Given the structure and nature of many Islamic businesses, such provisions might be more relevant than the more comprehensive provisions relating to market transactions. Control and influence in many Islamic companies is not necessarily purely a result of traditional share ownership. In designing suitable laws and regulations relating to takeovers, mergers and changes in control, careful attention needs to be given to these issues. Furthermore, there are many related issues, mainly within company law, relating to the exercise of control or influence by individuals and legal persons who are not necessarily formally connected to the company through a defined capital or contractual relationship. The concepts that have been developed for so-called shadow directors, and the extension of duties to persons in accordance with whose instructions the board is accustomed to act, have relevance in this context. For example, would members of the *Sharī`ah* advisory panel be caught by such provisions?

The rights of individual shareholders, as opposed to the body of shareholders acting in general meeting, is another area of potential concern in the case of traditional Islamic business structures. Most legal systems assume that at least as a matter of company law all shareholders should be treated the same by the board of directors. In other words, even a shareholder with a controlling or highly influential block of shares, unless he or she becomes a "shadow director" or assumes some similar status under the relevant law, in legal theory has no special status within the company. His or her rights are exactly the same as those of any other shareholder. Furthermore, in most jurisdictions, majority shareholders do not have any special obligations,[47] other than perhaps the obligation to net and disclose their holdings; and in some cases they may be treated, usually by statute, as insiders for the purposes of anti-insider dealing laws. Good governance procedures tend to echo these rules, while at the same time paradoxically looking to significant shareholders and, in particular, institutional shareholders to support governance regimes. The important point in reciting these issues is to recognise their potential significance in fostering the development of Islamic financial markets. Far more is involved than simply providing a market. Considerable

[47] But in regard to institutional shareholders, see The UK Stewardship Code, July 2010, Financial Reporting Council, UK.

thought needs to be given to the wider legal environment, and in particular to the institutional structures that are funded by and issue the relevant securities.

### xi. Regulation of institutional investors (collectives, etc.)

We have already noted the desirability of considering specific regulation in regard to the creation and operation of certain types of institutional investment. We have also emphasised the potential importance of institutional investors in giving financial markets depth and liquidity, and in fostering good practices (and within issuers, good governance). Having said this, it is the case that in many jurisdictions many forms of institutional investment remain, if not unregulated, far less regulated and supervised than is probably prudent in the interests of investors, markets and the economy. The political significance as to the extent of indirect ownership in securities by pension funds, insurance companies and financial intermediaries should not be underestimated. The internationalisation of markets has rendered these indirect investors at risk to a much more interdependent and complex reality. For example, the problems BP experienced in resolving the environmental crisis caused by the leakage of oil off the US coast, and the impact that this had on its share value, has resonated around the world given the number of pension funds and other institutional investors holding BP stock.

The legal structure of institutional investors will differ, but as we have already indicated most depend on trust law. The extent to which in many non-common law jurisdictions – and, in particular, Islamic jurisdictions – the local law adequately comprehends the depth and breadth of fiduciary obligation is questionable. It is clear that in the case of collective investment schemes there is the potential for considerable abuse and self-dealing. There are also real issues relating to transparency of the reliability of valuations. The Islamic Financial Services Board (IFSB) has attempted to address many of these issues in its Standard,[48] which itself draws upon the work of the International Organization of Securities Commissions (IOSCO). However, it is clear that the implementation of the IFSB's recommendations in any meaningful sense presupposes not only willingness on the part of the relevant institutions, but a legal environment which in some jurisdictions does not exist and, without substantial legal reform, is unlikely to develop. While the recommendations, insofar as they aspire to the maintenance of good practice, perhaps avoid the far more difficult issue as to whether, in certain forms of collective investment, there is a fundamental incompatibility with Western notions of fiduciary accountability. This is particularly the case when institutions commingle investments and do not have adequate segregation of funds.

### xii. Ethical investment

The desire of investors to promote only businesses that are – in terms of their objectives, activities and management – ethical is not new. Indeed, there are many examples of the Quakers and others adopting such an approach. Various formal

[48] See IFSB-6: "Guiding Principles on Governance for Islamic Collective Investment Schemes", (2009) IFSB.

initiatives were developed in the 1980s often associated with the movement for greater corporate social responsibility, fair trade and good governance. There are now several specialised indices of investments that have been judged by those sponsoring the lists as potentially ethical investment opportunities. Governments, including the British and Swedish governments, have backed such initiatives particularly in the context of international development. Having regard to the requirements of *Sharī`ah*, it is arguable that proper Islamic financial instruments represent ready-made ethical investment opportunities for investors whether Muslims or not. Indeed, the Catholic and Anglican churches have accepted this proposition,[49] albeit with certain reservations. Judged purely in ethical terms, investments that are *Sharī`ah* compliant would encompass many of the ethical and moral criteria required for ethical investments from the perspective of, for example, Christians and Jews or simply those wishing to act in a humanitarian manner. While there have been some attempts to promote Islamic investments as ethical investments to a much wider market than Muslim investors, these initiatives have been limited.

### xiii. Extra legal issues (governance/compliance)

Concern as to the better governance of businesses is not new, as we have seen. However, it is only in the last 40 or so years that objective standards of good governance that have international relevance have been articulated and promulgated by various organisations, including the United Nations, Organisation for Economic Co-operation and Development (OECD) and IOSCO. It is important to appreciate that good governance is primarily about systems and the promotion, through appropriate mechanisms, of integrity and responsibility. Consequently, there is today some degree of scepticism, after the excesses and greed in recent years demonstrated by the sub-prime financial crisis, as to how effective such an approach can be in inhibiting self-dealing and misconduct. There is, today, perhaps a greater realisation that traditional governance procedures, even if mandated by stock exchange listing agreements and the like, need to be re-enforced by the assumption of a greater degree of responsibility on the part of boards and, in particular, non-executive directors – especially in financial institutions.

Today, many speak rather more in terms of promoting good stewardship. This harks back to the comments of President Roosevelt during the introduction of the measures which became the basis for the “New Deal” in the US in the 1930s: “What we seek is a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people’s money are trustees acting for others.” This imports obligations throughout the business structure rather more onerous than has hitherto been contemplated within traditional governance.

[49] For example, L’Osservatore Romano commented, “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service” (*World Bulletin*, 20 April 2009).

In some jurisdictions where IIFS operate, such as Malaysia and Indonesia, governance procedures are well established.[50] More recently, there have been a number of initiatives in Saudi Arabia and certain Gulf states to promote good governance. Indeed, it has with justification been pointed out that adherence to *Sharī`ah* would itself lead to responsible governance. The *Qur'ān* itself emphasises the obligation of stewardship placed on all Muslims. Having recognised the powerful injunctions in traditional Islamic teaching, the extent to which actual procedures that would be recognised as promoting good governance from a Western perspective are not always in evidence. In some measure, this may be the result of ownership and control patterns in Islamic businesses and simply an issue of resources. Finding suitably qualified and experienced individuals who can exhibit independence is not always easy in developing markets. Indeed, this has been an issue even in jurisdictions such as Japan and Australia.

We have already emphasised the importance of effective and efficient compliance procedures in the financial sector. Again, in some Islamic jurisdictions there are indications that more needs to be done to recruit and train compliance personnel. Indeed, this has been recognised by some governments, including Dubai and Qatar. Of course, this is not confined to developing or Islamic markets. For example, the Government of Singapore has recently initiated programmes with the International Compliance Association to develop and train compliance personnel. Of course, there are numerous initiatives that are taking place to increase the level of professionalism within the Islamic financial services industry and the depth of knowledge and learning. This is commendable. However, it remains to be seen whether many of the more academic programmes will in fact facilitate the appropriate level of practical expertise that is needed now, let alone in the future. Governments that are concerned to see the development of Islamic finance will need to become rather more involved in fostering expertise, not least in compliance-related matters.

Other issues also need to be addressed in ensuring adequate and effective regulation and supervision. It is, for example, important that the local accountancy and legal professions have the competence and capacity to provide professional support. This is a particularly pertinent issue in regard to Islamic finance. The level of competence and integrity of those working within the financial services industry is also of the utmost significance. The existence of mechanisms for the effective and efficient dissemination of reliable financial information and the support of informed, independent and competent commentators within the general or specialist media is vital. The willingness and capacity of investors – and, in particular, institutional investors – to concern themselves with issues relating to good governance and the promotion of integrity is needed for the long-term development of stable and efficient markets. Of course, running through many of these issues is the need to have adequate education and training, preferably pertinent to the relevant domestic circumstances. Expertise on regulatory and compliance issues is at a premium in developed jurisdictions, and at this point in time

[50] See also IFSB-10: "Guiding Principles on *Sharī`ah* Governance Systems for Institutions offering Islamic Financial Services", (2009) IFSB.

many developing markets find it necessary to import it. Knowledge of Islamic finance, particularly in regard to regulatory matters, is also limited in a number of jurisdictions.

### xiv. Enforcement

Before leaving these wider issues, we emphasise the importance of an effective legal environment for enforcement. Given the nature of Islamic law and the deep obligation on Muslims to obey ordained law, enforcement tends to be of less significance than in systems of law, such as the common law, where arguably it is the existence of a predictable sanction that determines a rule as one of law. Islamic law is not sanction driven. On the other hand, when we move into essentially regulatory obligations where the moral justification of the obligation is less obviously related to an ordained prescription, the absence of practical and proportionate sanctions renders compliance problematic. This is a particular issue in regard to financial and fiscal law, where moral imperatives are far more difficult to discern than in, for example, the traditional criminal law. It also has to be recognised that some of the more important rules attempt to inhibit conduct that may be morally ambiguous and can result in very significant financial benefit. For example, there remains in some jurisdictions genuine discussion as to the morality of insider dealing. Most would perceive unfairness in a director taking advantage of information that comes into his or her possession as a director and which anyone with whom he or she may deal is legally barred from acquiring. However, what about a potential offeror company, or some other person, who trades in the market before making a public announcement utilising nothing more than the knowledge of their own intentions? Is this insider abuse? We have already raised similar issues in regard to money laundering.

The traditional criminal law is a very blunt weapon. It requires a high standard of proof and even in the most developed jurisdictions it has not always proved effective in dealing with complex issues in the financial sector. Even in circumstances where the stigma of a criminal conviction might be deserved, such as in cases of insider abuse, the practical problems in establishing a case to the requisite standard of proof have often been insurmountable. Consequently, resort in many jurisdictions has been made to civil enforcement procedures. As the experience of the UK shows, however, this is not a panacea. On the other hand, having rules and regulations that cannot or will not be properly enforced brings the law and authority into disrepute. Experience has shown that even in some of the most well resourced jurisdictions, effective policing of financial laws has been deficient. In the context of developing jurisdictions, there are the additional problems of resources and expertise. Furthermore, where there is serious wrongdoing in the financial sector, this will often be associated with other misconduct. While financial regulatory authorities may, with justification, wish to proceed with sensitivity, other agencies within the criminal justice system may be more robust.

What is important here is the recognition that while characterising a rule as one of law might have a declaratory impact, in many cases without the possibility of effective and efficient enforcement it can seriously undermine confidence not only in the markets but in the legal system as a whole. Sadly, experience shows that governments and, in particular, regulatory authorities do not always take this on board. It is also important to remember that regulations can well result in the shifting of legal risk from one party to another. We have already noted, for example, the arguably disproportionate burdens, including legal, regulatory and reputational risk, placed on financial intermediaries under anti-money laundering regulations.

Finally, it is also imperative that the legal system is capable of delivering effective and efficient determination of legal disputes.[51] To afford investors and others rights which cannot be vindicated is entirely counterproductive. To ensure that rights can be enforced in the civil courts the tribunals must also be sufficiently resourced, with independent and competent judges supported by appropriate legal procedures and powers. In particular, it is often the case that if rights are to be at all meaningful, it is necessary to take preliminary and often protective steps. Generally speaking the *Sharī`ah* does not provide the array of interim and preliminary orders that are in practice necessary. This is an issue that we return to.

## *C. Regulatory Models and Interrelationship of Systems*

### i. Overview of the main regulatory/supervisory models

Analytically it is possible to identify different approaches to financial regulation resulting in differing models. As we have already seen, regulation is not, or rather should not be, an end in itself. The drawing up and imposition of regulations carries a significant cost and may well have the result of inhibiting desirable activity and perhaps shifting risks in a manner that is not intended and is counterproductive. Market regulation has tended, historically, to develop with the aim of fostering market stability and development. Nonetheless, history also provides many examples of legislation and regulatory interventions that do not have a direct relationship with the economic development of the particular market, but are motivated by some other political projective. For example, many early laws and some of more recent vintage were passed rather more to consolidate the privilege of holding a market, and thus securing revenue by way of charge or tax, than to foster commercial intercourse. Other laws attempted to secure monopolistic rights for those running markets. These might be justified not only on the basis of economic viability, but have a wider regulatory significance. We have already noted that in attempting to create a viable market with at least some depth in small and developing economies it might be desirable to require all securities-related transactions to be put through a particular market, or at least through what securities industry exists. The centralising of trading or at least settlement might also have fiscal justifications and facilitate the better protection of investors.

[51] S. Frommel and B. Rider (eds.), *Conflicting Legal Cultures in Commercial Arbitration*, (1999) Kluwer.

In the modern world in practical terms there is rather less scope for diversity in regulatory models than in the past. This is a result of a number of factors that are not limited in their relevance to the financial sector. Perhaps the most compelling pressure for a degree of standardisation is the internationalisation of the financial services industry.[52] This has occurred at all levels, including issuers, investors, institutions and markets. The goals mobility of capital, and freedom of movement and establishment, have resulted in a substantial and ever-increasing degree of interrelationship between markets. There are few institutions and markets that are not exposed to some degree of interdependency. Having said this, however, it is perhaps in regard to IIFS and some markets where inter-penetration is less manifested. While there may be a greater degree of interdependency within and between Islamic markets, the obligations imposed by *Sharī`ah* have operated to provide a barrier to wider penetration. Excluding multinational financial institutions that offer windows of Islamic finance, the degree of involvement in non-Islamic institutions by Islamic investors is proportionately much greater than the converse. It is only relatively recently that non-Islamic governments and institutions have recognised the benefits of utilising Islamic financial products – in particular, the *Sukūk* – for raising funds, from the Islamic world and elsewhere. The uncertainties within Islamic law and concerns as to how non-Islamic courts might resolve issues have combined to inhibit the potential for development of this market. The failure of several high-profile *Sukūk* issues has also dented the reputation for resilience of Islamic finance.

In the further development of Islamic financial products and the markets that accommodate them, it is probable that from a purely legal standpoint laws relating to insolvency and the taking and enforcement of security will have a greater impact than the form of market regulation. Indeed, in practical terms, of rather greater significance than the law in the relevant Islamic jurisdictions will be the interpretation of existing laws in other jurisdictions, especially the US and the UK. This is clearly shown by the decision of Judge Robert Summerhays in the US Federal District Court for the Western District of Louisiana on 31 March 2010 in the bankruptcy proceedings relating to East Cameron Partners. In the case of asset-backed *Sukūk*, it is vital for the adequate protection of *Sukūk* holders in the event of an insolvency of the originator that there has been an effective and complete sale, before the event of insolvency, to the investors. It is only on such a basis that they will be protected otherwise than as unsecured creditors.

When considering legal challenges, it must be remembered that different jurisdictions may take very different approaches. This point was forcefully made in the English Court of Appeal by Potter LJ. In *Shamil Bank of Bahrain EC v Beximco.*[53] He pointed out that "strictly interpreted 'the Glorious *Sharī`ah*' refers to the divine law as contained in the *Qur'ān* and *Sunnah*. However, most of the classical Islamic law on financial transactions is not contained as 'rules' or 'law' in the *Qur'ān* and *Sunnah* but is based on the often

[52] See, in particular, *Objectives and Principles of Securities Regulation*, (2003) IOSCO, updated June 2010.
[53] [2004] 4 All ER 1072 at 1081.

divergent views held by established schools of law formed in a period roughly between 700 and 850 CE." The English High Court and Court of Appeal held that, despite a contractual provision, the parties could not trump the English law by the principles of the *Sharī`ah*. The provision at most indicated that the parties intended to act in accordance with the principles of Islam. Furthermore, in article 1.1 of the Rome Convention, provision is made only for the choice of the law of domestic jurisdictions and not non-national systems, such as the *Sharī`ah*.

Furthermore, in some states where there is a diversity of jurisdictions within the state, not all courts may take the same approach. Indeed, the complexity and uncertainty that so-called forum shopping creates is potentially a real problem for the development of Islamic financial products and services. This is exacerbated by the underdeveloped law in many Islamic jurisdictions in relation to arbitration and the recognition of the orders and judgments of other courts, particularly those in other jurisdictions.

It is also the case that, as Khan J, an expert witness, in the *Beximco* case explained, a certification or decision of, for example, a bank's *Sharī`ah* board "would not be a decision binding on any court dealing with a dispute under *Sharī`ah* . The dispute would be resolved by the court in the light of its own view of the position under *Sharī`ah* law*."* The reluctance of the courts of many non-Islamic states to entertain arguments based on attempts to contractually render *Sharī`ah* applicable can be understood and defended on traditional conflict of law principles.[54]

### ii. Legal issues relating to prudential supervision/intervention

It is pertinent to point out the traditional distinction between the way in which securities markets and their intermediaries have been supervised as compared with banks. For the last 50 or so years, deposit-taking banks have been supervised on a prudential basis. This involves the proactive monitoring of their operations primarily from the standpoint of financial soundness and, in particular, capital adequacy. Banking supervisors engage in a structured programme of inspections, which to a greater or lesser degree are designed to test the information reported to them by the bank and its auditors. On the other hand, in regard to intermediaries involved in the securities markets, until relatively recently supervision was, after admission, rather more reactive. As we have seen, there is a long history of requiring those who operate as professional intermediaries in the financial markets to obtain a licence or some other form of permission. The level of official and independent scrutiny over this process, and in particular the verification of information submitted by applicants, varied greatly from one jurisdiction to another. Of course, in recent years, particularly as a result of the work of

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[54] See, for example, *Islamic Investment Company of the Gulf v Symphony Gems NV* (2002) WL 346969 (QBD); and, in particular, *Beximco* (supra) [2003] 2 All ER 849, affirmed [2004] 4 All ER 1072; and in regard to the law of tort – *Riyad Bank v Ahli United Bank (UK)* (2006) EWCA Civ 780. A recent decision of the English High Court does leave open the door that *Sharī`ah* compliance may be raised, in certain circumstances, as an issue of corporate capacity (*The Investment Dar Company KSCC v Blom Developments Bank SAL* (2009) EWHC 3545 (Ch.)).

bodies such as IOSCO and the creation of the Single European Market, there is a much greater degree of standardisation in this process. Indeed, the ability of intermediaries to operate trans-nationally has underlined the vital importance of the home jurisdiction taking this process seriously.

The realisation during the 1990s that in practical terms it may be very difficult to sensibly distinguish between banking and other financial activities led to many jurisdictions developing "one stop" regulation and attempting to subject all financial institutions to continuous and proactive monitoring. Therefore, the prudential approach to regulation was extended to all those engaged in the investment and banking business. The recent financial crisis has resulted in a number of governments revisiting these issues. The classic distinction between retail and proprietary investment business within financial institutions in the minds of many today is perhaps where the line needs to be drawn in the type of regulation and possibly the approach to supervision. Consequently, in a number of the major financial markets there are significant changes taking place which are likely to result in greater monitoring and intervention in the case of those businesses which are determined as representing the greatest risks. However, the treatment of, for example, a systemic risk will be rather different, probably both institutionally as well as in character, from the response to a perceived investor risk.

The relationship between traditional regulation and prudential regulation is aptly stated in the UK Financial Services Authority's Markets Regulatory Agenda.[55] The FSA states" "It is important to recognise the proper role of market regulation and, in particular, how it complements, rather than substitutes for, a sound system of prudential regulation for relevant market participants, such as banks and other major players. Our markets agenda is aimed at improving markets' resilience and transparency as a counterpart to actions taken at firm level to discourage and prevent reckless behaviour and strengthen the financial system's ability to copy with shocks." This approach is commendable.

Finally, in this context it is worth mentioning the particular concerns that have arisen in regard to offshore financial institutions and services. Of course, today the designation "offshore" has rather more to do with a state of mind than geographic location. Technology has rendered the specifics of physical location almost irrelevant. However, until relatively recently there were jurisdictions that were prepared to accord those using their legal system considerable advantages in terms of secrecy, regulation and tax treatment. There are, of course, wholly legitimate reasons why jurisdictions might wish to give privileged or special treatment to overseas investors. Nonetheless, some countries acquired a reputation for being either too lax in the observance of international standards of behaviour, particularly in regard to money laundering and tax evasion, or even complicit in the activities of criminals. Much has changed as a result of international pressure driven not only by a desire to facilitate the tracing and interdiction of suspect funds, but also for reasons related to the collection of revenue. This is not the place to enter into a discussion as to the regulation of offshore activity, although it does, of course, impact on the efficacy of international regulation and the stability of markets.

[55] May 2010 at paragraph 3.27.

There are a few Islamic jurisdictions that have courted offshore business and sought to develop this service.[56] Some are actively considering offering *Sharī`ah*-compliant products and services to offshore clients. Having said this, the relevant regulatory authorities are well aware of the need to ensure observance with international best practice and, in particular, they have the capacity and authority to cooperate with foreign regulatory authorities.

### iii. Regulatory models

It was our intention to review, in the context of the development of Islamic markets, the various regulatory models that have been refined in some leading financial centres. However, given the pace of regulatory change and the level of international interaction in this regard, there is probably less value in describing what might soon be historic systems. It is impossible to segregate the political and economic imperatives in the fashioning and maintenance of regulation. Regulation in practice operates, or should operate, to give effect to these imperatives. The identification of failures in the more dominant regulatory systems – for example, in the US and the UK – has been well documented and is less relevant in looking forward to the creation and establishment of viable and sound Islamic markets. What is important to appreciate is that the changes that are taking place as a result of the perceived weaknesses of regulation and inadequate supervision, and particularly the inability or reluctance of authorities to intervene, will – as a matter of law – be addressed. In particular, governments will take to themselves powers to intervene on the basis of prudential monitoring at a much earlier stage and impose regimes which might be better able to deal with specific or interrelated crises. Of course, it always remains to be seen whether the agencies charged with these functions will have the resources, will and support to do so. It is also obviously the case that most of the changes that are in the process of being made are in perspective retrospective.

### iv. Regulatory approaches

It is a matter for debate whether the approach to regulation should mould the model or system of regulation, or vice versa. Of course, ideally and simplistically the philosophies and policies that result in an approach to a problem should determine, at least in substantial measure, the model adopted for implementation. However, financial markets are never simple. The issues that need to be addressed are complex, interrelated and often disparate. Furthermore, given the breadth of issues that need to be accommodated within a regulatory system, it is impossible to synchronise policy to a point at which there is no regulatory inheritance in terms of activity or institutions. Consequently, it is only possible to distinguish in very broad terms different approaches to regulation, which in most systems exist to a greater or lesser degree in harmony.[57]

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[56] See, for example, Labuan Islamic Financial Services Act 2010.
[57] See B. Rider and M. Ashe, “The Insider Dealing Directive”, in M. Andenas and S. Kenyon-Slade, *EC Financial Market Regulation and Company Law*, (1993) Sweet and Maxwell.

It might be useful simply to indicate the approaches that are discernable in market regulation – emphasising that, in modern markets, these are likely to coexist and operate together. Historically, perhaps the oldest approach was simply to inhibit fraud and related abuses on the market. Traditionally, this approach, while adopting the precept of *caveat emptor*, was concerned to ensure that investors should not be made fools of. While a foolish person would only have himself to blame if he made foolish decisions, the law should prevent him from being deliberately misled. The fraud approach has been extended, so that now – albeit somewhat illogically – insider dealing is considered as a species of fraud.[58] In the US, for example, insider dealing is regarded as a fraud on the market as a whole. Associated with this approach is the desire to promote and maintain investor confidence in the market. Obviously this might wane if it is felt that there are fraudsters in the market, but also perhaps insider dealers and money launderers. Intervention on the basis of confidence may, of course, be wider than simply on issues of integrity and extend to stability and soundness. Associated, progressively, with these approaches is the desire to promote sensible and, therefore economic, decisions in regard to wealth. Thus, those who have decisions to make, directly or indirectly, should be given as much reliable and relevant information as possible. The assumption is that access to material information will encourage and support sensible decision-taking. This may be furthered, by requiring those who offer advice or who transact business to exhibit appropriate levels of competence. Indeed, when they fail to do so, it may be appropriate to regard them as insurers in relation to loss flowing from their incompetence. Of course, the problem then arises as to in what circumstances it is appropriate to require intermediaries to proffer advice that has not been directly sought. Indeed, there are examples of regulatory approaches, often referred to as "merit systems", where the market or possibly a regulator actually intervenes to warn investors, perhaps by list or specific intervention, as to the relative merits of an investment.

This may go further than requiring certain issues to be advertised as speculative or highly speculative. In extreme cases it might involve mandatory removal from the market of an investment that, while not fraudulent, is determined to be "wasteful" or lacking in merit. It is interesting to consider in this context the relationship of the traditional common law prohibitions against activities that are considered *contra bonos mores* with the concept of *Halāl* in Islamic law, albeit these determinations are based on wider issues than simply the relative economic merits of an opportunity. Of course, in some jurisdictions investment opportunities and transactions will need, in any case, to conform to a national plan or be subject to certain regulatory controls. This used to be more common when planned economic development and restrictions on foreign ownership of certain categories of wealth were more in vogue. The consumer-based approach to regulation attempts to assimilate investments, or at least certain rights or transactions, with those relating to consumer goods, at least in terms of legal expectations and remedies. The extent of protection may range from analogous liability for latent defects to notions of fitness and suitability. It may well also cast responsibilities

[58] See *R. v McQuoid* (2009) EWCA Crim. 1301; and B. Rider, "Comment", 17 *Journal of Financial Crime* (2001) 285.

on regulators to intervene on behalf of investors and others or assist them in maintaining their rights. Closely associated with this approach, but obviously having a wider relevance, is concern to show financial stability and soundness and ensure that in the event of a default there is adequate protection of funds by indemnity. Indeed, those responsible for providing indemnity or insurance may be cast in the role of a monitor or even regulator, determining exactly who is entitled to the privilege of being indemnified. This approach is not unrelated to that which encourages participants in the market to adopt and maintain the standards associated with professionalism. This may or may not be associated with obligations to self-regulate.

Perhaps one of the most interesting approaches to regulation is to require manifest fair dealing. This in some respects encompasses the more protective approaches that we have discussed, as it gives effect to the reasonable expectations of the client to be treated fairly.

This approach is objective in the criteria it sets, but subjective, to some degree, in application. While this approach has been taken furthest by the FSA in the UK, the notion of fair dealing is very old. Indeed, there were provisions in statutes in the 17th century in the City of London requiring those who engaged on behalf of others in financial transactions to act fairly. The "New Deal" legislation in the US, and even some Blue Sky (i.e. state) laws before then, speaks in terms of fair and orderly markets and engaging in fair and equitable conduct. To some extent this harkens back to the concept of stewardship to which we have already referred.

Of course, these and other approaches will often vary in their application to different types of investment advisers and their circumstances. For example, those who act for professional investors may be required to exhibit less caution in the advancement of their clients' interests than those who knowingly are acting for a vulnerable private client. It has been said that while speculators may have a reasonable expectation that the law will protect them from fraud, it might not be reasonable to expect that they will be given the breadth of protection that a small investor has. Obviously, all obligations import costs and at the end of the day the balance and burden of costs will impact on the efficiency and sustainability of the market and industry. It is not desirable that there is such a shift of responsibility onto market professionals and intermediaries that access to the market becomes too expensive. Indeed, the same concern applies to the costs and risks imposed on those seeking to raise capital. Disclosure comes at a very real cost. The failure to consider the costs and benefits or certain regulations, such as those relating to money laundering, has arguably impacted on certain types of business. It is very important to appreciate that almost every law carries with it the implication of a determination of responsibility and therefore a contingent risk.

Not only might the scope and texture of the obligations pursuant to a particular approach vary, but also the character of the obligation. We have already noted that legal systems may seek to impose an array of obligations resulting in the prospect of liability at different levels within the legal system. For example, breach of one rule may give rise to the prospect of a criminal conviction, while breach of another may merely operate to render a transaction unenforceable in the civil law. This is related to the very important issue, in any legal system, as to the extent to which rights and obligations imposed by the law can be waived, modified or excluded by agreement between the parties. This is potentially an extremely important issue given the significance of contractual obligations in many forms of Islamic finance. Of course, it is generally not possible to contract out of obligations imposed by *Sharī`ah*, for obvious reasons. However, it may well be possible to modify the circumstances whereby a duty arises, thereby impacting on the essential obligation. It is also important to note that, in pursuing a particular regulatory approach, the articulation of obligations within the law may vary considerably in form. This may range from the prescriptive obligations of substantive law to the principles-based approach of, for example, the FSA in the UK. Again, however, there are important collateral issues. In Britain, where there are legal or disciplinary consequences in violating a principle which in essence is potentially vaguer than a substantive rule, there are real judicial issues.

### v. Trans-national models (and soft law)

We have mentioned already the significance of international initiatives that serve to strengthen domestic regulation,[59] but also to some degree require – or at least encourage – the observance of certain standards. The obligation on a state, or possibly an agency, to follow a particular standard or approach will vary depending upon whether the obligation is binding as a matter of law or is simply persuasive. As a general proposition, the implementation of a standard that is to have domestic legal effect will require domestic enactment. This is not always the case, as some constitutions may give direct effect to international treaty or convention obligations, or have legislation already in place that gives effect to, for example, decisions of the General Council of the United Nations. In the context of the European Union, only certain types of obligation will be directly applicable in member states. In the context of financial regulation, and in particular the development of Islamic markets, there are relatively few sources of international obligation that operate at this level within the legal system.

It is far more common to find obligations arising as a matter of commitment to a particular organisation, such as IOSCO, in regard to the matters under discussion. The standards that are promulgated by these intergovernmental organisations and the like compose a system of what has been described as “soft international law”. While, in the main, not binding in any legal sense, their adoption by domestic legislation or agency action is nonetheless compelling if the privileges of international comity are to remain unencumbered. Indeed, compliance with such standards may well be, as a matter of law, a requirement in other jurisdictions for access to various privileges or for the provision of assistance. Failure to adhere to these standards may well result in

[59] See, for example, a recent statement of the Committee of European Banking Supervisors (CEBS) supporting full harmonisation in a single rule book of banking regulation within the European Union; 8 October 2010.

international criticism and ostracism. Certainly, no jurisdiction seeking to establish a viable financial market could afford to ignore these provisions.

A potentially serious issue for Islamic financial markets is that in the negotiation and framing of certain standards, given the relative youth of Islamic financial markets, there has been little or no opportunity for the particular needs of IIFS and products to be addressed.[60] Indeed, it is only recently that bodies have developed with expert knowledge of Islamic finance and a mandate to advocate on behalf of those who wish to see the development of Islamic finance. While this problem should not be overstated, it is a fact that many of the standards that impact to a greater or lesser degree on, in particular, the operation of financial intermediaries have long been established and are now embedded within the domestic laws of most states. Consequently, in purely practical terms it is difficult to reopen the debate even if there is political interest in doing so. The approach of many of the established markets and their regulators is that those wishing to offer Islamic products and services must comply with the law as it is in the relevant jurisdiction and in addition to the *Sharī`ah*. Hitherto there has been little attention given to the particular issues that arise in the regulation and operation of IIFS in the context of some of these standards. Consequently, it is conceivable that issues will arise which will have to be negotiated.

### vi. Interrelationship of legal systems (and domestic intra-systems)

Islamic financial markets, institutions and products will be governed by the *Sharī`ah*. We have already noted that while there is consistency within the five primary schools of Islamic jurisprudence on most aspects of the relevant law, there are significant issues where there is divergence of views. In the context of the development of Islamic markets, it is of concern that some of these different views as to the law relate to very important aspects of securitisation and derivative rights. There are also issues relating to the significance of misrepresentations and the remedies that are available. It is also the case that the body of Islamic law that has so far been elaborated is not sufficiently encompassing to provide adequate guidance in all the circumstances necessary for developing sound and efficient markets. While welcome attempts are being made by various organisations to address the more serious areas of uncertainty through deliberation and scholarship, this is a slow and not always effective process.

Consequently, it is recognised that there will be a need for a significant amount of law and regulation that is not derived from traditional Islamic sources. Of course, the secular law and the processes that create it may and probably will be Islamic and it would be wrong to assume that such legislation and regulation does not carry the authority of *Sharī`ah*. However, as we have already mentioned, much will depend upon the provisions of the relevant constitution and the view in the final analysis of *Sharī`ah*

[60] See generally A.A. Mi, "The Role of Islamic Jurisprudence in Finance and Development in the Muslim World", 27 *Company Lawyer* (2008) 3.

courts and jurists.[61] Where a rule of ordinary law is judged not to be compatible with the *Sharī`ah* there are different legal consequences, as opposed to religious consequences, in different jurisdictions. In some it is provided in the constitution that the relevant provisions of the ordinary law will have no effect. A rule that is not compatible with Islam is not law and there is no obligation to obey it. Indeed, as is recognised in Iran, in certain situations there may be in Islam an obligation not to obey it.[62] Under other constitutions a rule that is judged to be incompatible will remain a legal rule, albeit Muslims will be under no obligation within Islamic law to obey it. This is compounded by the inherent uncertainty of some principles of Islamic law both in their application and interaction with secular laws.

Recent judicial decisions have, in some quarters, been thought to seed additional uncertainty. For example, Justice Datuk Abd Wahab Patail in *Arab-Malaysian Finance Berhad v Taman Ihsan Jaya Sdn Bhd*[63] in a robust judgment, albeit now on the merits reversed, emphasised the importance of examining a series of transactions (in the context of *Al-Bay` Bithaman Ajil*) as a whole and considering the substance of what was in issue. He rejected resort to "legal devices or trickery (*Hila*)", pointing out that God was all seeing and could not be deceived by artifices. He stated: "In developing a *Fiqh al-Muamalat*, caution must therefore be exercised for it is all too easy, when creating and then relying on legal fiction, to fall into the pit of complacency and inadvertently developing a '*Fiqh al-Hiyal*'.[64] Bearing this in mind it is not sufficient that the distinction between a sale and a loan is maintained in form, but it must also be maintained in substance. It is the reality and not the form and labels that matter." It is also interesting that the court underlined that it had an affirmative obligation on it to inquire whether a transaction violated the *Sharī`ah* under the relevant provisions of the Malaysian Constitution and laws, and could not merely assume compliance.

Of course, in non-Islamic states the determination of legality under *Sharī`ah* will be irrelevant to the status of the obligation, albeit as we have seen, there may be other legal consequences – such as where there has been a representation or undertaking of due compliance with Islamic law. Indeed, the situation may be even more complex as a result of the common law doctrine of illegality. In the result, there is the potential for considerable uncertainty as to the status of obligations and their enforceability.

Furthermore, in regard to the obligations imposed by Islamic law there are special considerations. The jurisprudence as to the consequences of a prohibited act (something that is *Haram*) is articulated in different ways by the various schools. It is

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[61] See, generally, Abdur-Rahmaan ibn Salih al Mahmood, *Man-made Laws vs Shari`ah*, (1999) International Islamic Publishing House; and Abdur Rahman I. Doi, *Shari`ah: The Islamic Law*, (1984) Ta Ha Publishers, London.

[62] For example, Act 2 of the Maldives Constitution provides that the nation is Islamic and Act 10 provides that no law shall be enacted which is at variance with Islam. See, in particular, M.H. Kamali, *Principles of Islamic Jurisprudence*, (2003) Islamic Texts; and M.I. Siddiqui, *The Penal Law of Islam*, (2010) Adam, Ch. 1.

[63] [2008] 5 MLJ 631.

[64] *Hiyal* is the plural for *Hila*.

important to appreciate that in Islamic law the obligation to obey the letter and spirit of the *Sharī`ah* is a personal duty of the believer. Indeed, given the overarching virtue of *Tawhīd*, involving the full submission of the believer to God, an attempt to evade or circumvent the *Sharī`ah* becomes itself unacceptable and worthy of condemnation. It has also been emphasised in judicial decisions that "regardless [of] whether a person is a follower of the Religion of Islam or not, the logic remains true that if a god is omniscient, that god knows the truth of what is done and intended, regardless of the terminology or language used. The effect of the assumption of omniscience is therefore that legal devices or trickery (*Hila*) would fail in the eyes of Allah."[65]

While the character of the violation may have specific consequences in terms of other legal rules, particularly of a criminal nature, the essential obligation is on the relevant individual. In other words, there is not as such a doctrine of illegality as recognised by common law systems. A resulting transaction may well be unenforceable because no other believer, including a *Sharī`ah* court, would wish to recognise an obligation, "…for He commands them what is just and forbids them what is evil…" (*Surah al-A'raf* (7) verse 157) and "…for He commands them what is just and forbids them what is evil: He allows them as lawful what is good and pure and prohibits them what is bad…" (*Surah al-A'raf* (7) verse 157).

Under the *Sharī`ah* there are significant obligations of disclosure (such as *Katman*), and where these are not discharged due to dishonesty (*Khiyanah*) then the law might regard a resulting transaction as void on the basis that its very purpose has failed. It is also the case that property or wealth derived from a *Haram* act is unacceptable. In another *Hadīth*, the Prophet stated: "The flesh gathered on one's body by means of unclean earning deserves to be thrown into the fire of hell."[66] Thus, it is important to recognise in Islamic law that "not only the ends sought must be right (and pure) but also the means to achieve those ends must also be right".

Where several jurisdictions are involved, as they often will, the situation becomes all the more complicated. In many Islamic jurisdictions there are few developed procedures for resolving conflicts of law, other than the imposition of the local law. Furthermore, procedures for the recognition of foreign judgments, and in particular determinations by *Sharī`ah* courts and councils, are few and under-developed. Not all Islamic jurisdictions have even the basic laws in place for recognising, let alone giving effect to, foreign judgments. As we have seen, given the fact that financial institutions and services must operate within a much wider legal environment than simply the relevant financial law, the potential for resolving many of these issues in the short term is not great. What is required is a process whereby conflicts and related issues can be resolved across the legal spectrum.

It is worth noting here the steps that have been taken in certain jurisdictions to provide not only a greater degree of certainty in the law, but a much more viable basis for

[65] Justice Datuk Abd Wahab Patail in *Arab-Malaysian Finance Berhad v Taman Ihsan Jaya Sdn Bhd* [2008] 5 MLJ 631. Although this decision was reversed on appeal, the *Hila* principle was not questioned.
[66] Abdur Rahman I. Doi, *Shari`ah: The Islamic Law*, (1984), Ta Ha Publishers, London, p. 373.

recognition and resolution of conflict issues. Article 8 of the Dubai Law on the Application of Civil and Commercial laws (DIFC Law No. 3 of 2004) provides: "DIFC Law is able to apply in the DIFC notwithstanding any Federal Law on civil or commercial matters, the rights and liabilities between persons in any civil or commercial matter are to be determined according to the laws of the time being in force in the Jurisdiction chosen in accordance with paragraph (2)." Paragraph (2) makes the laws of England and Wales the default laws. Of course, such provisions, while not unique, are exceptional.

## *D. Overview of Relevant Aspects of the Sharī`ah in the Development of Stable Islamic Financial Markets*

### i. *Sharī`ah-Fiqh al-Muamalat* (including authority and principal prohibitions)

The *Sharī`ah*'s primary sources are the Holy *Qur'ān* and the *Sunnah* of the Holy Prophet. The Holy *Qur'ān* regards the *Sunnah* as being an equally important source of law and must be adhered to in order for one to be fully *Sharī`ah* compliant: "If you obey him only then will you be guided" (The Holy *Qur'ān*, Surah an-Nur (24) verse 54). Before the principles of Islamic *Sharī`ah* can be discussed, it would be important to state the *Maqāsid* (objectives) of Islamic *Sharī`ah*. There are six primary objectives; *Sharī`ah* aims to protect and preserve religion, life, progeny, property, intellect and honour. These objectives are imperatives and permeate the *Sharī`ah* and its application.

In the context of IIFS and businesses, there is a further factor that needs to be specifically addressed. The Holy Prophet recognised that "whosoever relieves a fellow human being of a burden in this world, Allah would relieve him of a burden on the Day of Judgment" and "no one can be a true believer unless he loves for his fellowmen what he loves for himself". Consequently, there is if not an obligation an aspiration for *Barakah* or a blessing that actions shall be considerate. Therefore, it has been argued by scholars that in assessing the acceptability of proposed actions, their impact on society and the environment should be weighed in the balance. Furthermore, in compliance with the *Sharī`ah*, it is also important to note that "that which is lawful is plain and that which is unlawful is plain and between the two of them are doubtful matters about which not many people know. Thus he who avoids doubtful matters clears himself in regard to his religion and his honour, but he who falls into doubtful matters falls into that which is unlawful…" (*Hadīth*, narrated by Al-Bukhari).

One of the main obligations imposed on all believers by *Sharī`ah* is that all activities that are considered to be *Haram* (impermissible) must be avoided. The main products and activities that are explicitly prohibited under *Sharī`ah* include the consumption and handling of pork, alcoholic products, pornography, firearms, and any activity which involves usury. The issue of *Riba* has perhaps attracted most attention in that it is probably the most serious hurdle to combining financial activities in Islam with conventional finance and banking. "Allah will deprive usury of all blessings …" (*Qur'ān,* Surah al-Baqarah (2) verse 276) and "…Fear Allah and give up what remains of your demand for usury, if you are indeed believers" (*Qur'ān*, Surah al-Baqarah (2) verse 278). The prohibitions on taking interest and thereby undermining the economic value of a thing within the *Sharī`ah* are absolute, although there is discussion as to the scope of what *Riba* actually means.[67]

While the inherent integrity of Islamic thinking must be applauded, it is increasingly recognised that in certain contexts the Islamic law needs to be developed – albeit within the confines of Holy law.[68] Indeed, the eminent *Sharī`ah* lawyer and scholar, the late Dr Zaki Badawi has observed that *Sharī`ah* boards should "resurrect the tradition of imaginative solutions formulated and implemented by the Hanafi Scholars of the past". He considered that such a dynamic approach might well result in certain derivative securities being considered acceptable. Indeed, there are those, respected in Islam, who even contend that interest payable in ordinary banking transactions is outside the concept of *Riba,* although it must be said that the vast majority of scholars would have serious objections to such a view. It is not without interest that in a leading case before the Court of Appeal in England, the scholars who were called as expert witnesses expressed the view that "whenever a question of interpretation of the principles contained in the *Qur'ān* and *Sunnah* is involved, the application of the rules of the *Sharī`ah* has and will continue to give rise to disputes between different jurists".[69]

The notion of *Gharar* (uncertainty) is also a significant issue for those working in the area of finance. In the *Qur'ān* and the *Hadīth*s, this word is used on more than 50 occasions in very different contexts appearing to mean things as diverse as danger and deception.[70] "The Messenger of Allah forbade the sale through fraudulent means or the *Gharar* sale"[71] and "O you traders, beware of telling lies (in your business) transactions."[72] It has been described as "hazard caused by lack of clarity regarding the subject matter or the price in a contract or exchange. A sale or any other business contract which entails an element of *Gharar* is prohibited."[73] Consequently, it is argued that certain conventional practices would not be considered compatible with *Sharī`ah*,

[67] See, for example, Z. Haque, *Riba: The Moral Economy of Usury, Interest and Profit*, (1995) Ikraq. And see, generally, M. Cook, *Forbidding Wrong in Islam*, (2003) Cambridge University Press.
[68] For a discussion of the dynamic aspects of *Sharī`ah*, see M.I. Dien, *Islamic Law – From Historical Foundations to Contemporary Practice*, (2004) Edinburgh University Press.
[69] Statement of Khan J., former Chairman of the *Sharī`ah* Appellate Bench of the Supreme Court of Pakistan, in *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] 4 All ER 1072 at 1082.
[70] See Lu'ayy Minwer Al Rimawi, "The Legal Aspects of Arab Securities Regulation with Particular Reference to Disclosure as a Tool of Investor Protection when Offering/Listing Shares in Jordan", (2004) University of London, PhD Dissertation, p. 77; and A. Buaung, "The Prohibition of *Gharar* in the Islamic Law of Contracts; A Conceptual Analysis with Special Reference to the Practice of Islamic Commercial Contracts in Malaysia", (1995) University of London, PhD Thesis, pp. 131–135.
[71] Abdur Rahman I. Doi, *Shari`ah: The Islamic Law*, (1984) Ta Ha Publishers, London, p. 359.
[72] Al Tibeani and Abdur Rahman I. Doi, *Shari`ah: The Islamic Law*, (1984) Ta Ha Publishers, London, p. 375, and p. 364 referring to the prohibition of Al-Najash.
[73] Muhammad Ayub, *Understanding Islamic Finance*, (2008) John Wiley & Sons Ltd, Chichester, p. 57.

such as futures and options contracts. There are also obvious issues in regard to traditional insurance contracts. It has been argued that the concept of *Gharar* is known and discernable in other systems of law, including the common law, as the doctrine of uncertainty. This is debatable. While, for example, the common law requires objective certainty of contractual terms, it is apparent that the concept of *Gharar* is much wider. Where a contract or transaction involves elements of *Maisir*, the contract will also be prohibited by *Sharī`ah*. The terms *Maisir* and *Qimar* connote the acquisition of wealth by chance or at the expense of another party. These reflect the fundamental principles that the acquisition of wealth should be earned by a positive contribution in terms of wealth or work and that in seeking profit risks should be shared with a more-or-less proportionate return.

Of course, not all practices or transactions are enumerated in the main sources of Islamic law. There is some room for contemporary issues. This can be found within a secondary source of Islamic law – that is, *Al-`Urf*, which refers to all habits that are accepted by people during any period of time, whether they concern all people or just a group of them (such as merchants). Such habits, or *Al-`Urf*, must not contradict the basic principles of Islamic law. The extent to which *Al-`Urf* provides a fertile and viable source for financial law remains open to discussion. Few have been as bold as the late Dr Badawi.

### ii. Markets

There is always the danger of labels giving a false impression. What is actually meant by the description “Islamic market”? Most of the literature refers to the character of paper actually traded on organised markets – invariably *Sukūk*. However, historically there were developed markets that were operated under *Sharī`ah* where many commodities were bought and sold. Having said this, there is little evidence of attempts to apply general principles of law other than of a transactional nature. Thus, the market was nothing more nor less than the sum total of individual transactions. Naturally, each transaction was governed by the *Sharī`ah*. While the public interest in fair and stable prices is recognised, there are no specific obligations to the market itself. Of course, where someone attempts to undermine operation of the market by circulating false information or manipulating prices, then this would amount to a crime. There are markets today which trade exclusively in Islamic financial products and which in all respects seek compliance with the *Sharī`ah*. However, of far greater significance in economic terms are those markets, including some of the largest in the world such as London, Tokyo and Hong Kong, which are by no stretch of the imagination *Sharī`ah* compliant in their operations, but upon which *Sharī`ah*-compliant bonds or *Sukūk* are listed for trading. The extent to which it is acceptable to trade *Sharī`ah*-compliant investments in or on a market that offers opportunities to invest in *Haram* activities is a nice question which has not been authoritatively determined. Indeed, there are scholars who harbour the same reservations as in regard to conventional banks that offer Islamic windows at which purportedly *Sharī`ah*-compliant services and products are on offer. Suffice it here to simply make the point that not all are prepared to accept that the legitimacy of a product or service can be divorced from the market or circumstances in which it is offered or traded.

### iii. Disclosure

We have seen the significance that disclosure has in the effective and efficient development of markets. Perhaps one of the best articulations of this is by US President Roosevelt: "There is … an obligation upon us to insist that every issue of new securities … shall be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public.… The proposal [i.e. the relevant US legislation] adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware'. It puts the burden of telling the whole truth on the seller."[74] While these comments were addressed primarily to the US Securities Act 1933 and to primary issues of securities, the so-called New Deal federal securities legislation introduced far-ranging obligations of periodic and continuous disclosure into the US markets. In Islam, the obligations of disclosure and fair dealing are no less. The Prophet said: "Both parties to a business transaction … if they tell the truth and make everything clear, they will be blessed in their transaction, but if they lie and conceal anything, the blessing will be blotted out." And: "It is not permissible to sell an article without making everything [about it] clear, nor is it permissible for anyone who knows [about its defects] to refrain from mentioning them" (narrated by al Bayhaqi).

There have been decisions of courts considering Islamic law that where parties to a contract enter into it in full knowledge of its terms, then the presumption is that it is enforceable and the court will not take on the issue of compliance with the *Sharī`ah*.[75] However, in the *Arab-Malaysian Finance Berhad* decision (to which reference has already been made) the court at first instance, rejecting what it characterised as a traditional common law approach, took a rather more robust stance and considered that it had a judicial responsibility to inquire into whether challenged transactions were in compliance with the Islamic law as interpreted by all schools. The substance was more important than the form. While the actual decision was overturned on appeal, it remains to be seen whether this approach to the application of the law is incorrect.

### iv. Stewardship

We have mentioned the significance that the law of trusts and general fiduciary law have in the financial services industry. We have also referred to the importance that stewardship, based on notions of fiduciary obligation, has in the context of regulating the responsibilities of intermediaries and those who look after other people's wealth. The concept of fiduciary obligation in English Law was authoritatively set out by Millet LJ in *Bristol and West Building Society v Mothew.*[76] The learned judge stated: "A fiduciary

[74] See, generally, L. Louis and J. Seligman, *Fundamentals of Securities Regulation,* (2001) Aspen Law and Business.
[75] See *Bank Islam Malaysia Berhad v Adnan Omar* [1994] 3 CLJ 735.
[76] [1998] 1 Ch. 1 at 118; see also C. Bamford, "Conflicts of Interest in the Financial Markets", in B. Rider and M. Andenas, *Developments in Evergreen Company Law*, Vol. II, (1996) Kluwer.

is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.…"

Whether similar fiduciary obligations exist in Islamic law has been a matter of controversy. Many Islamic scholars, basing their views on the numerous texts requiring personal integrity and fair dealing, forcefully contend that Islam imposes on those in a position of trust very similar obligations as the common law and, in particular, civil law would recognise. For example, "O you who believe! Eat up not your property among yourselves unjustly…" (Surah an-Nisa (4) verse 161). In the context of fair dealing the *Sharī`ah* requires personal honesty: "Mix not the truth with falsehood, nor conceal the truth…" (Surah al-Baqarah (2) verse 42). Fairness and integrity is also emphasised in many texts: "He has set up the balance. In order that you may not transgress balance. And observe the weight with equity and do not make the balance deficient" (Surah ar-Rahman (55) verses 7–9); and "Woe to *al-Mutaffifin* (those who deal with fraud). Those who when they have to receive by measure from men, demand full measure. And when they have given by measure or weight to other men, give less than what is due. Do they not think that they will be resurrected (for reckoning)" (Surah al-Mataffifin (83) verses 1–4); and "O you who believe! Betray not Allah and His Messenger, nor betray knowingly your *Amanat* (the things entrusted to you)…" (Surah al-Anfal (8) verse 27). There are many condemnations of fraud as an injustice: "…for He commands them what is just and forbids what is evil…" (Surah al-A'raf (7) verse 157).

To a Western lawyer such statements may lack specificity. It has been strongly argued that Islam recognises an obligation to look after and protect the property of others. While it is clear that in Islamic law there is an obligation on trustees to protect and account for the property they hold, absent a specific contractual obligation or obligation imposed by, for example, the *Waaf*, it is not at all certain a *Sharī`ah* court would impose liability for the taking of "secret profits" in the range of situations that a common law court might.

### v. Securities

While there is a long history in Islamic law, particularly under the Ottoman Code of Transactions,[77] of instruments representing existing property and money, it is relatively recent that significant interest has developed in securitisation. Equity shares and participative rights, indicated in tradable instruments, exist for partnerships and companies. However, it is in the context of debt securities and, in particular, *Sukūk* that the greatest hope for developing effective and efficient Islamic capital markets exist.[78] AAOIFI defines a *Sukūk* as "certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity".[79]

As we have seen, the constraints that Islamic law places on the manner and form of contract are considered in addition to the wider impact of principles of *Gharar*. Of particular significance in practical terms will be the ability under domestic laws to effectively and efficiently transfer rights pertinent to the subject matter of the basic contracts. For example, the ability to divide and negotiate interests in land or other property, whether real or moveable, and the willingness of the relevant law to recognise changes in ownership are of crucial significance. Again, in practical terms the flexibility of the local law in facilitating transactions at different times, albeit related or perhaps serialised, is of importance. The traditional requirement under *Sharī`ah* for all related transactions to be synchronised creates potential problems.

Mention has already been made of the constraints that may exist in Islamic law in regard to the scope of contractual rights that are permissible. For example, transactions where it cannot be shown that there is economic justification in either the terms or execution may be at risk.[80] Disproportionate returns or inadequate sharing or participation in risk might also be questioned. Transactions in which a benefit is contemplated without risk or sharing in liability would be unlawful. The inability to establish a direct relationship to property, in the Islamic sense of the concept, might also render the contract invalid. Receivables and debts may not normally be the basis upon which, for example, a *Sukūk* is created, as in the final analysis the purchaser would be a creditor rather than an owner. Uncertainty in terms of obligation or intention might vitiate the mutual obligation. Any hint of speculation based on chance would also be unacceptable. Consequently, in structuring the various contracts that provide substance

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[77] See, generally, *The Mejelle: An English Translation of Majallah el-Ahkam-el-Adliyya and a Complete Code of Islamic Civil Law*, (2001) The Other Press; and B. Russell, *Business Law in the Middle East*, (1976) Oyez.

[78] See, for example, *The Development of Islamic Finance in the UK*, (2008) UK Treasury; *Consultation on the Legislative Framework for the Regulation of Alternative Finance Investment Bonds (SUKUK)*, (2008) UK Treasury and Financial Services Authority; and, in particular, *Malaysian Debt Securities and Sukuk Market*, (2009) Central Bank of Malaysia and Securities Commission of Malaysia.

[79] See SS-17: *Shari`a* Standard No. (17), "Investment *Sukuk*", (2004) AAOIFI.

[80] See M. Al Bashir and M. Al Amine, *Risk Management in Islamic Finance – An Analysis of Derivative Instruments in Commodities Markets*, (2008) Brill Academic Publishers.

for securitisation, considerable care needs to be taken if an effective and tradable *Sukūk* is to be created.

Islamic law is in practice not a unified and comprehensive code. There are, in regard to the matters referred to, differences of opinion among the principal schools and even between scholars of the same school. The consequences in Islamic law of non-compliance with an obligation are not always certain. The impact of certain vitiating factors, such as *Maisir* or a failure of frank disclosure, may also not be clear. The interrelationship of many of these issues with the ordinary non-Islamic law creates a further level of uncertainty and concern. It must also be remembered that most transactions will involve potentially more than one jurisdiction. Conflict of laws, even within a single jurisdiction, may be a real issue. The relatively underdeveloped state of Islamic law in relation to the recognition of foreign and certainly non-Islamic judgments and orders is yet another issue.

The *Sukūk* has become the most significant device for raising and developing Islamic finance. However, there remains concern that in a number of cases there may not be sufficient compliance with *Sharī`ah*. The *Sharī`ah* demands that investors have proprietary interests in the asset that is the basis of the structure and thereby a direct interest in the income derived from its use or accretion in value. In many cases the manager of the issue will not have an effective purchase from the originator, often as a result of the domestic legal issues to which we have already referred. Thus, there is uncertainty as to whether shares in a company, which do not confer proprietary rights to the assets of the company, can be the basis of a compliant *Sukūk*. The situation is compounded in jurisdictions that do not recognise a separation of legal and beneficial ownership.

The distinction between *Sukūk* that are asset-backed, where there is an effective transfer of ownership, and those that are only asset-based, where parties rely on only beneficial transfer of ownership while leaving the procedures for an effective legal transfer not perfected, becomes a very real issue in cases where the originator becomes insolvent. In case of originator insolvency, where there has been a proper transfer of ownership, investors will be protected. However, if the *Sukūk* is only asset-based, investors may well be in no better position than an unsecured creditor.

Another area where there is some degree of disagreement is in regard to remuneration for *Sukūk* managers. Many *Sukūk* provide for a distribution of resulting profits at stated fixed percentages often based on LIBOR. It is also not uncommon to find a contractual term giving any excess to the manager by way of incentive. If profits are less than the agreed percentages, then it is open to the manager to make an interest-free loan to the investors, making this good from future excess profits or from a reduction in the cost of repurchasing the relevant assets at redemption of the *Sukūk*. It has, however, been argued that this is objectionable in that it amounts to a sale with a credit. Consequently, the preferred approach, endorsed by AAOIFI, is to establish a reserve account to cover shortfalls. Where the terms of the agreement only provide for an incentive payment without management fees, some jurists consider the agreement is, if not unlawful, improper, due to *Gharar*. Care needs to be taken, however, in structuring agreed incentives, which are not of themselves objectionable, so that they relate to the actual returns from the business and not the prevailing rates of interest.

Central to the creation of viable Islamic finance is the principle that reward should follow risk. Consequently, where the terms of the agreement require the manager to purchase or repurchase the relevant assets at par value on redemption, without any regard to their true value on that day, it is arguable that the agreement is non-compliant. Under *Sharī`ah*, the possibility of a guarantee of return of capital only arises where there has been a default or wrong on the part of the manager. Of course, it is acceptable for the agreement to provide for the purchase to take place on terms to be agreed by the parties.

Given these and other factors, it is not surprising that Western rating agencies have been cautious in evaluating Islamic financial products. This has inevitably had implications for the market.

### vi. Principal financing devices[81]

There is a measure of sensitivity in even suggesting that Islamic law can be pragmatic. While there is convincing evidence in the sacred texts that the law should be flexible and adaptable to changing circumstances – provided, of course, that the fundamental values of Islam are respected in spirit as well as word – given the character of revelation, commentators have tended to play down the pragmatic quality of *Sharī`ah*. Nonetheless, history records the development of concepts and legal devices to facilitate trade over the centuries. Having said this, the Islamic tradition has not been as imaginative and pragmatic as the common law. It is mainly in the last 30 or so years that, within Islamic financial law, diverse applications have been recognised, to a greater or lesser degree, as acceptable. It is helpful here to set out the more popularly utilised contracts in the Islamic financial services industry that form the basis for *Sharī`ah*-compliant equity and debt financing. Specifically, we examine the principles of *Muḍārabah*, *Mushārakah*, *Murābahah*, *Ijārah*, *Salam*, *Istisnā`* and *Tawarruq*, and their application as the underlying contracts for *Sharī`ah*-compliant equity and debt financing. *Muḍārabah* and *Mushārakah*, which are carried out through profit-sharing contracts (*Uqud al-Ishtira'*), form the underlying contracts for *Sharī`ah*-compliant equity financing. Meanwhile, *Murābahah*, *Ijārah*, *Salam*, *Istisnā`* and *Tawarruq*, which are executed by way of deferred contracts of exchange (*Uqud al-Mu'awadhat*) and which involve the

[81] The following discussion (D. vi. to vii.) is based largely on the work of Dr Siti Faridah Abd Jabbar of the Institute of Advanced Legal Studies at the Institute of Advanced Legal Studies, University of London and the author gratefully acknowledgs her advice and assistance. See also Jabbar, "*Sharia*-compliant Financial Instruments", 30 *Company Lawyer* (2009) 220. Useful reference can also be made to N.N. Thani, M.R.M. Abdullah and M.H. Hassan, *Law and Practice of Islamic Banking and Finance*, (2003) Sweet and Maxwell; and S. Archer, R.A.A. Karim and V. Nienhaus, *Takaful Islamic Insurance: Concepts and Regulatory Issues*, (2009) Wiley Finance.

underlying contract of buying and selling of assets, are utilised to structure *Sharī`ah*-compliant debt financing.

**Equity-financing contracts**

In Islamic equity financing, as we have seen, the person with a surplus of capital would finance the business enterprise undertaken by another who lacks the requisite capital. Capital and labour are given equal credit in generating wealth. Thus, both parties generally share in the outcome of the business venture, namely in its profit and loss. Where there is more than one financier, each is ranked *pari passu* in claims against the business venture. This is unlike most Western capital structures, which rank financiers or creditors according to a hierarchy of claims. The two types of Islamic contract which form the underlying structures for *Sharī`ah*-compliant equity financing are *Muḍārabah* and *Mushārakah*.

***Muḍārabah***

The *Muḍārabah*, which is also known as *Qirad* or *Muqarada*, is translated variously as profit-sharing partnership, trust financing, trustee profit-sharing, equity-sharing and sleeping partnership. The authority for allowing *Muḍārabah* is contained in the *Sunnah* as narrated by Suhayb that the Prophet Muhammad was reported to have said: "Three things done which have a blessing in it, namely credit sale, *Muqaradah* [*Muḍārabah*] and a mixture of flour and barley for the purpose of invitation and not for the purpose of sale".[82] In *Muḍārabah*, a capital owner or financier (*rabb ul-mal*) gives a specified amount of money to another person (entrepreneur, known as *Mudārib*) for the latter to invest in a business venture. The capital advanced by the financier cannot be a debt owed by another party to the financier, nor can it be a debt owed by the entrepreneur to the financier. While the financier provides the full financing, it is the entrepreneur who manages the business, although the entrepreneur may hire others on remuneration to help him in the operations of the venture and the remuneration would be accounted for in the *Muḍārabah* account. The financier does not participate or intervene in the daily operations of the venture, but since his wealth is at stake, he has the right to specify at the outset of the *Muḍārabah* the nature of the venture, and the mode and place of trade, and to inspect accounts.

Therefore, whether the entrepreneur may engage in a general business venture or is restricted to a particular and specific one depends on the agreement that has been entered into between the entrepreneur and the financier. In the absence of permission by the financier, the entrepreneur cannot dispose of the *Muḍārabah* capital by loan or donation, or create a sub-*Muḍārabah* with another person. In the event that the entrepreneur acts contrary to the conditions that have been specified, he is deemed to have breached the trust placed in him, has acted *ultra vires* and shall be liable for any resulting loss or damage. The immediate consequence of such a default is the right of the financier to wind up the *Muḍārabah*. Some contemporary *Muḍārabah* contracts do provide that if the *Muḍārabah* is declared void, all profits accruing at the time shall revert

[82] Sunan ibn Majah.

to the financier and the entrepreneur shall only be entitled to a standard wage. Such a condition in a *Muḍārabah* contract may be made in favour of a financier without having to resort to the due process of the courts.

A *Muḍārabah* would usually be limited to a certain period of time and, at the end of that period, where there are profits, the financier and the entrepreneur would share in the profits according to the ratio that shall be made specific and certain at the beginning of the *Muḍārabah* and which shall be clearly indicated in the agreement. Distribution of profits can only be made at the time of liquidation of the *Muḍārabah* after the financier has recouped his capital. Should any periodic profit distribution take place before final accounting, it is considered interim and tentative and is subject to a final review to make good on any loss of the capital. In other words, profit shall always be a reserve for capital and must first be applied to make good on any loss of capital before any profit-sharing takes place. This requirement operates as a natural security and guarantee peculiar to the economics of *Muḍārabah* in order to guard against any negligence or inattentive attitude on the part of the entrepreneur, especially where he is not liable for any loss in the absence of misconduct or negligence on his part.

In the event of a total loss as a result of circumstances beyond the control of the entrepreneur, the financier alone bears all the financial losses with the entrepreneur losing only his time and efforts. In other words, the entrepreneur, as a trustee of the *Muḍārabah*, shall not be a guarantor of the capital unless the loss is caused by the entrepreneur's misconduct or negligence. Where there are both losses and profits at the time of liquidation, but the losses are greater than the profits, the net loss must be deducted from the capital prior to returning the balance of the capital to the financier. In the event that the total expenses are equal to the total revenues, there will be neither profit nor loss, and the financier will receive his full capital back with the entrepreneur obviously having no profit in which to share. In an ongoing *Muḍārabah* where losses have been incurred, the losses are to be brought forward and compensated by the future profits of the venture. It is forbidden to stipulate in a *Muḍārabah* agreement the condition that one party shall preferentially receive part of the profit and that the other party may or may not receive any profit share. Where there is more than one financier for the same business venture – namely, one venture is jointly financed by a number of financiers – profits are to be shared in a mutually agreed proportion previously determined and cannot be a guaranteed amount, while loss is to be shared in the proportion in which capital has been invested by the different financiers. Before the expiry of the period fixed for a *Muḍārabah*, the *Muḍārabah* continues for as long as the entrepreneur does not contribute his own funds into the business venture.

Therefore, it is arguable that a *Muḍārabah* is similar to a conventional sleeping partnership or a conventional preferred shareholder contract, although some differences in law and practice obviously exist. In *Muḍārabah*, the profit-sharing ratio has to be made specific and certain at the beginning of the venture and shall be clearly indicated in the *Muḍārabah* agreement; but in a conventional partnership, while the existence of such an agreement is encouraged, the absence of such does not affect the partnership.

In the case of, for example, partnerships established under English or Malaysian law, the profit-sharing ratio will be equal by virtue of the relevant statutes. In *Muḍārabah*, loss that is not occasioned by the negligence (or, in some traditions, recklessness) or misconduct of the entrepreneur is not to be borne by him, but by the financier alone or, where there is more than one financier, by all the financiers in the proportion in which capital has been invested by them. However, in conventional partnerships, all the partners are free to agree on the distribution of loss. In the event that there is no such agreement, under the common law, loss will be distributed according to the agreed profit distribution ratio, and in the absence of such, both loss and profit are to be shared on an equal basis by the partners.

The applicability of the *Muḍārabah* structure in relation to the practice of banking was first discussed by Baqir Al Sadr, an Iraqi scholar, whose book on interest-free banking in Islam was published in Kuwait in 1970. He argued that where depositors deposit money with a bank and the bank then advances the money to a client, the principles of *Muḍārabah* may be employed, with the depositors sharing in the bank's profits and the bank sharing in the profits of the client's venture. In contemporary Islamic banking, the *Muḍārabah* structure is employed, resulting in what is arguably a high degree of fiduciary responsibility to depositors on the part of the bank while it acts as a financier to the client entrepreneur. The difference between a *Muḍārabah* in Islamic banking and a loan in conventional banking lies in the cost of capital to the bank's client. In Islamic banking, it is expressed in a ratio of profit; while in a conventional banking relationship it is expressed as a predetermined fixed rate. Nonetheless, *Muḍārabah* as practised in the contemporary Islamic banking industry may pose a major practical problem in regard to the asymmetrical nature of the risks involved. Bank depositors, it may be argued, face the major risks of bank failure and uncertainty regarding the level of profits to be shared. Having said this, the risk of bank failure is also a feature in conventional banking and would be made minimal with effective bank regulation. The uncertainty of returns is unique to Islamic finance, but from a *Sharī`ah* point of view, it is the very risk that justifies the depositors' reward.

For the Islamic bank, the problem is more acute. The *Sharī`ah* principles of surety (*Kafālah*) prescribe the limits as to how far an Islamic bank can take any subject matter or tangible property as security for the financing facilities that it grants. It certainly cannot seek any guarantee from the financed party that its funds employed for the financing of the client's business will be repaid; such a guarantee can only be sought from a third party at no consideration. Furthermore, the bank might well be prejudiced as a result of a client not being entirely truthful in regard to the profitability of the enterprise and, thus, the amount of profits to be shared. This risk is exacerbated in those jurisdictions where transparency and, in particular, audit requirements are limited. One way by which Islamic banks can mitigate, if not avoid, the risks is to ensure that a proper analysis as to the feasibility of the business venture proposed by the entrepreneur client has been carried out. At the same time, the bank may insist that the entrepreneur client procures a third-party guarantee or surety (described as *Kafālah*) to cover the entrepreneur's liability in the event that the latter's conduct infringes the conditions of the financing facility and some loss of capital is thereby unfairly suffered by the Islamic bank. Alternatively, a form of mutual insurance (*Takāful*) or pledge (*Rahn*) could be taken from the entrepreneur to cover his liability in the event of negligence (but probably not recklessness) on his part, but such a guarantee cannot be taken from the entrepreneur to cover the capital or profits because, in *Muḍārabah*, this cannot be guaranteed by the entrepreneur.

Despite the seemingly settled principles applicable to a *Muḍārabah* contract, there is disagreement among the schools on certain issues. For example, it has been argued as a matter of strict interpretation that, for a *Muḍārabah* contract to be valid and for the entrepreneur to be considered as having control over the capital, the capital must be wholly delivered to the entrepreneur. On the other hand, other scholars argue that the *Sharī`ah* permits some flexibility in that the capital may be delivered in stages and partially put at the disposal of the entrepreneur as long as the entrepreneur has free access to the capital. Furthermore, it has been argued by some jurists that the duration of the *Muḍārabah* should not be tied to any particular period. There are also disagreements in relation to the distribution of profit, continuity of a *Muḍārabah* after profit distribution, and restrictions with regard to the activities, scope and objectives of the *Muḍārabah*.

There are those who contend that the financier can participate in the operations of the business venture and that the terms in the *Muḍārabah* agreement are not binding terms or obligations. With regard to the former argument, it is submitted that if the financier can participate in the operations of the business venture, then it is no longer a *Muḍārabah*, but a *Mushārakah*, which we discuss in due course. With regard to the latter contention, *Sharī`ah* would appear to require strict observance subject to the arguments that we address elsewhere in regard to necessity. Surah al-Ma'idah (5), verse 1 of the *Qur'ān* is translated thus: "O you who believe! Fulfil [your] obligations." Meanwhile in the *Sunnah*, the Prophet Muhammad was reported to have said: "Muslims honour their covenants" (narrated by al-Bukhari, at-Tirmidzi (1352) and al-Hakim). Referring to both authorities, it may be argued that as Islam places great emphasis on the act of honouring contracts and fulfilling obligations, it is simply incompatible with Islamic principles to hold the view that the terms in a *Muḍārabah* agreement are non-binding. Likewise, such a view may be rejected on the basis of *Maslahah*, or public interest. It is of paramount public interest to ensure that commercial-related promises are upheld. Otherwise, in the long run, it may bring negative repercussions to the economy of a country, as businesses would be reluctant to trade in an environment where certain commercial promises are non-binding.

### *Mushārakah*

Let us now consider the *Mushārakah*, which is another type of Islamic contract that is often used as the underlying structure for *Sharī`ah*-compliant equity financing. The authorities for allowing *Mushārakah* are derived from both the *Qur'ān* and *Sunnah*. Surah Sad (38), verse 24 of the *Qur'ān* is translated thus: "…many partners [in business] oppress one another, except those who believe and do righteous good deeds and they are few." In a *Hadīth*, it was narrated by Abu Hurairah that the Prophet Muhammad was reported to have said: "Allah is the third between two partners, as long as they do not betray each other. Where one of the two betrays the other, Allah turns against [leave] them" (*Hadīth Qudsi*). Further, it was reported that the Prophet Muhammad had said: "The Hand [blessings] of Allah is on two partners [parties] as long as they do not betray each other." *Mushārakah*, as in *Muḍārabah*, is a profit-sharing partnership involving a business joint venture between two or more parties; however, unlike in *Muḍārabah,* in *Mushārakah* all parties contribute to the capital in agreed proportions and have the right to participate in the running of the business venture.

The parties in *Mushārakah* can negotiate on the profit distribution ratio, which need not reflect the capital participation ratio. This, as we have seen, is similar to a conventional partnership where not only capital contribution, but also the varying degree of labour contributed by each partner, may be recognised as contributing to productivity and profit, with the result that the partner with a higher labour participation may be entitled to a higher share of profits despite contributing less capital. In the event of a loss in *Mushārakah*, all parties bear the loss in proportion to their capital participation ratio. This is unlike in a conventional partnership, where the parties are free to negotiate not only the ratios of capital participation, but also the profit and loss distributions where each need not reflect the other. Further, in a conventional partnership, in the absence of an express agreement, profit and loss are to be distributed equally among the partners notwithstanding the capital participation ratio. In common law where profit distribution has been agreed upon, but not loss, distribution of loss will follow the profit distribution ratio (see, for example, *Re Albion Life Assurance Society*[83]) and not capital distribution, as in *Mushārakah*. Loss arising out of wilful negligence (recklessness) in *Mushārakah* must be indemnified by the partner who is responsible for it, but in a conventional partnership all the partners would be jointly liable for the loss suffered by a third party occasioned by the negligence of one of the partners.

There are two categories of *Mushārakah*, namely *Sharikah al-Mulk* (property partnership) and *Sharikah al-`Aqd* (contractual partnership). *Sharikah al-Mulk* involves joint ownership of specific property without its joint exploitation. On the other hand, *Sharikah al-`Aqd* involves the joint exploitation of capital with joint participation in profits and losses, where joint ownership is a consequence of, and not a pre-requisite for, the formation of partnership. There are three different methods in establishing a *Sharikah al-`Aqd*: first, by way of *Sharikah al-Māl* (finance partnership), where the main criterion in the formation of the partnership is money; second, by *Sharikah A`mal* (labour partnership), which is based on a partner's skill or experience; and finally, by *Sharikah al-Wujuh* (credit partnership), where credit alone is utilised for the partnership investment. Each of the three methods can take the form of either an unlimited, unrestricted and equal partnership (*Mufawadhah*) or a limited investment partnership (*Sharikah al-`Inān*). Of all these types of *Mushārakah*, the *Inān Sharikah al-Māl* (finance

[83] (1880) 16 Ch D 83.

limited investment partnership), which is more popularly known as participating financing, is the most utilised type of *Mushārakah* in Islamic banking.

A *Mushārakah*, as in a conventional partnership, is terminated after an agreed period of time or after the fulfilment of certain conditions, although it is permissible for the partners mutually to agree to terminate the *Mushārakah* before such a fixed period or fulfilment of the conditions. The obligations and actions of the partners that took place before the termination will remain unaffected and they will continue to exist. If the *Mushārakah* is set up to be in a particular business, it comes to an end by actual liquidation of the assets that constitute the subject matter of the partnership. Where a partner wishes to withdraw from the *Mushārakah*, he may do so after giving the other partners due notice to this effect. In this circumstance, he will be entitled to his share in the *Mushārakah*, and his withdrawal would not result in the termination of the partnership of the remaining partners – unless, of course, the *Mushārakah* involves only two partners, in which case it would obviously necessitate dissolution of the partnership.

In contemporary Islamic banking, a relatively new *Mushārakah* contract has been developed called *Mushārakah Mutanaqisah* or *Mushārakah Muntahia Bittamlīk* (diminishing partnership). In this type of *Mushārakah*, a bank invests in a business venture as a partner and its share in the *Mushārakah* is progressively retired or liquidated. This is achieved by the other partner paying to the bank, in the periodic profit distributions of the business, not only the bank's profit share, but also a predetermined portion of the other partner's own profit that goes towards reducing the bank's capital share and thereby also reducing the bank's claim on profits. A *Fatwa* was issued in 1979 by the First Conference of Islamic Banks in Dubai on the permissibility of *Mushārakah Mutanaqisah*. Although not explicitly referred to in the *Qur'ān* and *Sunnah*, the permissibility of *Mushārakah Mutanaqisah* is premised on a number of Islamic legal principles and maxims. Islamic scholars have unanimously agreed (*Ijma*`) that *Mushārakah Mutanaqisah* is suitable to be applied in situations concerning transactions and administrations based on, first, the principles of *Maslahah* (public interest). Second, it is permissible based on the Islamic legal maxims that what is not prohibited is permissible; that the initial state of things is permissible unless it is clearly prohibited (*al-aslu fi al-ashya' al-ibāhah*); and that there is no danger or any endangerment (*la dharar wa la dhirar*). On this second basis, it has been concluded that there is nothing in the *Qur'ān* or *Sunnah* that prohibits *Mushārakah Mutanaqisah*. And third, *Mushārakah Mutanaqisah* is permissible because it does not involve the elements of *Riba* and *Gharar*, which we have already discussed.

### Debt-financing contracts

Islam has traditionally favoured equity financing over debt financing, as *Sharī`ah* encourages the sharing of risks and rewards as opposed to the incurring of debts. While Muslims are discouraged from incurring debts, those who extend loans to persons in genuine need are, however, highly commended. The Prophet Muhammad was reported by Anas to have said: "On the night of my heavenly ascension, I saw written on the gates of Paradise: ‘A charitable gift will earn rewards of ten times its value, whereas a loan will earn a reward of eighteen times its value.’ So I asked [the angel] Jibril, ‘Why should a loan be more virtuous than charity?’ He replied, ‘Because a beggar will ask [for charity] even when there is no need for it. Whereas a borrower will not ask for a loan unless it is needed.’” (Sunan Ibn Majah). Although the act of extending a loan to another is praiseworthy, enrichment from it is, however, roundly prohibited. Hence, conventional debt financing, which is mainly effected through interest-based lending (*Riba an-Nasi’a*) that penalises the debtor for his delay in paying back the loan, is incompatible with the principles of *Sharī`ah* and is, therefore, impermissible (*Haram*), as we have seen. What is allowed (*Jaiz* or *Mubāh*) is debt financing by way of deferred contracts of exchange (*Uqud al-Muawadhat*), which involves an underlying contract of buying and selling of assets. The underlying Islamic contracts for *Sharī`ah*-compliant debt financing include *Murābahah* (marked-up sale), *Ijārah* (leasing), *Salam* (forward purchase), *Istisnā`* (contract for manufacture) and *Tawarruq* (monetisation of commodity).

***Murābahah***

*Murābahah* is a marked-up sale, where a seller sells an asset to a buyer at cost plus profit. In the early 1970s, Sami Homoud, a Jordanian scholar, believed that *Murābahah* could be employed in the Islamic banking system to address the issue of asymmetric risks prevalent in a *Muḍārabah* structure. According to Homoud, *Murābahah* is less risky than *Muḍārabah* as the mark-up and the period for the client to repay the bank are agreed in advance between the bank and the client. In contemporary Islamic finance, *Murābahah* is utilised for the financing of inventory and fixed assets. It is an asset-based mode of financing as the provision of financing is inextricably linked to the provision of an asset. In this type of contract an Islamic bank first buys an asset from a supplier and then resells it to the bank’s client at a marked-up price covering the bank’s cost plus profit. It is a short-term and relatively low-risk type of trade financing, since the bank only buys an asset that has been identified by the client, from a supplier who has also been identified by the client, and the marked-up price is agreed in advance between the bank and the client, while the period for repayment to the bank is stipulated at the outset. Nevertheless, the mark-up that the bank charges the client has been criticised, and even condemned, by some scholars and commentators as being no different, in reality, from interest in a conventional loan. However, others have argued that, unlike in a conventional loan, in a *Murābahah* contract the bank assumes asset price and credit risks and this takes it out of the prohibition on *Riba*. In *Murābahah*, the client may decide not to take delivery of the asset at the due date for execution of the *Murābahah* contract, thus forcing the Islamic bank to dispose of the asset and this creates an asset price risk to the bank. Even if the client takes delivery of the asset, there is still the credit risk of the client defaulting on the payment. Unlike a conventional bank, an Islamic bank cannot punish a defaulting client by charging and retaining a default fee (unless such is paid in full to charity). It is, thus, argued that these risks are those that justify the mark-up the bank charges.

In practice, Islamic banks carry out the purchase from the supplier and the sale to the client simultaneously. The risk that the bank is exposed to is, therefore, minimal.

Meanwhile, some Islamic banks try to absolve themselves from the asset price risk by requiring the client to take delivery of the asset directly from the supplier. This raises criticism, as the banks do not assume possession of the asset, even constructively, whereas possession is a key condition of a religiously acceptable *Murābahah*. Without possession of the asset by the banks, the arrangement is said to be a synthetic *Murābahah* transaction and is in substance no more than a short-term conventional loan with a predetermined interest rate incorporated into the price at which the borrower purchases the asset. Consequently, some Islamic banks alternatively ask the client to take delivery of the asset, as an agent of the bank. Here, the bank is the owner of the asset as the original purchaser and the bank's client merely acts as the agent of the bank for the purposes of taking delivery of the asset. However, several Islamic banks, particularly it seems in the Sudan, do not even adopt the agency arrangement between a client and a bank. Here the banks buy, own and possess the subject matter of the contract and later offer to sell the same to a client who has the right to accept or reject the offer. Where the client accepts, the client becomes the owner to whom the title to the goods passes irrespective of the fact that payment to the bank is by instalment. In this situation, the financing bank would usually have a right of lien or charge to the asset as collateral.

Another important issue that has been raised in the contemporary *Murābahah* transaction is whether the promise by the bank's client to purchase the goods once the bank buys the goods to finance its ultimate purchase by the client is binding. Classical *Sharī`ah* jurists have taken the view that such a promise would be regarded as non-binding. On the other hand, according to the Maliki school of Islamic jurisprudence, such a promise would be considered as legally binding and it is this view that has prevailed among contemporary *Sharī`ah* scholars. By the same token, the validity of a modern *Murābahah* practice whereby the client is required to pay a premium called "*Urbūn*" has also been questioned. The payment of *Urbūn* by the bank's client as a premium for his promise to buy and as an initial consideration for the *Murābahah* transaction is not acceptable according to classical interpretation of the *Sharī`ah*, simply because such a promise is not binding in the first place. Concern is exacerbated by the fact that, in practice, *Urbūn* is non-refundable in the event that the bank's client does not honour his promise to buy the goods. In relation to this issue, AAOIFI has issued a decision whereby the use of *Urbūn* as a consideration for the initial promise by the bank's client to buy the subject matter of the *Murābahah* transaction shall not be valid if made at the promise stage. However, if it is paid as part of and in the process of the execution of the *Murābahah* contract, it shall be valid.

*Hamish jiddiyyah* involves the payment of a sum by the client to the bank to emphasise the client's intention of buying the goods. It is non-refundable if the deal is not finalised for reasons attributable to the client. It is intended to cover any costs that have been incurred by the financing bank. While *Hamish jiddiyyah* and *Urbūn* have similar characteristics, there is an important difference. In *Urbūn*, the bank may confiscate the whole amount of the *Urbūn* (no more nor less) irrespective of whether the liability of the client to the bank exceeds or falls below the amount of the *Urbūn*. In *Hamish jiddiyyah*, however, the bank may further charge the client in the event that the liability of the client exceeds the sum of *Hamish jiddiyyah* deposited. In case the liability of the client is less than the *Hamish jiddiyyah*, the balance would normally be refunded to the client.

Yet a further issue which relates to a *Murābahah* transaction is the question of who bears the risk should the subject matter of the *Murābahah* contract be damaged. It has been suggested that this question may be resolved by referring to the law on the passage of property where, prior to delivery of the subject matter to the bank's client, the risk of damage rests with the bank. Where the subject matter has been delivered to the client, the client would bear the risk notwithstanding the fact that the payment of the purchase price has not been made. This is because *Murābahah* is, from an Islamic perspective, a sale transaction and not a loan transaction and, therefore, it can be inferred that after the signing of the subsequent deferred-sale *Murābahah* contract between the bank and the client, the parties are deemed to have intended that the property should have passed to the client upon delivery. If this view is accepted, the issue is settled using a similar approach as in a conventional sale of goods. Applying the law of the conventional sale of goods, by analogy, where the client takes delivery of the subject matter of the *Murābahah* directly from the supplier, the bank bears no risk whatsoever as the risk of damage is transferred directly from the supplier to the buyer. Where the client takes delivery directly from the supplier, but as an agent of the Islamic bank, the bank as the principal bears the risk unless damage is caused by the client's negligence, in which event the client would bear the risk. A further related issue in *Murābahah* is whether the client has rights of claims against the bank for breach of warranty to the goods. In practice, Islamic banks enter into an agreement with the client where the client agrees to waive all rights of claims against the bank for breach of warranty, while the bank's rights of warranty against the supplier as the initial purchaser are assigned to the buyer.

In contemporary *Murābahah* transactions, most Islamic banks require security and guarantee just as conventional banks do with conventional loans. In practice, *Murābahah* contracts will stipulate one or a combination of these terms; namely, first, in the event of default, the bank is entitled to provisional attachment of the subject matter of the *Murābahah* and to recover the amount owed from the proceeds of selling the subject matter; second, the client must give a charge over the subject matter to the Islamic bank and the bank is entitled to foreclose on it in the event of default; third, the account of the client with the bank stands as a collateral; and finally, the client should insure the subject matter, naming the bank as a beneficiary in the policy. At the same time, a *Murābahah* contract in contemporary Islamic banking may also provide that in the event of default, some or all of the following terms apply. First, in the event of a failure to pay two or more successive instalments, the bank is entitled to declare all the other instalments immediately due. Second, the bank is entitled to claim the amount of the payments in default and any damages arising out of that default. Third, the bank is entitled to charge or attach the subject matter of the *Murābahah* and cause the sale of the subject matter by court order and use the proceeds to cover the amount of the debt. Fourth, the bank is entitled to further sue for the balance if the proceeds of the sale do not cover the amount of the debt. Fifth, subject to issues of *Riba*, the bank may be entitled to claim for damages for the delay in receiving the payment, which is the consequence of default. Finally, the bank is entitled to reimburse itself from the accounts of the client with it, irrespective of whether the account is established before or after the indebtedness. This is undertaken by the bank on the basis that the bank has collateralised the client's account with it. It has been said that *Murābahah* has a profound impact on the practice of banking, since Islamic banks are not confined to traditional lending activity, but may also involve themselves in sale and purchase activity where banks buy goods required by the client for resale to the client at a higher price. Likewise, Islamic banks are not limited to the activities of sharing profits and losses, but may also undertake the role of a normal business entity by giving services or selling goods to clients with the aim of making a profit. Through *Murābahah*, Islamic banks may get involved in trading of goods, which is a prohibited activity for the conventional banks.

***Ijārah***

*Ijārah* is similar, in many respects, to a conventional leasing contract where the owner of an asset (lessor) leases out the asset to another (lessee) at an agreed rental fee and at a predetermined lease period. While the lessee may enjoy the use of the asset, the ownership of the leased asset remains with the lessor. In contemporary Islamic debt financing, *Ijārah* is executed by the bank purchasing the asset required by the client and then leasing the asset to the client for a rent and for a given period. Such financing is usually undertaken to purchase major items of capital equipment where the assets themselves serve as collateral and the payment is usually by monthly or quarterly instalment of up to a period of usually five years. *Ijārah* is a longer-term, higher-yielding and lower-risk type of investment as compared to *Murābahah*. While both *Ijārah* and *Murābahah* finance the purchases of assets, unlike *Murābahah*, in *Ijārah* the lessor investor retains title to the asset until the end of the *Ijārah* contract, thus assuring an effective security interest. In the event of a default in payment by the lessee, the lessor can repossess the asset and thus avoid the cumbersome and seemingly debtor-partial rules that accompany a default under *Sharī`ah*. *Ijārah* may also be referred to as the sale of a usufruct, or the sale of a legal right to use the property of another. Such a sale has been unanimously approved by the Sunni schools of Islamic jurisprudence (*Ijma`*) on the basis that the need for the usufruct of different subject matter in the form of goods and services is like the need for the subject matter itself. As the contract of sale of such goods and services is permitted, then as its corollary, the contract of sale of their usufruct is also permitted.

For *Ijārah* to be valid, there are a number of pre-requisites: *inter alia*, these include the requirements that the usufruct of the goods or services being hired should have value; the article should be physically fit for hire; the lessor should hand the hired article over to the lessee in its complete form and shape; the lessor must have full possession and legal ownership of the article being hired out; the existence of the hired article should continue throughout the contract period; the benefit from the *Ijārah* must be lawful according to *Sharī`ah* – for example, not leasing a property to be utilised as a gambling outlet; and the goods to be rented should be present and capable of being handed over to the lessor after the completion of the *Ijārah* contract. Further, the rent of the hired goods should be specifically fixed. This will normally be based on the relevant market interest rate, with the monthly payments following a conventional amortisation table. Rent will be due where one of the following two conditions is met – namely, where there is a complete acquisition or attainment of the usufruct of the hired goods, or where the lessee is able to use the usufruct of the hired goods notwithstanding he is yet to actually enjoy it. In addition, the usufruct of the hired article must be specified. Specifications include the period of the use of the usufruct, the purpose of the hired goods, and the nature and amount of the rent.

According to *Sharī`ah*, where loss of or damage to the subject matter of *Ijārah* occurs, the lessor as the legal owner of the subject matter bears the risk in the absence of cause or negligence on the part of the lessee. Therefore, in contemporary Islamic banking, an Islamic bank as the owner of the subject matter of *Ijārah* has to assume the risk for loss of or damage to the subject matter, as the bank's client is merely a lessee. Nevertheless, Islamic banks mitigate that risk by insuring the subject matter of *Ijārah* through *Takāful*. The client would normally be given a copy of the *Takāful* policy, and in the contract between the bank and the client it would be stipulated that the client should observe the conditions of the *Takāful* policy. If the subject matter is destroyed and it is found that the client has failed to observe any of the conditions of the *Takāful* policy, thus barring the bank from recovery, the client could be held liable. In some cases, Islamic banks will make the client pay for the *Takāful* contributions by incorporating the *Takāful* contribution costs into the lease instalments to be paid by him. This practice has raised serious criticism from many Islamic legal scholars on the basis that *Ijārah* is in essence a lease transaction. Therefore, the bank as the lessor with the insurable interest in the subject matter should instead pay for the *Takāful* contribution. There would appear to be some merit in this view.

In a conventional lease, there are two types of lease – namely an operating lease, where the lessor takes back the asset when the lease ends; and a full-payout financial lease, where the lease payments cover the total value of the asset and, therefore, title to the asset is passed to the lessee at the conclusion of the lease. The operating lease is similar to the aforementioned *Ijārah*, although there is a difference with regard to responsibility for maintenance and insurance. In a conventional operating lease, the responsibility remains with the lessee, but in *Ijārah* the responsibility is with the lessor. In the second type of conventional lease, which is a full-payout financial lease (which is also known as a hire-purchase), similarities may be found in *Ijārah Muntahia Bittamlīk* (also referred to as *Ijārah Thumma al-Bay`* or *Ijārah wa-Iqtina*.) Although *Ijārah Muntahia Bittamlīk* cannot be grounded in traditional Islamic jurisprudence, its permissibility may be established on the principle of *Maslahah* (public interest) so as to facilitate the acquisition of an asset by a person who cannot otherwise afford to acquire owing to a lack of capital. While this is still debated within the schools, there is widespread acceptance of this legal justification in practice. In both hire-purchase and *Ijārah Muntahia Bittamlīk*, leasing is combined with purchase where the lessee may lease purchase the asset by including in the instalment payments a portion that goes towards the final purchase and finally the transfer of ownership of the asset to the lessee.

In *Ijārah Muntahia Bittamlīk*, as in hire-purchase, the transfer of ownership may also be given effect by the lessee paying a token or other consideration, or by accelerating the payment of the remaining amount of rental, or by paying the market value of the leased property. However, the transfer of ownership by way of *Hibah*, by way of a promise to give the leased asset as a gift and for no consideration, or as a gift which is contingent upon the payment of the remaining instalments, is peculiar only to *Ijārah Muntahia Bittamlīk* as such a promise would not be binding in a conventional hire-purchase. Nevertheless, the subsequent contract of sale or gift should be independent of the earlier *Ijārah* contract and cannot be taken as an integral part of the contract of *Ijārah*. In the event that the final transfer of ownership to the lessee cannot be carried out for any reason, the rental already paid by the lessee cannot be refunded as he has already had the valuable consideration of enjoying the *Manfa`ah* (usufruct) of the lease. A further difference between *Ijārah Muntahia Bittamlīk* and a conventional hire-purchase agreement is that in the former, there is no compound interest in the event of default or delay in the instalment payments, unlike in the latter.

In a conventional hire-purchase arrangement, it is often the case, at least in a consumer context, that a selling dealer introduces his buying client to a financial institution, with the latter paying the former a commission as remuneration for the introduction. The financial institution then enters into a direct hire-purchase relationship with the buying client and the client pays the instalments directly to the financial institution. There are, thus, two separate transactions. One is a sale by the selling dealer to the financial institution and the other is a hire-purchase between the financial institution and the buying client. In this situation, the dealer is not an agent of the financial institution. Unless there is a collateral contract or statutory provisions (as there is in a number of jurisdictions), the financial institution is not liable for any misrepresentation by the dealer to the client in relation to the asset sold and hire-purchased. The dealer, as a seller, bears the liability and may even be required to provide guarantees to the financial institution for the performance of the client, such as undertaking to repurchase the asset should the client default. On the other hand, in *Ijārah Muntahia Bittamlīk*, the financing bank owns the asset until title in it is transferred to the client. As the owner of the asset, the bank bears all liabilities in relation to the asset, although in practice, Islamic banks mitigate their liabilities by undertaking a number of measures such as insuring the asset.

***Salam***

*Salam* is an advance or forward purchase that involves the purchase of goods or commodities in which an advance payment is made to the seller, but the delivery to the buyer is deferred into the future. It is also known as *Bay` Salaf* or *Bay` Mafalis* and is an exception to the fundamental rule in Islamic commercial jurisprudence that prohibits the sale of a commodity that is not presently in the possession of the seller. *Salam*, thus, may involve the sale of goods that are not currently in existence or unascertained as long as the goods are fungible in nature, are generally available in the market at the time of delivery, and are not totally non-existent or rare so as to be out of supply or out of season, which renders the goods inaccessible to the seller. Although *Salam* and conventional futures are both forward contracts, *Salam* is permissible by *Sharī`ah* while conventional futures are not. This is because *Sharī`ah* allows the deferment of either payment or delivery of the sold item, but not both. In *Salam*, payment is made at the time of contracting, and only delivery of the subject matter is deferred to a future date; while in conventional futures, both payment and delivery are deferred. The permissibility of *Salam* is an exceptional case based on the grounds of *Darurah* (necessity). Its permissibility is based on both the *Qur'ān* and *Sunnah*. Surah al-Baqarah (2), verse 282 of the *Qur'ān* is translated thus: "O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing." Meanwhile, in the *Sunnah* as narrated by Ibn Abbas, the Prophet Muhammad was reported to have said: "Those who pay in advance for anything must do so for a specified measure and weight and for a specified period" (*Hadīth* Bukhari, Vol. 3, Book 35, nos. 44,443 and 445).

In *Salam*, there are a number of requirements to be observed. The buyer is not allowed to enjoy ownership rights over the purchased goods before taking them into possession. Thus, the buyer cannot resell the goods, not even at cost, or contract for their transference (*Hawalah*), or use them as partnership capital until the buyer takes possession of the goods. However, the buyer has a right to request for a surety, pledge or both, so as to ensure that the seller duly observes his commitment. In the event of the seller's death, the *Salam* is deemed rescinded and the buyer may claim for a refund of his advance payment from the heirs of the seller. However, in the event of the buyer's death, the *Salam* remains operative. Should damage occur to the goods at the time of delivery, such damage will only nullify *Salam* if it exceeds the normal extent of damage. Once payment has been made, the buyer cannot change the conditions in *Salam* with regard to the quality, quantity or delivery date of the contracted goods. Both parties, however, have the right to rescind the contract and the buyer has a right of refund of the advance payment he made. *Salam* cannot be contracted on a loan basis, although it may be contracted on a partly cash and partly loan basis, but with the *Salam* being effective only to the extent of the cash payment. A *Salam* contract should also expressly state the periods or places of delivery of the goods.

*Salam* is therefore, to a certain extent, no different from an ordinary sale as all the basic elements of a contract of sale apply to *Salam*. Yet there are some differences. In *Salam*, it is necessary to fix a precise period for the delivery of the goods, but in an ordinary sale it is not necessary. In *Salam*, a seller can sell a commodity that is not in his possession, but in an ordinary sale a seller cannot. In *Salam*, only those commodities that can be precisely determined in terms of quality and quantity can be sold, but in an ordinary sale anything that can be owned is saleable, unless prohibited by the *Qur'ān* or *Sunnah*. Further, a *Salam* cannot take place between identical goods – for example, wood for wood or rice for rice – but in an ordinary sale it is permissible. Finally, in

*Salam*, an advance payment should be made at the time the contract is entered into, but in an ordinary sale payment may be deferred or may be made at the time of delivery of the goods. In practice, *Salam* may be adopted as the underlying contract for working capital finance. In such an instance, an Islamic bank would pay in advance the full purchase price of, say, potatoes that the bank purchases from a client-farmer. The client-farmer would use the cash he receives from the bank as his working capital. When the time comes for the delivery of the potatoes to the bank, the bank would appoint the client-farmer as its agent to re-sell the potatoes to a third party. It may be agreed between the bank and the client that the client is entitled to a service fee for his efforts as a selling agent of the bank. Should the prevailing market price of potatoes fall below the price that the bank had paid for the potatoes, the bank shall bear the loss. As such, Islamic banks are less inclined to adopt *Salam* as compared to *Murābahah*.

***Istisnā`***

*Istisnā`* is provided for in the Hanafi school of Islamic jurisprudence. In other words, *Istisnā`* is also a contract for manufacture where the subject matter must be non-existing or unidentified goods since *Istisnā`* is a sale contract of goods identified by specification and not by designation. Where the contract is for the sale of, for example, a particular designated piece of machinery or building, it is, thus, not an *Istisnā`*. Payment in *Istisnā`* need not take place in advance and may be made in instalments according to the progress of the work. In the event that the seller manufacturer is declared bankrupt or insolvent and the subject matter is still in the process of being manufactured, the buyer has no prior right over a third party to the materials in the possession of the manufacturer for the purpose of producing the subject matter of the *Istisnā`*, unless the subject matter has been completely or partially delivered to the buyer. Similarly, the buyer cannot be regarded as the owner of the materials unless the manufacturer has previously undertaken, as a guarantee for the completion of the work, that such materials will only be used for the order of the buyer. This form of guarantee is only enforced in the event that the manufacturer has requested the buyer to pay part of the price in advance for acquiring some of the materials needed. In practice, it would be prudent for the manufacturer to request a down payment or some security payment to protect his interest. This is especially so where the product manufactured under the *Istisnā`* contract is specification-driven and may not be easily disposed of to a third party.

*Istisnā`* is similar to *Salam* in that both are contracts of sale of goods the delivery of which is deferred to the future, but at the same time there are many differences between the two contracts. First, we need to consider the nature of the subject matter sold and purchased. In *Salam*, the subject matter is not in the possession of the seller, but one which he will grow or procure for supply to the buyer; in *Istisnā`*, however, the subject matter is one that will be manufactured by the seller. Otherwise, it would not exist. Second, in *Salam*, the buyer seeks to fix the price of future goods that are effectively assured to exist anyway, but in *Istisnā`* it involves the sale of goods that are customarily made to order. Items that are not manufactured or constructed – that is, items that are natural things, such as animals or plants – are not covered by *Istisnā`*.

Third, in *Salam*, advance payment is necessary, but not in *Istisnā`*. Finally, in *Salam*, the time of delivery of the goods is fixed, but generally not in *Istisnā`*.

*Istisnā`* exists only in the Hanafi school of Islamic jurisprudence. Furthermore, it is the view of the majority of scholars in that school that the contract is only acceptable on the condition that it binds neither party until the goods are made and accepted by the buyer. On the other hand, a minority of Hanafi scholars take the view that it is binding on both parties from the start, although neither party has to immediately perform their obligations and if the item made does not conform to the description in the contract, the person who has given the order has the option of whether to accept it or not. It is this, albeit minority, view that is now followed in contemporary Islamic finance and it is in line with the secular law of contract, which provides that once a contract has been entered into it is binding on the parties concerned. Since classical Islamic law allows the manufacturing party in *Istisnā`* to sub-manufacture by contracting a second *Istisnā`* with a third party, Islamic banks frequently employ this structure, known as back-to-back *Istisnā`*, to finance purchases of major manufactured goods such as ships and planes. In the back-to-back *Istisnā`*, the bank acts as a seller under the first *Istisnā`* and accepts a series of payments over a long period from the client. Under the second *Istisnā`*, the bank acts as a buyer and pays progress payments over a shorter period to the manufacturer. The difference in the payments under the two *Istisnā`* is the bank's profit. In a back-to-back *Istisnā`* contract, it is important to distinguish the contract as two separate *Istisnā`* so as to make the transaction a non-*Riba* type of financing.

***Tawarruq***

*Tawarruq* literally means the monetisation of a commodity. It involves a three-party contract, whereby A sells an asset to B in cash and B then sells the asset to C for credit. C, in turn, sells the asset to another third party in cash. In practice, Islamic banks adopt *Tawarruq* where the bank purchases an asset from a supplier in cash and subsequently sells the asset to a client for credit. The client then sells the asset back to the supplier in cash. In practice, therefore, *Tawarruq* is utilised by Islamic banks as a *Sharī`ah*-compliant mechanism to enable a client to obtain a loan from the banks, especially where the client's intention is not to purchase an asset, but merely to get cash. Owing to its nature that is similar to the conventional unsecured lending, and unlike other *Sharī`ah*-compliant financial instruments that are akin to the conventional secured lending, *Tawarruq* easily replaces conventional loans for most purposes. For example, in the case of ordinary consumer loans, some non-Islamic banks have adopted this nomenclature claiming that they offer *Sharī`ah*-compliant facilities. This has resulted in controversy and uncertainty.

In 2009 the *Fiqh* Academy of the Organization of Islamic Conferences (OIC) ruled that *Tawarruq,* as practised in the contemporary Islamic financial services industry, is impermissible because the cash obtained in contemporary *Tawarruq* is "pre-arranged" (*Munazzam*) and not determined by market forces as in classical *Tawarruq*.[84] Owing to

[84] Resolution 179 (19/5) 26–30 April 2009.

the arranged simultaneous transactions, which usually involve a lower spot price, contemporary *Tawarruq*, therefore, contains the prohibited element of *Riba*.

However, it is noted that this resolution is not the first on *Tawarruq*. The same resolution (in content) had been passed earlier by another Islamic *Fiqh* Academy, one of the bodies under the Muslim World League Council. The academy had issued two resolutions regarding *Bay` at-Tawarruq*. In 2005, the Council passed a resolution allowing the practice of classical *Tawarruq* provided that it fulfils all the necessary requirements of a valid sale contract. However, in 2007, the Council passed another resolution prohibiting *Tawarruq* if it is practised as organised *Tawarruq*. Meanwhile, AAOIFI has published its own standard to underline the requirements on *Tawarruq*.[85]

The lack of consensus among scholars, as indicated by the different resolutions on *Tawarruq* issued by various *Sharī`ah* authorities, has given room for institutions offering Islamic financial services to continue applying the concept in their financial products, notwithstanding its controversy. In fact, Bursa Malaysia has successfully launched a regulated platform for the trading of commodities under *Tawarruq* principles in the form of *Bursa Suq al-Sila.* (This is further explained in section e. xvii. below.)

### vii. *Sharī`ah*-compliant securitisation

Islam prohibits enrichment from trading in debt as much as it prohibits enrichment from the debt itself. Therefore, the trading of financial assets is prohibited as much as the prohibition of interest on loans. Hence, the practice in conventional finance where businesses pledge or sell their accounts receivable is not compatible with Islam since those receivables are not real assets, but are instead financial assets that cannot be sold or used as collateral. What is permitted, though, is the securitisation of non-financial assets such as *Ijārah* assets, *Salam* assets, and asset pools within a *Muḍārabah* or a *Mushārakah* structure that consists of a majority by value of non-financial assets. The securitisation of *Ijārah*, for example, is permissible since the underlying assets are the real collateralised *Ijārah* assets from which a steady stream of cash flows are created from the lease payments. It is common in *Ijārah* financing for a special-purpose vehicle (SPV) to be created. The task of the SPV would be to issue to investors what is known as *Sukūk* al-*Ijārah*, or *Ijārah* certificates, and to use the proceeds to purchase assets from a supplier. Thereafter, the assets would be leased by the SPV (lessor) to a particular company (lessee) that would utilise the assets in its production. The lessee company would make periodic rental payments to the lessor SPV, which in turn would use part of the proceeds to pay the supplier. A portion of the proceeds would also be used to give a predetermined return on investment to the certificate holders. The certificate is capable of giving its holder a predetermined return on investment because the sum of the periodic rental payments from which the return is secured has been agreed in advance between the lessor SPV and the lessee company. The return is low, however, because a *Sukūk* al-*Ijārah* fund is a low-risk fund with minimum risks of capital loss. Nevertheless, *Sukūk* offers medium- to long-term fixed or

[85] SS-30: *Sharī`a* Standard No. (30), "*Tawarruq*", (2008) AAOIFI.

variable rates of return and has fulfilled a need for medium-term investments that were formerly lacking in *Sharī`ah*-compliant instruments. *Sukūk* is different from a conventional bond because, in the former, return on investment is based on the revenue generated by the performance of an underlying real asset, while in the latter, return on investment is fixed in the form of interest, which is not contingent upon any underlying asset.

A type of debt transfer that is permissible by *Sharī`ah* is *Hawalah*. Unfortunately, this term has been applied in the West to systems of so-called underground banking and money transfer, which may not always comply with the requirements of local law.[86] Indeed, the term has become tainted by the perception that criminals, tax evaders and even terrorists use such "*Hawalah*" networks for covertly moving their illicit funds. Nonetheless, *Hawalah* literally means the transfer of something from one person to another or from one situation to another. In legal terms, it involves merely an agreement by which a debtor is freed from a debt by another assuming responsibility for its repayment, or by transferring the responsibility from one person to another with the effect that a debtor is replaced by another debtor. In essence, *Hawalah* is a transfer or assignment of debt from an assignor to an assignee, which results in the debt of the assignor to a creditor becoming the debt of the assignee to the same – thus serving the function of essentially a money remittance service. *Hawalah* is not a transfer of right in which a creditor is replaced by another creditor, and neither is it a contract of sale of debt, the latter being impermissible under *Sharī`ah*. The permissibility of *Hawalah* in Islam is based on a number of the *Sunnah* of the Prophet Muhammad. It was narrated by Abu Hurairah that the Prophet said: "Procrastination in paying debts by a wealthy person is injustice. So, if debt is transferred from your debtor to a trustworthy rich debtor, you should agree" (*Hadīth* Bukhari, Vol. 3, Book 37, Nos, 486 and 487 and Book 41, No. 585).

*Hawalah* is therefore permissible so as to facilitate payments and recovery. Nonetheless, there are a number of requirements that have to be fulfilled for a *Hawalah* to be valid and acceptable in *Sharī`ah*. First, there needs to be consent of all the parties involved, namely the assignor-debtor, the assignee-payer and the beneficiary-creditor. The consent of the assignor is necessary for the obvious reason of ensuring that he does indeed agree to the transfer of his liability to the assignee, while the consent of the assignee is crucial since there can be no liability on his part without him first accepting such liability. As for the creditor, it is to ensure that he agrees to the transfer of his right to payment from the debtor to another person. Once agreed upon by all the parties concerned, the *Hawalah* becomes a binding contract and cannot be terminated unilaterally. The next requirement for a valid *Hawalah* relates to the obligations of both the assignor and assignee to the creditor where they must be identical in denomination and terms. In other words, the transferred debt or the transferred part of a debt must be equal to the payable debt in kind, quality or amount. This means that the assignment of

[86] See B. Rider "Fei Ch'ien Laundries – the Pursuit of Flying Money", 1 *Journal of International Planning* (1992) 77; and B.V. Kumar, "Unaccountable Funds and Underground Banking", in B. Rider and M. Ashe, *Money Laundering Control*, (1996) Sweet and Maxwell.

debt shall be at the nominal value of the debt or debt instrument. The creditor shall not be paid in excess of the actual amount of debt owed to him, otherwise it would constitute *Riba*, which is unequivocally prohibited in Islam. This requirement, however, does not mean that the liability of the assignor must be similar in quantity to the liability of the assignee towards the assignor. *Hawalah* is permissible even if the amount of one of the two liabilities is either greater or lesser than the other liability, provided that the creditor will be paid only an amount equivalent to the debt owed to him. A further requirement for a valid *Hawalah* is the need for an immediate effect. A *Hawalah* contract cannot be suspended for a period of time or concluded on a temporary basis, nor may it be contingent on future unlikely events. The liability of the assignee to pay, however, arises only when the debt becomes due and it is permissible to defer payment of the transferred debt until a mutually specified date. In other words, it is permissible to conclude a *Hawalah* contract on a deferred payment basis where the debt transferred to the assignee is to be paid to the creditor in the future, whether the payment of the debt is not yet due and was transferred as such to the assignee, or the payment of such debt is due, but the assignee required that it should be transferred for future payment at an agreed date. In the latter case, the assignee cannot be asked for payment before the agreed date. A *Hawalah* contract may be concluded on a restricted or unrestricted basis. In a restricted *Hawalah*, the assignee is to settle payment of the transferred debt using tangible or financial assets of the assignor that is in the possession of the assignee. In an unrestricted *Hawalah*, the assignee settles payment of the transferred debt by utilising his personal funds. He does, however, have recourse to the assignor for settlement. The beneficiary-creditor also has recourse to the original debtor or assignor under the following circumstances: namely, upon the death of the assignee; where the assignee defaults in payment of the liability or becomes insolvent or bankrupt; or the assignee denies concluding the *Hawalah* contract and has taken a judicial oath to this effect and there is no evidence to prove otherwise. With regard to the assignee, he is released from liability under the following circumstances: namely, upon his payment of the debt; by further transferring the debt to another person with the creditor’s consent; by the creditor waiving the assignee’s liability; or by the acceptance of payment by the creditor’s heir where the creditor has died.

In contemporary finance, the term *Hawalah* is often used in established financial institutions in the Arab world to denote wire transfers and similar transactions. Examples of contemporary financial products or services that are forms of *Hawalah* are cheques, drafts, pay orders, remittances, promissory notes, bills of exchange, and endorsements that denote the document by which the transfer of debt is completed. An issuance of a cheque, for example, is a form of *Hawalah* where the beneficiary is a creditor of the issuer for the amount of the cheque, in which case the issuer, the bank and the beneficiary are the assignor, the assignee and the creditor, respectively. Where the beneficiary is not a creditor to the issuer of the cheque, then the issuance of the cheque is not a *Hawalah* transaction since without an existing debt there cannot be a *Hawalah*. In such a situation, the transaction is an agency contract for recovery of the amount of the debt on behalf of the assignor, which is also permissible under *Sharī`ah*.

As we have seen in practice, *Hawalah* is more popularly referred to as an informal money or value transfer system, or an alternative or parallel remittance system where it exists and operates outside of, or parallel to, traditional banking or financial channels. In this system, transfers of money or value take place based on communications between members of a network of *Hawaladars*, or *Hawala* dealers or operators. The *Hawaladars* are usually family members or regional affiliates who base their transactions on trust, rather than any sort of negotiable instrument. In this *Hawalah* system, people in geographically remote areas can give things of value to each other without the physical and even electronic conveyance of money. After the December 2004 tsunami, for example, the *Hawalah* system was widely used to get funds from expatriate Tamil communities into eastern Sri Lanka, albeit in that country the system is called "*Undiyal*" instead. Thus, *Hawalah* flourish in regions where conventional banking instruments are either weak or absent. In Afghanistan, for example, the formal banking system lacks the capacity to offer international or domestic remittance services, and confidence in the banking system is weak. The informal financial system is used as the most cost-effective mechanism for fund transfers.

### viii. Conflict of laws within Islam

Mention has been made of the differences that exist in the interpretation and application of the *Sharī`ah* by the five principal schools. What is perhaps a more important issue in practice is whether it is acceptable to shop from one school to another to find interpretations that better suit the objectives and desires of the persons concerned. There have been cases where interpretations of different schools have been utilised at different stages of a transaction to establish that it is *Sharī`ah* compliant. It is argued by some scholars that this trend to pick convenient interpretations from different juristic traditions has increased as a result of non-Islamic academic interest in the *Sharī`ah* and the expediency of practising commercial lawyers.

The traditional view is that a person is obliged to follow the traditions of the home into which he or she is born – *Taqlid*. Thus, a person who is born into a Hanafi home should follow the Hanafi tradition, whereas a person born into a Maliki home must follow the Maliki school. In a more simplistic age where there was less interaction between societies, this was practical and convenient. Whether it has ever been entirely a satisfactory approach in regard to commercial dealings is debatable. Where transactions are negotiated between followers of different schools, most scholars take the view that the applicable interpretation should be agreed by the parties at the start. Of course, in simple transactions there is perhaps less scope for real controversy and the pervading obligations of good faith and fair dealing minimise the risk of serious disagreement. However, in the context of international financial transactions, where the law is relatively more dynamic, then there may well be potential for uncertainty. Consequently, some scholars have advocated invoking the principle of *Takhayyur*, or choice. In the legal sense this gives the believer the liberty of being governed in his personal and commercial affairs by the law of any of the four schools. Of course, it would still not be acceptable to cut and paste interpretations from different schools to one's taste. The decision, or rather election, is to be governed in one's dealings by the tradition that one in good conscience elects. In all cases, strict observance of the all-pervading spirit of Islam is required. However, the doctrine of election does provide an opportunity of avoiding conflicts, particularly in regard to international transactions. It would be misleading, however, to assume that all scholars are willing to accept the principle of *Takhayyur*. Where there is a conflict between the *Sharī`ah* and a law that is not characterised as Islamic, then the issue is rather more simple. It will always be the obligation of the believer to obey the *Sharī`ah*.

Another issue that should be mentioned here is the principle of necessity. *Sharī`ah* recognises that there may be situations of emergency (*Darurah*) where, to preserve life, a believer is at liberty to, for example, eat prohibited foods, provided that he neither relishes the experience nor takes more than is absolutely necessary. This principle has been recognised and applied in other areas of human experience. Indeed, the borrowing of funds subject to the payment of interest, and therefore prohibited as *Riba*, has been justified in the eyes of some scholars, where the project involved the construction of a dam which would not only greatly improve the lot of many but also at least arguably better preserve the lives of believers. Of course, not all agree with such an approach and resort to arguments based on necessity are at best problematic in Islam.

### ix. Compliance and risk management of Islamic institutions

The notion of integrity is complex and in some respects a construct. It is multifaceted and, in the context of a business, comprehends the probity of both the business and those through whom and with whom it operates. The implications for the reputation of the enterprise of even an isolated incident involving misconduct or abuse can be extremely serious. Indeed, in the context of Islamic finance we have already noted the potentially far-reaching consequences of conduct that is inappropriate and unacceptable. The perception that most people, including the media and relevant regulatory authorities, have of reputation is not sophisticated or perhaps fair. Taint arising by virtue of the default of even one individual can spread through an organisation like cancer, destroying respect, undermining confidence and resulting in dysfunction. While there is legitimate debate as to the value of reputation in different businesses in differing environments, it cannot be seriously contended that reputation is not an important asset, held and managed in trust – as is any other asset within the enterprise. There is clearly an obligation on those responsible for the governance and management of businesses to advance and protect this asset. This is of particular significance in the context of Islamic institutions – indeed, the Prophet who had himself engaged in trade on behalf of his wife Lady Khadijah observed "a trustworthy and an honest and truthful businessman will rise up with martyrs on the day of Resurrection".

Reputation is, however, a particularly fragile and vulnerable asset. Once harmed or undermined, it is extremely difficult to restore – and perhaps, in certain contexts, impossible. It is not simply the acts or defaults of the enterprise itself that may devalue reputation. Indeed, in the majority of cases it will be the acts of others associated with the enterprise. Their misconduct will taint their employer or principal. Indeed, the very failure of the employer or principal to prevent, control the problem, or contain its impact may well itself harm the business's reputation for probity and, thus, its standing. Indeed, the *Sharī`ah* recognises this by placing responsibility for the acts of agents and employees on the shoulders of their masters.

It is also the case that within any organisation, those involved and associated with it will, to a greater or lesser degree, have tied their own personal and professional reputation to that of the organisation. The English courts have, for example, recognised that an employee or former employee has a right to be compensated for their being devalued in the employment market as a consequence of their employer's failure to address frauds and abuses which undermined the reputation of its business. It is particularly interesting that this case arose in regard to the criminal activities of what was then the first international Islamic bank. As we have seen, many regulatory systems recognise the very real obligation on those in supervisory positions to exercise care and concern in ensuring that the business, and the integrity of those associated with it, is not tainted by the frauds and misconduct of those over whom they have authority. Indeed, in some cases, those in control or with supervisory responsibilities will be held accountable to the same degree as the person for whom they had responsibility and who abused his or her position. By the same token the obligation of non-executive directors and those placed in a position to assure or validate systems of good governance are no less onerous. In this context, we are not talking simply in terms of a moral or even a professional obligation, but a legal duty with the real risk of liability. This might manifest itself in direct personal liability to pay significant amounts of compensation in the civil court, exposure to regulatory and disciplinary actions, and even – in extreme cases – personal exposure to the criminal law.

In discharging their duties to protect the integrity and reputation of the businesses for which they have a responsibility, directors and officers should focus in particular on real threats that are likely to occur, resulting in a significant risk of harm. While we are concerned with rather more than "legal risk" manifesting itself in a devaluation of reputation, it is pertinent to identify the sort of liability that might arise for the enterprise and those associated with it personally. Let us therefore consider the liability of the business itself and those involved in managing it.

**Complicity in a crime**

Islamic criminal law generally requires the direct involvement and complicity of the defendant. The exceptions are narrow and, with the exception of the Maliki School, largely irrelevant to our present discussion. Indeed, the Malikis only recognise collective responsibility in the context of a concerted action. Having said this, the *Sharī`ah*, by imposing obligations directly on an individual who is in fact responsible for a wrongful act, cuts through many of the conceptual issues that arise in Western legal systems in cases where corporations or joint actors are involved. Of course, in many secular legal systems companies can be held liable under the criminal law to the same extent as individuals. The dishonesty of those who act for the company may be attributed to or merged with the company so that not only are the acts of its agents and representatives considered those of the company, but also their state of mind. Where a company is convicted, or even accused, of a serious crime, it can have immediate and direct implications for its business. When a company is held liable, this may also result in civil and other liability to those who have suffered as victims of the crime, or who have otherwise suffered loss as a result of the misconduct. Loss of reputation may well be actionable on the part of employees.

**Complicity in a regulatory offence**
As in the case of criminal liability, a breach of regulations by an individual may well be attributed to his or her employer. Indeed, in some cases the courts have held that the misconduct of the individual is the misconduct of the company and the company has been fined or otherwise penalised accordingly. It may well be that the consequences of the commission directly or indirectly of a regulatory offence will have as adverse consequences for the business as a conviction before the criminal law courts. In some respects, there is even a greater likelihood of civil liability.

**Complicity in a civil wrong**
The law of tort applies much the same rules as the criminal and regulatory law. Indeed, it may well be that the civil law will go even further than the criminal law in being able and willing to attribute the liability of an employee or agent to the principal. It is important to appreciate that in cases where this occurs the business will be liable at least to the same extent as the individual who actually engaged in the wrongdoing.

Judges have understandably been reluctant to stand by and see directors facilitate the looting of their companies by others with whom there is often a fair suspicion that they are in cahoots. A series of recent decisions in the English courts has underlined the significance of the constructive trust as a means of reaching out and imposing an essentially restitutory liability on those who receive the benefits of a breach of trust or who knowingly facilitate the breach. While the principles are by no means new, the way in which the judges have applied them has been dynamic. In recent cases, the English courts, for example, have fashioned a relatively effective device to impose restitutory liability on those who, knowing the facts that constitute a breach of trust, knowingly participate in it or facilitate the laundering of the proceeds in circumstances where an ordinary person would consider what they have done, or perhaps not done or asked, is dishonest. The liability in such cases is not that of a constructive trustee in the conventional sense of the word; their liability is as an accomplice and the monetary liability that they are exposed to is to make restoration as if they were a constructive trustee. A particularly significant case is that of *Attorney General for Hong Kong v Reid*,[87] which went to the Privy Council, on an appeal from New Zealand. The Privy Council, following the approach of the Court of Appeal of Singapore in *Sumitomo Bank Ltd v Kartika Ratna Thahir*,[88] considered that on the basis that equity looks as done that which should be done, there was a sufficient basis in law for tracing into the proceeds of a bribe. Furthermore, their Lordships' comments, and particularly those of Lord

[87] [1994] 1 AC 324.
[88] [1993] SLR 735 affirmed [1994] 3 SLR 257 (a particularly interesting decision given that the wrongdoing occurred in a Roman Dutch law jurisdiction – Indonesia).

Templeman, were wide enough to include the proceeds of a "secret profit". If the proceeds of, for example, insider trading could be traced and be the basis of a constructive trust, this body of law would have potentially far-ranging implications. For example, it would mean, as was in effect held by the High Court of Hong Kong in *Nanus Asia Inc. v Standard Chartered Bank*,[89] that the proceeds of insider dealing could be traced into the hands of a recipient who took otherwise than as a bona fide purchaser without notice. It would also follow that accomplice liability could be imposed on those who facilitated the insider dealing provided they had the requisite degree of knowledge and were, objectively speaking, dishonest. These are real issues for those concerned with Islamic finance given, as we have seen, the tendency for plaintiffs to establish their causes of action in common law jurisdictions.

**Facilitator liability**

The flood of cases seeking to impose civil liability on those which might broadly be described as "fiduciary facilitators" are based on a principle of law most clearly set out by Ungoed-Thomas J in *Selangor United Rubber Estates v Craddock* (a bankrupt).[90] In this case, the judge referred to an established principle of equity that, where a person knowingly participates in another's breach of trust, he will be regarded as standing in the same place as the trustee. While there has been much discussion in the books and cases as to the exact nature of this liability and whether it is properly considered a constructive trust relationship in all cases, suffice it to say in this context there would appear to be only two problems in fashioning this rule to become a most effective weapon against insider abuse.

The first is simply what sort of misconduct on the part of a fiduciary will be sufficient to bring the principle into play.[91] Most of the cases have involved either a conventional trust relationship or at least something so close as to make little practical difference. It would seem, however, that the property divided or misappropriated by the trustee must be capable of sustaining a proprietary or tracing claim. This point arose in *Nanus Asia Co Inc. v Standard Chartered Bank*.[92] In this case, the Hong Kong court was required to determine whether Standard Chartered was in a position analogous to that of a constructive trustee with regard to profits from insider dealing in the United States made by a Taiwanese who, with an employee of Morgan Stanley, had misappropriated price-sensitive information from Morgan Stanley and then traded on it on the New York Stock Exchange. There was no problem with regard to the bank's state of knowledge as it had already been joined in civil enforcement proceedings in New York. The Hong Kong court held that proceeds of the abuse of inside information were "held" by Standard Chartered on trust for the US authorities and various other claimants in the United States. At the time, some thought this decision, although welcome, went somewhat further than the English law, as it was not thought that the misuse of confidential information, let alone mere inside information, was capable of sustaining a trust

[89] [1990] 1 HKLR 396.
[90] [1968] 1 WLR 1555.
[91] B. Rider, "The Wages of Sin – Taking the Profit out of Corruption", *Dickinson Journal of International Law* (1995) 391.
[92] [1988] HKC 377.

relationship thought to be a pre-requisite for a viable tracing claim in equity. With the rather more robust approach of the Privy Council in *Attorney General for Hong Kong v Reid*,[93] it is probable that an English court would today take much the same approach as the learned judge in Hong Kong.

There has also been considerable discussion as to the requisite state of knowledge for liability.[94] The cases have indicated two basic standards, one requiring subjective knowledge and the other a rather more objective or constructive standard. It was thought that the distinction could be justified in terms of whether the third party who facilitates the breach of trust comes into possession of the relevant property or simply facilitates its control or attention by another. In the first case, a more objective standard was considered appropriate, and knowledge of facts that would put a reasonable man on notice that something dishonest was afoot would be sufficient to justify liability akin to that of a trustee. On the other hand, where the participation of the third party does not extend to possession of the property, it was thought that the requisite degree of *scienter* should be actual knowledge. In the view of recent cases, it would seem that the question of knowledge is rather more bound up with the nature of liability that is being imposed.

Where the third party does not come into possession of the trust property or its proceeds, then it is difficult to conceive of him as a constructive trustee or, for that matter, as having any status that would involve a proprietary nexus. The liability of such a person for participating in the breach of trust will be personal. In *Agip (Africa) Ltd v Jackson*,[95] the Court of Appeal found no difficulty in regarding a chartered accountant who had facilitated laundering the proceeds of a fraud by incorporating companies and opening bank accounts in the names of these companies liable as if he were a constructive trustee and thereby holding him personally liable to restore the funds in question. Of course, in such cases, the liability is personal to the defendant and does not involve a propriety liability. In this case, the court found that the person concerned had acted dishonestly. He knew of facts that, in the circumstances, made him suspicious, but he then deliberately refrained from making the enquiries which an honest man would have made and which would easily have uncovered the fraud.

Although the cases do indicate varying qualities of knowledge, it would seem the better view today is that before a third party can be held liable as a facilitator, the court will have to be shown that he knew the facts or deliberately turned a blind eye and then acted with a lack of probity. In *Royal Brunei Airlines Sdn Bhd v Philip Tan Kok Ming*,[96] a case on appeal from Brunei, the Privy Council handed down an opinion that does bring some clarity to this area of the law. The Privy Council emphasised that the liability of a person who assists or procures a breach of trust, but does not himself actually receive the property in question, is based on his dishonesty. The Privy Council considered it matters not whether the trustee has himself been dishonest. Furthermore, the probity of

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[93] [1994] 1 AC 324.
[94] C.A. Png, *Corporate Liability – a Study in Principles of Attribution*, (2001) Kluwer.
[95] [1991] 1 Ch 547
[96] [1995] 2 AC 378.

the facilitator is to be judged by reference to the honesty of others. The test is whether he had acted in a way otherwise than an honest man would have in the circumstances. This would invariably involve conscious impropriety on the part of the facilitator, rather than mere negligence, let alone simple inadvertence. However, a person might well be considered to be acting dishonestly for the purpose of imposing liability where he recklessly disregarded the rights of others. The Privy Council underlined that in determining whether a facilitator had acted dishonestly, his actual knowledge at the relevant time had to be considered by the court and this was a subjective issue. What might have been known by a reasonable man in the position of the facilitator might be probative, but was not conclusive. Furthermore, the personal and professional attributes of the facilitator must also be considered in determining what he did and for what reason. In the leading English case of *Twinsectra v Yardley*,[97] the House of Lords endorsed the trend away from the imposition of liability on the basis of an essentially objective determination. Instead, referring to Lord Nicholls in Brunei, their Lordships adopted what Lord Hoffman described as a combined test, having both a subjective and an objective element. First, it must be shown that the defendant acted in a manner that reasonably honest people would not have. Second, it must be shown that the defendant actually appreciated that this conduct would be considered dishonest by other people.

Another factor that needs to be considered is attribution of knowledge from an agent to a principal and, in particular, from an individual to a corporation, and vice versa. While generally speaking in *Sharī`ah* the knowledge that a properly mandated agent has will be attributed to his principal, this is not always the case, particularly when the law requires there to be personal and subjective knowledge. Of course, many of the obligations imposed under *Sharī`ah* operate on the basis that the person concerned is aware of the circumstances. Responsibility is generally personal and not attributed or constructive. Outside pure agency, the same is true in regard to the use of business entities. While there may be, in commercial terms, collective responsibility between partners, it is not clear that the same principles operate in Islamic law in regard to companies. These are real issues that need to be addressed, if potential uncertainties and resulting problems are to be minimised. Many other legal systems are far more prepared to attribute responsibility on the basis of control, risk and deep pocket theories. For example, the willingness of the English courts to take a robust line in cases where it is necessary to attribute or merge the knowledge of one person, usually the actor, with a company or other person to achieve the regulatory or public objective of a law is impressive.[98] This is an issue of some importance in regard to the responsibilities of IIFS and those who are responsible for their management. It also has implications for *Sharī`ah* scholars and councils.

[97] [2002] 1 All ER 377.
[98] See, for example, *Re Supply of Ready Mixed Concrete (No. 2)* [1995] 1 AC 556; and *Meridian Global Funds Management Asia Ltd v New Zealand Securities Commission* [1995] 2 AC 500.

**Secondary liability**

While the Islamic criminal law[99] generally does not distinguish between primary and secondary offenders, in the secular law it is quite possible for a business to become liable under the criminal, regulatory and civil law as a "secondary" party. The conduct and state of mind of those who act for it becomes the state of mind of the business. Thus, a company may well be considered to have aided and abetted one of its employees or directors to commit a fraud or engage in money laundering or a breach of trust. Indeed, it may even be considered to have "handled" or laundered the proceeds of one of its employee's thefts or deceptions. It is also possible for companies, and of course individuals within a business, to conspire in the commission of a crime or a tort. Regulatory provisions often throw the net over those who have "participated in" or facilitated a breach of the rules. It is important to remember that the secondary liability may well result in exactly the same kind of penalties and consequences as liability of the primary offender.

**Liability for those who manage or supervise**

There is in regard to most forms of liability a distinction between those who are responsible for exercising a general or specific management function within an organisation and those who are charged simply with supervision. However, it is important to remember that the distinction is not always clear cut and that in the civil law, for example, there is no distinction in the duties that a director is required to carry out, whether he be appointed as an executive director or as a non-executive director. Furthermore, the law is dynamic and there is an increasing trend to articulate and enforce specific duties of surveillance on non-executive and supervisory directors and officers. For example, in the United Kingdom the Bribery Act 2010 in section 7 provides that a commercial organisation will commit an offence of bribery where a person associated with it bribes another person intending to obtain or retain business, or an advantage in business, for the organisation. Under section 8 of the Act a person is associated with a commercial organisation if they perform services for or on behalf of the organisation, such as an employee or agent. However, it is also provided that the commercial organisation has a defence if it can show that "adequate procedures" have been put in place to prevent bribery by those associated with the organisation. The government is to publish guidance as to what such procedures might involve. To avoid a conviction, however, the burden is clearly on the organisation to show that it had prepared and properly implemented relevant and adequate procedures. It should be noted, however, that this provision as originally drafted and proposed by the English Law Commission was rather tougher and focused liability on those who were in a supervisory relationship with the person who engages in the bribery. Of course, a rather similar approach to the imposition of responsibility for risk has long been common in health and safety legislation. It should also be remembered that other legal systems, such as at state and federal levels in the US, may impose even more responsibility than in the UK.

[99] See, generally, R. Peters, *Crime and Punishment in Islamic Law*, (2005) Cambridge University Press; Anwarullah, *The Criminal Law of Islam*, (1997) A.S. Noordeen; and Y. al-Qaradawi, *The Lawful and Prohibited in Islam*, (1985) Islamic Book Trust.

Particular issues arise in regard to *Sharī`ah* boards. While the method of appointment varies, members of such boards are often appointed directly by the shareholders or participants in an Islamic business on the proposal from the board of directors. In most Islamic jurisdictions the legal obligations of members of the *Sharī`ah* board have tended to be taken for granted. Given the personal integrity of scholars appointed to such boards, specific problems have been merely anecdotal. However, given the overlap in many legal systems of general laws relating to, for example, conflicts of interest and insider dealing, there is scope for both uncertainty and perhaps liability.

**Compliance – the issues**

We have noted the importance that financial regulators accord effective compliance systems. It is recognised in many Islamic jurisdictions that this is an area that needs attention if sound and fair markets are to develop. In designing an efficient compliance system, we have seen that it is important to identify real risks facing the institution. This process, which may be conveniently called the audit, is concerned to ascertain what threats exist and whether there are adequate procedures for minimising exposure and providing containment. It is not concerned with handling specific problems. However, in evaluating the likelihood of serious harm occurring, the audit will assess whether the client has in place and could successfully operate appropriate procedures, designed to minimise and limit harm to its reputation. One of the issues that will be of concern is the institutional and procedural ability of the business, once a problem is detected or becomes obvious, to respond with timeliness and efficacy to preserve evidence, contain harm, reduce the risk of further damage and initiate a recovery strategy. As more is increasingly expected of management in assisting the authorities in pursuing their enforcement or regulatory mandates, the greater are the legal and other obligations to cooperate on those who, for example, employ a fraudster. Therefore, the prospect of corporate and personal liability is not confined to the direct consequences of the misconduct in question. A failure to have proper recording or compliance procedures may throw up a real threat, as might an inability to control the environment within which the fraud or misconduct occurs.

An audit cannot assure management, let alone those responsible for the governance of an enterprise, as to the safety of its reputation. It can and should, however, provide those whose responsibility it is to protect the integrity of the enterprise, with sufficient information and advice to enable them to initiate measures that can be reasonably assumed to provide the best defences. Whether those defences are satisfactorily erected and maintained is a matter for the relevant organisation. However, the fact that management has commissioned an audit and initiated appropriate action will be a relevant issue in establishing that it has done everything that it reasonably could have done to address the threat in issue. This may well mitigate the legal and regulatory consequences of a determination of liability. Thus, the audit may prove to be a significant item of confirmation that the board and management have taken reasonable steps to protect the integrity of the business and comply with the relevant legal and/or other obligations. Of course, the fact that an audit has been commissioned will not of itself serve as mitigation if the information that it provides is not taken properly into account.

There are offences and issues of liability the scope of which can be narrowed, or even closed, by showing that reasonable steps have been taken in addressing a particular problem or risk. This is particularly so in the management of conflicts of interest. What might otherwise be considered to be a conflict of interest may be regularised by providing for disclosure and appropriate authorisation. Where the core of an offence or complaint is that the management or a particular manager failed to exercise adequate supervision, then prove that everything that could reasonably in the circumstances be done, had been done might well resolve the issue. Thus, an audit that enables appropriate action to be initiated may of itself contribute in a significant way to the reduction in the scope of liability.

It must be appreciated, however, that at the end of the day the protection and advancement of a business's reputation is a matter for those charged with the management of that business. While this responsibility can be shared, it cannot be delegated or transferred to outsiders. As *Sharī`ah* emphasises, integrity is all about taking responsibility as a steward.

There are a number of very important legal, regulatory and managerial issues that need to be carefully addressed in delegating or outsourcing significant areas of responsibility. This is a particular issue in regard to the traditional role of *Sharī`ah* boards. While it is perfectly appropriate and, often necessary, to obtain expert advice in the discharge of the duties attaching to stewardship, it is not possible to delegate to another all the duties attaching to, for example, the office of director. There is a real issue that those who condone or seek to “pass the buck” in cases of fraud or other types of serious abuse, including the control of money laundering, will nonetheless be considered complicit in the wrongdoing. There are professional firms that are prepared to advise on and actually conduct monitoring. It is important, however, that such services are primarily concerned with systems and their ability to prevent, discover and address misconduct that would damage the integrity of the enterprise. They should not be designed or intended to replace the responsibility of management to ensure that their duties of stewardship are properly discharged. Of course, in most cases of potential liability, the fact that competent advice has been taken and acted upon will obviate or lessen liability should an incident actually occur.

A particular issue that arises in regard to the audit, and in the course of monitoring, is what happens if the external adviser discovers a serious regulatory failure or crime, or suspects that such is or is in the process of occurring? It is probable that the response will not be the same in every jurisdiction and profession. Of course, to some degree this issue has already arisen for accountants engaged in audit, and in many countries there are legal rules. Generally speaking, an auditor who is not satisfied with the response that he receives from the management of the relevant business would have a duty to take the matter further. In some countries there is a legal duty to report concerns to the appropriate regulator and even the police. While much depends upon the contractual terms of employment of any consultant, normally information disclosed to the appropriate authorities in the public interest, such as to assist in the discovery of crime or a serious regulatory offence, would not expose the auditor or other professional to liability, provided that such was done reasonably and in good faith. Perhaps more interestingly from the standpoint of a client is the converse issue as to whether the police or a regulatory authority could demand information and documentation from such a consultant to prove that the client organisation was aware of certain problems or shortcomings and yet failed to properly address them. Generally speaking, such material, albeit of a confidential nature, might well be required pursuant to specific investigative procedures. While it would probably not, in most cases, be appropriate for the consultant to simply hand over such documents, where such are demanded pursuant to statutory investigatory powers it would be difficult to resist. Indeed, for example, there are cases in the US, Britain and France which clearly show this. Where the review and advice has been proffered by lawyers, it is possible that legal privilege may be claimed. Whether this would defeat the exercise of statutory powers in all jurisdictions is a moot point. However, law firms have specifically marketed such services on the basis that, unlike in the case of accountants and other professional advisers, there is the probability that legal privilege would be a protection.

It is an important obligation of management to protect the asset of reputation, and a failure to do this may well lead to personal as well as institutional liability. Faced with so many problems and the potential for making mistakes, possibly resulting in far more harm and liability, it is vital that the organisation has in place procedures for addressing such crises. The so-called crisis management should be addressed as a key issue in any Integrity Protection System. On the other hand, while the procedures may impose a degree of order and offer the prospect of protection for those working through them, there will inevitably be a host of specific issues which the procedures can at best only present to management for proper decision-making. While the facts of each case will vary, in a typical case the following legal and regulatory issues might well arise more or less simultaneously:

- the contractual (possibly employment) position of the perpetrator;
- related contractual issues, perhaps with persons with whom the perpetrator was dealing;
- issues arising from detection – such as, whether there was there a “whistle-blower” and, if so, how that individual (who might also be an employee or in a sensitive business or contractual relationship) has been dealt with;
- the need to protect the environment within which the “crime” occurred and the integrity of evidence (particularly electronic and documentary);
- the presentation of what has occurred to those who have a proper interest in knowing and, in particular, the need to avoid defamatory statement or interference with subsequent proceedings and investigations;
- ensuring “containment” of the fraud or other abuse, including making sure that it is disrupted and steps are taken to close down the opportunity for others to copy and/or exploit it;
- in the case of Islamic businesses, ensuring a prompt and effective return to *Halāl* activity;
- notification to relevant authorities, bearing in mind the risks of defamation and

improper disclosures;

- liaison with appropriate investigative and regulatory authorities (including possibly those overseas) and, in particular, determining under what circumstances there is an obligation to assist in the securing and provision of evidence;
- how to deal with requests for assistance and possibly threats from those who have suffered harm as a consequence of the fraud, or the company's failure to prevent (or control) it;
- how to deal with the media, public and stakeholders;
- how to initiate proceedings to recover losses that the company suffered, or on behalf of those for whom the company has a responsibility to assist, including attempting to freeze the assets of the perpetrator and possibly his associates;
- liaison with insurers;
- in Islamic businesses, how to deal with "tainted" property;
- liaison with professional organisations; and
- liaison with bankers and others who may be adversely implicated.

In attempting to address each of these issues, it will be necessary to seek the assistance of individuals inside and outside the enterprise. All these relationships will need to be managed, controlled and documented. For example, it is appropriate to disclose information relating to the suspected perpetrator and the circumstances of the "crime" only to certain persons and for specific purposes. A mistake could not only harm the position of the institution, but also expose those responsible for an inappropriate or unlawful disclosure to civil and even criminal liability. For example, in certain circumstances, it is a serious criminal offence for information to be disclosed relating to suspected instances of money laundering. Most frauds and other financial crimes will involve at least the prospect of a money-laundering offence. The dilemma of management faced with all these issues may well be dramatically aggravated by similar issues arising in other jurisdictions, in which the rules and legal procedures may be very different. In today's business environment it is not unusual for even the smallest business to be exposed, directly or indirectly, to overseas regulatory regimes. In cases of serious fraud it is not unlikely that, by the time the problem is discovered, the money will have been sent overseas, as might relevant evidence and even some of those involved.

In recent years, compliance has been recognised as playing a significant role in the development of sound and honest *Sharī`ah*-compliant institutions and businesses.[100] As business becomes more complex and the responsibilities of management more onerous, it is appropriate for more responsibility to be placed on the shoulders of

[100] See, for example, IFSB-10: "Guiding Principles of *Sharī`ah* Governance Systems for Institutions offering Islamic Financial Services", (2009) IFSB. See also IFSB-9: "Guiding Principles on Governance for *Takāful* Undertakings", (2009) IFSB; IFSB-6 and IFSB-3: "Guiding Principles on Governance of Islamic Collective Investment Schemes", (2009) IFSB and "Guiding Principles on Corporate Governance for Institutions offering Only Islamic Financial Services (Excluding *Takāful* Institutions and Islamic Mutual Funds)", (2006) IFSB.

professional compliance officers. However, in the context of the Islamic world, outside a handful of countries such as Malaysia and Pakistan, this expertise is in short supply. Indeed, this is a particular concern of regulators in many jurisdictions as expertise – especially in the financial sector – is limited and has generally been imported. This is not always satisfactory, as compliance systems and their operation must achieve a balance between what is required to comply with the relevant laws and achieve an acceptable degree of protection for the risks that we have been discussing on the one hand, and not inhibit proper and lawful business on the other. Not all jurisdictions and environments are the same, particularly in terms of their institutional arrangements and the approach of regulatory authorities. Therefore, rather like laws, it does not necessarily follow that what possibly works in the City of London or New York will achieve the same results in Doha or Dubai, let alone Jakarta. Furthermore, compliance in the realm of the *Sharī`ah* is a new and largely untested science. Indeed, even within the confines of the Islamic world there is debate as to the appropriate roles of internal *Sharī`ah* audit and the responsibility of *Sharī`ah* boards to take a wider surveillance role over management. This is compounded by the inherent uncertainty of certain principles of Islamic law both in their application and interaction with secular laws.

### x. *Sharī`ah* councils

The role of *Sharī`ah* advisers is of paramount importance in Islamic finance. Of course, scholarship plays a very significant role in the understanding, interpretation and even the development of *Sharī`ah*. Whereas in the vast majority of other legal systems scholars may be respected, they are not generally considered as authoritative, let alone determinative. While the exact responsibilities of *Sharī`ah* boards or councils vary from institution to institution, they are, in the view of most, responsible for not only advising on what is acceptable in *Sharī`ah* but also for monitoring, to varying degrees, compliance with their advice and interpretations. Indeed, in the context of *Sukūk*, AAOIFI requires *Sharī`ah* councils to perform a monitoring role.[101] While recognising the vital importance of *Sharī`ah* advisers, whether acting alone or more usually and preferably as a board or council, there is perhaps less agreement and certainty as to their responsibilities and obligations as individuals and collectively. To some extent, this is a result of the high respect accorded to such persons and their own obligation to observe the strictures of *Sharī`ah*.

The method and terms of appointment of *Sharī`ah* scholars vary from one jurisdiction to another and one institution to another. Much will depend upon local traditions and the availability of scholars of such high and manifest distinction and erudition. It has long been recognised that while in many jurisdictions there is no shortage of persons with the required degree of learning and experience in regard to the general discipline of *Sharī`ah*, this may well not be the case in regard to the Islamic law of transactions (*Fiqh al-Muamalat*). Even where there is scholarship, there may not be experience of the financial markets and of the practicalities of finance. In many cases today, such

[101] See AAOIFI, Governance Standards generally, but 4 and 5 in particular. See also IFSB-6 and IFSB-10.

knowledge and experience are at a premium. Of course, there are numerous initiatives taking place throughout the Islamic world and beyond to increase the pool of suitable scholars, but this cannot be achieved overnight. Consequently, there are circumstances where scholars out of necessity are required to advise more than one enterprise and institution.

While there will be contractual provisions in the relationship between the *Sharī`ah* scholars and the entities which they advise, it is not always the case that these terms address the regulatory issues that might arise. For example, where a board of directors is accustomed to act in accordance with the advice of a *Sharī`ah* scholar or board, under the laws of many countries, including most common law jurisdictions and even some Islamic jurisdictions, they would be considered to be "shadow directors" and subject to the same legal and regulatory obligations as are the directors. In fact, in certain cases they might well be held responsible for negligence and misconduct in the overall management of the company. Their responsibility under the general law would not be confined to their role as merely an adviser on the *Sharī`ah*. This is not widely appreciated.

Furthermore, it is hard not to see such persons as being in the sort of relationship with companies that would normally be considered to give rise to liability as insiders. *Sharī`ah* scholars not only have access to unpublished price-sensitive information relating to the company's intentions and perhaps operations, but also their own recommendations might well amount to market information or, indeed, inside information in the traditional sense. It follows that in such cases there would be a prospect of criminal and/or civil liability if the relevant information is being misused. While it might well be safe to assume that given the high moral standards of individual scholars, it is unlikely that they would themselves trade on the privileged information in question, in many countries liability may be based on the unauthorised disclosure of such information, or merely recommending action to others. The problem is exacerbated by the fact that many *Sharī`ah* scholars advise different, and even possibly competing, businesses. It is certainly arguable that once in possession of knowledge that a particular company is going to invest or act in a certain way, the scholar would then be prohibited under the laws of many countries from giving similar advice to another person. It is hard to see how any conventional approach based on segregation of information or function could effectively operate. Indeed, the courts in countries such as the US, the UK, Australia and Singapore have been very reluctant to accept the efficacy of highly developed and refined "Chinese walls" within financial institutions. Where just an individual or board is involved, there is no likelihood that any such arrangement would be considered acceptable. The survey conducted by the IFSB revealed only lukewarm enthusiasm for such procedures and devices among those who responded. There is also the issue, to which we have already referred, of attribution of knowledge. This, in the context we are discussing, could even result in other entities being taken to have the knowledge of a scholar who was in law a shadow director.

Even if effective procedures, by contract or otherwise, are devised to segregate the flow of information, which it is very hard to contemplate as feasible, then this would not necessarily address the issue of conflict of interest. In many systems of law, contractual provisions cannot excuse those in a conflict of interest, or a conflict of duties, from the legal consequences. In those legal systems where such issues have arisen, the law is both deep and complex. To date there has been little discussion of these issues within *Sharī`ah.*[102] Stipulations by contract or through some other mechanism to ensure confidentiality may not under the general law address any of these issues. Indeed, they may in fact lead to additional legal risks.

There is also the issue as to what is the appropriate course of action for a *Sharī`ah* scholar who considers that his advice has been ignored or even misrepresented. May he in effect "blow the whistle" on management? Of course, in most cases he would have been appointed and remunerated by management. It is not always the case that there will be convenient and unrestricted access to the shareholders, assuming that the relevant structure has shareholders who would be interested in any disagreement between the scholars and management. Indeed, in many Islamic financial transactions, the shareholders are likely to have a close affinity with the managers and it is the *Sukūk* holders or investors who might be more likely to be prejudiced. As we have already noted, even under *Sharī`ah* the consequences of non-compliant actions are not always certain in any case. The terms of appointment of *Sharī`ah* scholars and boards will often determine the scope of their authority to report to persons other than the management. Under *Sharī`ah*, it is open to question whether there is a right or a responsibility of scholars to do more than proffer advice. It is most unclear whether they should or could, for example, make a public statement or report a matter to the regulator. It is arguable that, given the nature of the obligation that the *Sharī`ah* casts on believers where there is a seriously unacceptable act, a scholar would at least have the right (if not the obligation) to intervene. However, a contract imposing an obligation under a non-Islamic law of confidentiality might still hold in such circumstances, bringing with it the prospect of a civil claim. There is also the possibility of suits based on, for example, defamation, interference with business and breach of fiduciary duty, in addition to breach of contract. In regard to sovereign funds and investors, there may well be statutory obligations of secrecy reinforced by the criminal law.

Whether it would be appropriate for a scholar to report non-compliance to the authorities is particularly controversial. In most jurisdictions where there is an absence of any special laws relating to Islamic finance, the position that regulators have adopted is that, provided there is proper compliance with the relevant non-Islamic laws, they have no further official interest. Whether this is a responsible and lawful attitude is questionable. Where funds are solicited on the basis that they will be managed in a way that is compliant with *Sharī`ah*, the fact that they are not, becomes potentially actionable under the general law. It should also be a matter of concern for the regulators either on the basis of fraud or given the risks of legal action, soundness and solvency.

[102] See Siti Faridah Abd Jabbar, "Prohibition in Islam and Prevention by the *Sharì`a* Supervisory Board of Islamic Financial Institutions", 17 *Journal of Financial Crime* (2010) 287.

In most cases, scholars will be appointed pursuant to a contract. In some structures there may well be issues relating to privity of contract and who may rely upon the terms of the contract. This might well be of practical importance, not only in regard to issues of confidentiality, recovery of remuneration and conflict, but also in relation to issues of negligence. The level of expertise particularly on practical matters relating to financial business is not always as high as it might be. Consequently, advice given and relied upon might be challenged as negligent. Although the high esteem with which scholars are generally regarded would tend to militate against such actions, we have noted that there is potentially a constituency of interests that may be harmed by inappropriate or incompetent advice on *Sharī`ah*. Therefore, it cannot necessarily be assumed that the responsibility to advise properly and with care is determined simply by contractual arrangements. Indeed, third parties may well have a good claim under the general law, regardless of Islamic law. The risks to scholars are not inconsiderable, particularly where the law might characterise them as shadow directors or being in a conflict situation. The danger is exacerbated by the possibilities of attributing knowledge and the possible ineffectiveness of contractual limitations on liability. In similar circumstances, few professional advisers would act without indemnity insurance.

While the *Sharī`ah* does not have a developed jurisprudence on fiduciary responsibility it is arguable that in certain circumstances *Sharī`ah* scholars might well step into a relationship that the general law would consider to impose fiduciary duties. We have already referred to this in the context of conflicts of interest and duty. However, the obligations might well go some way beyond this.

There is ambiguity in practice as to the obligations of *Sharī`ah* boards to concern themselves with monitoring and compliance. The focus tends to be on the making of particular and often specific decisions. However, as a matter of *Sharī`ah*, and certainly given the undertakings that are often given under the general law, in fact the scholars' obligations are much wider. While it would be exceptional to expect scholars to actually perform a compliance role, as would a board or council, they should be concerned that there are in place adequate procedures and persons to ensure that there is in fact compliance. These arrangements will need to be adequately monitored and assessed.

Problems occasionally arise in practice when there is conflicting advice on what is acceptable under *Sharī`ah*. Some institutions may have been inclined to "shop around" for advice from different scholars within the same or from different schools and traditions. Obviously the existence of fora where issues can be discussed, and the work of bodies such as AAOIFI, potentially make a significant contribution.[103] It is also the case that, in jurisdictions such as Malaysia where there is a central *Sharī`ah* Council established by Bank Negara Malaysia and the Securities Commission of Malaysia, many of the issues that have been raised in this section are, to varying degrees,

[103] C. Alexakis and A. Tsikouras, "Islamic Finance: Regulatory Framework – Challenges Lying Ahead", *International Journal of Islamic and Middle Eastern Finance and Management* Vol. 2 Iss. 2 (2009).

resolved or at least mitigated.[104] The same can be said of other jurisdictions that have a central *Sharī`ah* authority, such as Brunei, Indonesia, Pakistan and Sudan.

### xi. Non-compliance (including purification/punishment)

It is open to debate how far the *Sharī`ah* imposes affirmative obligations on believers to interfere in order to prevent unlawful and immoral acts. Where the deliberate failure to act allows the commission of a crime or other *Haram* act by another, then it is arguable that an individual who does not complain is morally at fault ("Who so ever of you sees an evil action, let him change it with his hands; if he is not able to do so, then with his tongue; and if he is not able to do so, then with his heart – and that is the weakest of faith") (*Hadīth* al-Nawawi 34). For legal responsibility, the majority of scholarly opinion would require some form of active participation in the wrongdoing. However, the *Sharī`ah* does recognise the appropriateness of "whistle-blowing". For example, the Prophet condemned immoral conduct and extolled the virtue of those who voluntarily revealed conduct that was against the interests of society. Jabir b. Abd Allah reported the Prophet as stating, "Meetings are confidential except in three situations; those for the purpose of shedding blood unlawfully, or for committing fornication, or for acquiring property unjustly" (Abu Dawud No. 4851).

A particular issue in Islamic law arises in regard to the proceeds of activity that is *Haram* (impermissible). In secular law the issue is relatively straightforward. If the property or money in question is the proceeds of a crime, the law will generally require that it be forfeited to the state. Where property is the proceeds of a fraud or other tort, then it might be subject to some process in the civil law of restitution.[105] The analysis is somewhat different in the *Sharī'ah*. While in a given case the secular law may well apply, the notion of unclean or tainted property is a somewhat broader concept. Controversy has arisen among scholars in regard to what might be described as purification, or "*Tanqiyyah*". In some jurisdictions the proceeds from investments that are later discovered not to be *Halāl* have been contributed as donation (*Sadaqah*) to charity. It is argued that this serves to "purify" the mistake. Where, however, what has been done is *Haram*, it is highly questionable whether this is acceptable. For example, there is a *Hadīth*: "Whosoever gathered unlawful riches and then gave out in charity, he will have no reward: on the contrary he will have to bear the burden of his evil deed" (Ibn Khazaimah, Ibn Hakkam and Al-Hakim); and the Prophet said: "When a servant of Allah earns property in an unlawful manner and then gives it in charity, it will not be accepted of him. There will be no blessing (*Barakah*) in that he spends and that he leaves behind (for his dependants) but it becomes a provision for the fire of hell. In reality, Allah does not wipe out evil with evil, but erases evil with good action.

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[104] See, generally, *Resolutions of the Securities Commission Syariah Advisory Council*, (2nd ed. 2006) Malaysia Securities Commission; and N.N. Thani, *Legal Aspects of the Malaysian Financial System*, (2001) Sweet and Maxwell, in regard to the background.

[105] See, for example, C. Nakajima, "Money Laundering and Constructive Liability", in B. Rider (ed.), *The Corporate Dimension*, (1998). See also, in terms of legal risk, B. Rider, "The Limits of the Law – An Analysis of the Inter-relationships of the Criminal and Civil Law in the Control of Money Laundering", 25 *Journal for Juridical Studies*, (2000) 1.

Undoubtedly, dirt does not clean dirt."[106] It would seem that the better view is that the process of purification is only acceptable if the *Haram* proceeds are incidental and innocently obtained. Except where it is possible to employ the doctrine of necessity, the scope of which is subject to much discussion by scholars, then it would seem that purification cannot take place in regard to *Haram* proceeds that have been deliberately obtained. Of course, some advocate a *de minimus* approach, but others see no justification for this expedient. Having noted this, the survey conducted by the IFSB in the context of this study disclosed widespread belief in the business sector that purification is acceptable and common.

### xii. Areas for development

We have attempted to identify specific issues and potential weaknesses in the efficient development of Islamic financial services and products from the legal and regulatory standpoint. Of course, as has been underlined, many of these issues are system- and even jurisdiction-related. Islamic law approaches issues of jurisdiction rather differently than most other – and, in particular, domestic – legal systems. The religious, legal and moral obligation to comply with *Sharī`ah* is placed on the believer, wherever he may be. However, the availability of enforcement effectively renders the application, and certainly the administration, of the law more territorial in character. Thus, while the Islamic criminal law (*al-Jinayat*) or penal law (*al-Uqubat*) is applicable to believers (and, within Islamic states, non-believers) wherever they may be, the practical reality of enforcement is more parochial. It always remains open to a *Sharī`ah* court that is willing to assume jurisdiction to take such action as it considers appropriate notwithstanding the absence of the relevant person. Given the close relationship in Islamic law between the criminal law (which is concerned with wrongs that impact on the public) and the law of tort (which is concerned with the impact on the rights of individuals), these issues are of practical significance in the context of international business. Jurisdictional issues in non-Islamic law and legal systems are of considerable practical importance, particularly in the context of financial transactions and the structuring of products and services. Indeed, consider the significant impact of US securities law, for example, whether applied extra-territorially or according to encompassing notions of domestic jurisdiction, on the conduct of financial transactions. While there remain real issues in this regard, the law is considerably more certain and predictable in its application, in this respect, than Islamic law.

It is not just issues relating to proper jurisdiction that create potential problems. There are significant differences of opinion as to the legality under *Sharī`ah* among the four Sunni schools of jurisprudence. While in ordinary commercial transactions the differences are probably more-or-less appreciated, there is more uncertainty in regard to the highly structured transactions that form the basis for most financial products. There is also far more scope for disagreement, in that the range of transactions and methods of trading are relatively more complicated, diverse and dynamic. This is compounded by the inevitable imitation of non-Islamic products and services, for market

[106] Abdhur Rahman I. Doi, *Shari`ah: The Islamic Law*, (1984) Ta Ha Publishers, London, pp. 352 and 353.

and political reasons, and the much greater degree of involvement of non-Islamic institutions and, in particular, legal advisers. Consequently, there remains uncertainty as to the appropriateness even in the main streams of jurisprudence in regard to speculative trading and the market practices that have developed to facilitate market stability. While the reach of the fundamental prohibition on *Riba* is relatively settled, it would be rash to assume that the perimeters or appropriateness in the structuring of transactions to address the prohibition are fully resolved. We have seen that the *Sharī`ah* roundly condemns any attempt to circumvent its prohibitions and is equally vehement against anything done to achieve such an objective. Consequently, there is always going to be an area of objective uncertainty as to when a new transaction or contract manifests mere ingenuity on the one hand and is regarded *ex post facto* as an attempt to evade the *Sharī`ah* on the other. While there is no evidence to support the view, some have observed that given the natural rivalry that exists between financial centres, perhaps exacerbated by their adherence to different legal traditions, the castigation of particular developments might be more political than religious. Whether this is true or not, there is in the minds of some, believers and non-believers alike, a perception or fear that this is or might be the case. Again, whether true or not, this creates uncertainty that is potentially damaging to the development of Islamic finance.

We have noted that there are also serious differences as to the legal consequences of a perceived breach of *Sharī`ah*. In particular, late settlement of financial obligations (under *Murābahah*), where justified, is generally accepted and permitted – even if in breach of agreement. Indeed, we have seen that the *Sharī`ah* does not always regard "contractual" obligations as strictly in terms of their mandatory force, as compared with, for example, the common law's approach of strict compliance. While there are in Islam, as in all developed legal systems, accepted justifications for non-compliance or variations in compliance, in most other systems these are narrower and more tightly controlled. In Islamic law, there is a greater element of subjectivity in the process and reality of justification. This again contributes to uncertainty. Furthermore, when non-compliance is considered to be morally unacceptable, then in Islamic law there are wide differences of attitude and consequence ranging from imprisonment to demands for full compensation. We have already noted that the attitude within the schools to what the common law would consider to be an operative misrepresentation can, at least in theory, range from the matter being considered as little more than a moral wrong, for which the person concerned may or may not wish to address – in a personal relationship to his beliefs, to a variety of financial consequences or the implications of the criminal law. While the state of mind of the person making the misrepresentation is, even in the common law, an important issue in the determination of an appropriate remedy for the person who has suffered as a consequence of reliance on the misrepresentation, the graduations of liability are well recognised within a coherent and developed body of law – albeit, for example, in England, this was not achieved until the Misrepresentation Act 1967. The problem in Islamic law is the diversity of approach, even in regard to the same conduct and state of mind, from tradition to tradition. This is potentially a very significant issue in the development of Islamic financial law given the significance that the law relating to misrepresentation has played in investor protection in most other systems.

There is a degree of uncertainty, albeit largely theoretical, in regard to the very concept of limited liability and the structuring of legal devices to minimise or exonerate individual investors from the consequences of risk. Indeed, there remain scholars across the schools who remain doubtful as to the acceptability of the conventional notion of limited liability,[107] notwithstanding that the AAOIFI's Standard 12[108] has accepted it as permissible. The comprehensive recognition of fictitious corporate legal personality – which is, of course, bound up as a matter of logic with limited liability – is also an issue that has yet to be fully resolved. This is compounded in many jurisdictions by the wholesale adoption of non-Islamic companies Acts, often from very different legal systems.[109] While the International *Fiqh* Academy of the OIC has accepted that a share issued by a company is evidence of undivided ownership of the company's assets and is therefore permissible, this view is at odds with company law in most jurisdictions. In the majority of legal systems, a share is not an undivided interest in the actual assets of the company but the enterprise of the company. Shareholders have no proprietary interest in the company's assets.[110] The development of financial services and institutions does not occur in a vacuum and there needs to be an environment in which proper and certain legal forms can be created and operated.

We have already referred to the need for laws that enable and facilitate the creation of recognised legal interests and their transfer in property and rights derived from property interests. This is in practice a particularly difficult area, which is compounded by inadequate interface with other areas of relevant law, including that relating to corporate and personal bankruptcy.[111] We have mentioned the need to ensure that transactions can be negotiated, verified, recorded and referenced with accuracy and efficiency. The *Sharī`ah*, in the opinion of many scholars, in the interests of protecting the weak and achieving certainty, imposes onerous obligations in regard to the execution of transactions and their documentation. These issues need to be addressed, particularly where the ability to trade in such interests is also restricted by laws relating to exchange control and other fiscal clearances, foreign ownership restrictions and expensive registration obligations. There is also the practical issue as to the ability, within a particular jurisdiction, of the local professions, whether legal or notary, to be able to adequately process and service these requirements at a cost which is not excessive.

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[107] See, generally, I.A. Khan Nyazee, *Islamic Law of Business Organisations – Partnerships*, (2002) Other Press.

[108] SS-12: *Shari`a* Standard No. (12), "Commodity *Murābahah*", (2004) AAOIFI.

[109] Historically, see R. Nelson (ed.), *Corporate Development in the Middle East*, (1978) Oyez; and, in particular, Fath El Rahman El Sheikh, *The Legal Regime of Foreign Private Investment in the Sudan and Saudi Arabia*, (1984) Cambridge University Press.

[110] See, for example, *Short v Treasury Commissioners* [1948] AC 534; *Macaura v Northern Assurance Co Ltd* [1925] AC 619; and *Abdul Aziz b. Atan v Ladang Rengo Malay Estates Sdn Bhd* [1985] 2 MLJ 165 at 168. per Shanker J.

[111] See also D. El Hawary, W. Grais and Z. Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated", (2004) World Bank Working Paper 3227.

The development of new systems for recording and transmitting data has added in some respects to the legal uncertainties that possibly exist in Islamic law, particularly in regard to proof of documentation and authenticity. Indeed, there are scholars who consider electronic communications and records unacceptable and this has obvious implications for the legality of electronic markets. Automated trading systems have also been criticised and their acceptability is seriously open to question.

Some of the issues that have been raised in regard to the basic contracts upon which most of Islamic finance is based would in substance be addressed by a greater degree of standardisation in the contractual documentation that is used. In practice within most jurisdictions there remains a relatively wide range of documentation even in regard to the most basic and traditional contracts. This is not surprising given the differences in traditions, emphasis and even professional competition between lawyers and other advisers. Local laws and customs and, to some degree, the heritage of metropolitan and imperial legal systems militate in favour of diversity. The background and education of lawyers also complicates the situation. It must also be debated whether standardisation is itself always beneficial in terms of the development of the law and the protection of weaker contracting parties. Indeed, there has been much debate in the common law tradition as to the relative rights of parties in standard form contracts and the implications of onerous clauses inserted by the more powerful party. Having said this, given the significance of foreign lawyers, particularly in the City of London, in the development of certain products and especially the *Sukūk*, there is a tendency towards standardisation both of terminology and documentation.[112] This has, within it, certain dangers. Lawyers, particularly of the calibre involved in the crafting of these documents, understandably wish to address issues both within the *Sharī`ah* and other relevant systems of law. Consequently, the resulting documents are highly complex, detailed and relatively expensive. Furthermore, there has been concern that the level of expertise on *Sharī`ah* varies and that there is a danger that the commercial and pragmatic approach of the more senior lawyers who are primarily common lawyers may result in a more robust and less sensitive understanding of Islamic issues. The dominance of essentially Western law firms also has serious implications for the development of sufficient expertise, on wider financial and commercial matters, for lawyers operating within the developing Islamic markets.

It is also arguable that the domination of large British and American law firms in certain areas of the development of the Islamic markets has resulted in a disproportionate concern for transactional legal issues, to the detriment of concerns for infrastructural and institutional development, investor protection and the sustainability of wholly Islamic markets. This is not a criticism of the international law firms, as they are properly and appropriately driven by the concerns of their clients. Their clients have hitherto not been concerned by these wider issues. Attention has been focused on the deal at hand. Those with regulatory and wider responsibilities for the development of sustainable

[112] In fairness, the same call has been made by many others, particularly in regard to regulatory requirements. See, for example, B. Rasul, Director, Securities and Exchange Commission of Pakistan, Conference, Kuala Lumpur, 28 October 2010, Bernama.

Islamic financial markets need to realise these limitations and be prepared to ensure a more sensible realignment of interests. Indeed, it is disappointing that those institutions that have been established to foster and develop scholarship in and concern about Islamic financial law have themselves focused on transactional issues and given little attention to these wider issues.

To some extent the relative failure to address such issues is understandable given the priorities of instructing clients and the fact that, in the relevant jurisdictions, there has been little evidence of determined enforcement or regulatory action. Consequently, lawyers in advising clients operating in these markets might with justification advise that concern about issues relating to market integrity and the protection of investors presented little legal or regulatory risk. The situation has not been helped by the failure of many Islamic scholars to show any real interest in these wider issues. Their focus has tended to be on the acceptability of products and services, rather than the wider concerns that are necessary for the establishment of fair and honest markets that can sustain development and continuity. In part, this may be due to the underdeveloped state of Islamic law in regard to fiduciary obligations in the context of financial transactions and services and the relatively unsophisticated concerns of the traditional commodity-based markets. There are certainly few scholars who have addressed, at least in writing, the issues that have concerned, and to some degree driven, the development of securities law in many other jurisdictions.

Given the relatively unsophisticated commercial and business environment in which early Islamic financial transactions developed, and notwithstanding the highly developed and complicated contracts that have continued to support the development of Islamic finance, it has not been necessary, in terms of demand from complainants, to consider many of the issues that have come to the fore in conventional markets. It is also probably the case that many of the concerns that have manifested themselves in Western markets have either not been of significance or at least have not been recognised as such in the embryonic markets. Having said this, where issues have arisen they have tended to be addressed through contract or reliance on the assumption that believers will act in good faith and in accordance with the high standards of Islam. Consequently, we have only recently seen the start of interest in what the *Sharī`ah* may have to say on such matters as conflicts of interest in financial institutions, insider dealing, money laundering and, in particular, the potentially risky position of *Sharī`ah* scholars when advising financial institutions. It is desirable that those who are willing to consider these issues, which may well be controversial, should be encouraged by those who wish to see the development of sustainable and sound markets. What is refreshing is the significant increase of interest that is manifest in a number of jurisdictions, such as Saudi Arabia, Malaysia, Indonesia and the Gulf, on issues associated with good governance. On the other hand, this comes at a time when many in the West feel far less comfortable about placing trust in the traditional procedures and systems of governance, in the light of their relative weakness as illustrated during the excesses than led up to the financial crisis.

Associated with these issues is the need to develop understanding as to the vital role of proper risk assessment, management and compliance. The *Sharī`ah* recognises the obligation on those who are in a position akin to stewardship to discharge their responsibilities to monitor and address risks as they arise. On the other hand, there is little evidence of a developed jurisprudence that would support such an obligation in the complex context of the financial markets. The natural reaction of scholars would be to place reliance on the general obligations of good faith reinforced by contractual provisions. Of course, the position in regard to compliance was not too different in many Western countries until a decade or so ago. With the import of specific monitoring obligations and the need to intervene in legal relationships, often sanctioned by other legal responsibilities such as the duty to report suspicious activity, mere reliance on tradition and contract may not be adequate.

## *E. Perceived Problems Relating to Securitisation of Islamic Assets*[113]

The securitisation of assets or future income streams is a well-established process that has operated for some decades. Recent financial innovation has led to the establishment and extensive use of new financial corporations to facilitate the creation, marketing and issuance of debt securities. Furthermore, securitisation schemes have become increasingly sophisticated.[114]

Securitisation has been driven by various considerations. For corporations, these include: cheaper costs for securing funding as compared with that available through banking facilities; reduction in regulatory capital requirements; and risk transfer and diversification of funding sources. For governments, the main motivating factor has been to reduce the average cost of budget financing compared to when conventional government debt securities issues are used.

As debt securities carry obligations to make future payments, they have the potential to render an economy, or sectors of an economy, vulnerable to solvency and liquidity problems, as seen during various periods of financial turmoil. These problems can have adverse effects on the real economy, with implications for financial stability and monetary policy. Hence, debt securities markets clearly need to be monitored and measured.

In the case of securitisation of Islamic assets, concerns over vulnerability and liquidity problems are driven by a widespread perception that, among other issues:

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[113] The author wishes to gratefully acknowledge that sections E. and G. are primarily the work of Mr. Madzlan Mohamad Hussain, partner, Zaid Ibrahim & Co.

[114] See *Handbook on Securities Statistics – Part 1: Debt Securities*, (May 2009) Bank for International Settlements, European Central Bank and International Monetary Fund.

- there is a lack of legal and regulatory frameworks to support the issuance and trading of Islamic securities – in most jurisdictions, the same legal and regulatory framework as are applied to conventional securities are applied to Islamic securities without taking into consideration the specificities of the Islamic securities;
- there is a lack of historical data to reflect on the behaviour and risk profile of Islamic securities as financial instruments – bearing in mind that the Islamic financial services industry itself is less than four decades old and *Sukūk* as an asset securitisation structure has only been introduced in the last two decades;
- due to the geographical concentration of *Sukūk* issuance, there is a lack of marketability and liquidity for such instruments – furthermore, there is a prohibition against selling debt at a discount, which limits the types of *Sukūk* structure that can be traded; and
- the diversity of *Sharī`ah* interpretations among scholars, not only from different schools of thought, but even from the same schools, poses uncertainty and unpredictability as to whether a *Sukūk* is truly *Sharī`ah* compliant, and this inevitably impacts upon their marketability.

Consequently, an understanding of the perceived problems relating to the securitisation of Islamic assets is crucial in determining the infrastructure needed to facilitate the development of the Islamic financial market.

### i. Processes of securitisation

Securitisation is defined as the process of packaging designated pools of assets with or without credit enhancement into securities and the sale of these securities to appropriate investors. It is a transformation of illiquid assets into security that is offered as collateral to a third-party investor. One useful working definition of securitisation is: "the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and thus more liquid than ownership interests in and loans against the underlying assets".[115]

**Participants**

The securitisation process involves a number of participants:

1. *Originator:* The entity whose assets are being securitised.
2. *Issuer:* The most common process involves an issuer acquiring the assets from the originator. The issuer is usually a company that has been specially set up for the purpose of the securitisation and is known as a special-purpose vehicle. The creation of an SPV ensures that the underlying asset pool is held separate from the other assets of the originator. This is done so that in the event that the

[115] J.C. Shenker and A.J. Colletta, "Asset Securitization: Evolution, Current Issues and New Frontiers", 69 *Texas Law Review* (1990/1991) 1369 at 1375.

originator is declared bankrupt or insolvent, the assets that have been transferred to the SPV will not be affected, resulting in “bankruptcy remoteness”.

3. *Trustee:* A trustee is usually appointed to ensure that the issuer fulfils all the requirements of transfer of assets and provides all related services promised earlier. The trustee collects and disburses to investors any cash flows generated by the pooled assets.
4. *Obligor:* Usually the originator, now wearing a different hat; it will service the debt owed to the SPV until maturity of the securities. Upon maturity of the securities it will buy back the assets from the SPV, often at a nominal value as set out under a purchase undertaking.
5. *Credit-enhancer:* A liquidity provider may supply back-up liquidity in the form of liquidity guarantees or enhancement.

**Processes**

The securitisation process involves several stages:

1. *Marking the assets:* The originator will identify and perform an evaluation and valuation of the assets.[116] Usually, the evaluation and valuation will focus on the credit quality of those assets, particularly the likelihood that payments will be made as and when required pursuant to the terms of the documents relating to those assets.
2. *Parking the assets into an SPV:* The assets are then pooled into a portfolio and transferred to an SPV, a tax-exempt company or a trust for the specific purpose of funding the assets. The originator must dispose of the pooled assets to the SPV by “true sale” – that is, a sale that is sufficient under the bankruptcy and insolvency laws to remove the assets from the bankruptcy estate of the originator. This is essential to ensure that the pooled assets are “bankruptcy remote”. Bankruptcy remoteness is important, as it will insulate the investors from the risk of default in the underlying pooled assets. A true sale will shelter the investors from claims made against the originators. A true sale also protects the originators from claims made by the investors. If the pooled assets are made into the SPV, the investor can only claim from the entity, and not from the general revenues of the originator.
3. *Issuance of securities:* The SPV will issue tradable securities or asset-backed securities (ABS) to fund the purchase. Credit rating agencies will rate the securities that are issued, in order to provide an external perspective on the liabilities being created and help the investor make a more informed decision. Because of the structure of the transaction (isolation of the underlying assets, often pursuant to a true sale, and bankruptcy remoteness), the holders of the ABS will be limited to assets and payments thereon; there will be relatively little concern about the financial condition or operations of the originator. The cost of

[116] In conventional securitisation, usually the assets comprise a portfolio of financial assets (i.e. loans). In Islamic securitisation, usually the assets comprise a portfolio of non-financial assets (i.e. real estate, commodities, machinery and/or heavy equipment); albeit a combined portfolio of financial and non-financial assets, according to a ratio permitted by the *Sharī`ah* scholars, may also be securitised.

funding through securitisation will be determined by the interest rate[117] on the ABS. Isolation of the underlying assets for securitisation in the SPV will often allow a company to finance those assets at a higher rating, and lower cost, than would be incurred if the assets were not isolated and if the company sought entity-level funding.

4. *Investment into securities:* Investors purchase the securities, either through a private offering (targeting institutional investors) or on the open market.
5. *Obligations throughout the tenure of the securities:* The trustee, acting on behalf of and in the interest of the securities holders, will monitor the performance of the obligor, dividing up the benefits (and risks) among the investors on a pro-rata basis. If there is a material event that impacts on the servicing of the debt, for example, the trustee will call for a meeting of securities holders.

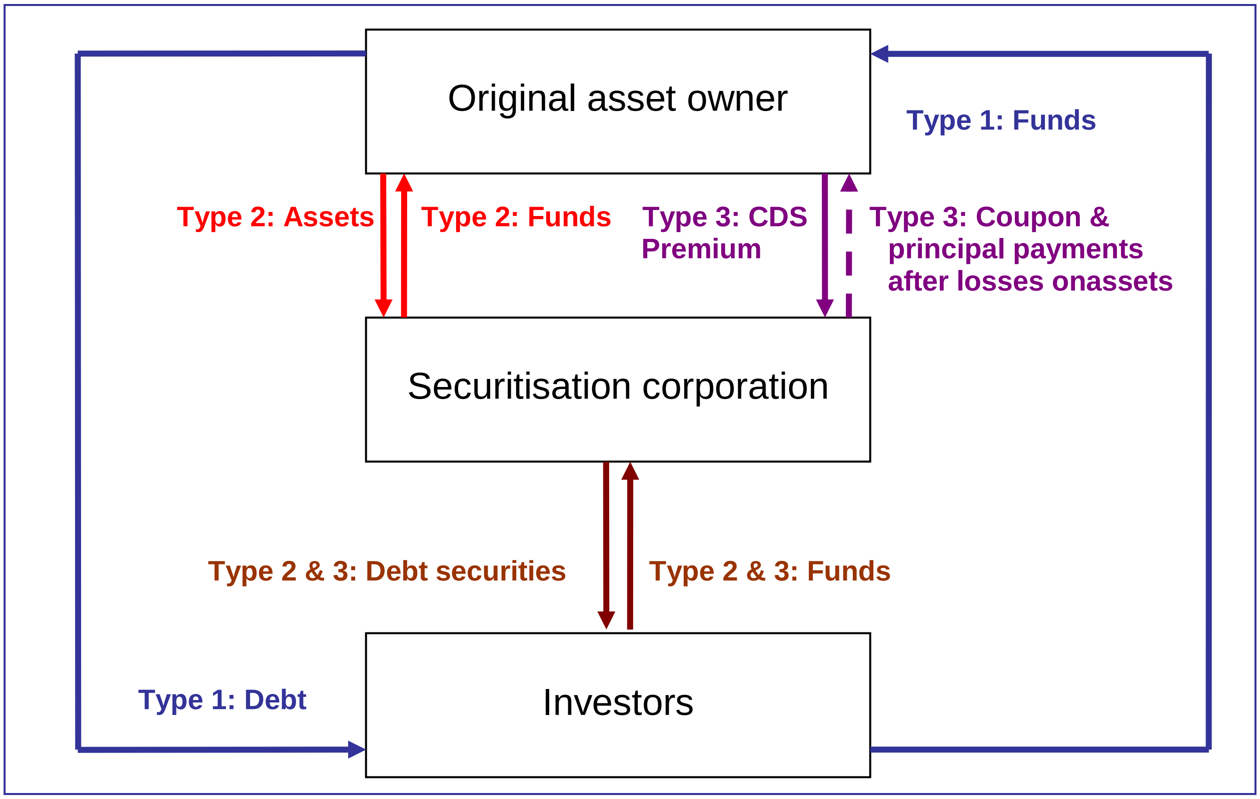
Securitisation schemes vary within and across debt securities markets. They can be grouped into three broad types:[118]

a. those in which the original asset owner creates new debt securities – that is, there is no securitisation corporation and no transfer of assets (Type 1 in Figure 3.1);
b. those involving a securitisation corporation and a transfer of assets from the original asset owner (Type 2 in Figure 3.1); and
c. those involving the transfer of credit risk only, but not the transfer of assets, either through a securitisation corporation or through the direct issuing of debt securities by the original asset owner (Type 3 in Figure 3.1).

[117] Of course, for Islamic securitisation no interest can be charged. Pricing will therefore be negotiated by parties based on the quality of the underlying assets, albeit interest rate benchmarks such as LIBOR can be used as a measure of pricing.

[118] Transactions where the original asset owner converts one type of asset (e.g. loans) on its balance sheet to another type of asset (e.g. debt securities) through the use of a securitisation corporation is not considered as securitisation, but rather as a restructuring of assets. In this case, the original asset owner sells assets to a securitisation corporation, and then the securitisation corporation issues debt securities back to the original asset owner. The original asset owner typically retains these debt securities on its balance sheet, rather than trading them in the secondary market.

**Figure 3.1 Securitisation Process**




The first type of securitisation scheme, usually known as on-balance sheet securitisation, involves debt securities issues backed by an income stream generated by the assets. The assets remain on the balance sheet of the debt securities issuer (the original asset owner), typically as a separate portfolio. The issue of debt securities provides the original asset owner with funds.

The second type of securitisation scheme, typically referred to as true-sale securitisation, involves debt securities issued by a securitisation corporation where the underlying assets have been transferred from the original asset owner's balance sheet. The proceeds received from selling the debt securities to investors fund the purchase of the assets. The income stream from the pool of assets (typically, interest payments and principal repayments on the loans) is used to make the coupon payments and principal repayments on the debt securities.

The third type of securitisation scheme, often referred to as synthetic securitisation, involves transfer of the credit risk related to a pool of assets without transfer of the assets themselves. The original asset owner buys protection against possible default losses on the pool of assets using credit default swaps (CDS).[119] The proceeds from the

[119] A credit default swap is a financial derivative whose primary purpose is to trade credit default risk.

issue of debt securities are placed by a securitisation corporation on deposit, and the interest accrued on the deposit, together with the premium from the CDS, finances coupon payments on the debt securities. If there is a default, the protection buyer (the original asset owner) is compensated by the protection seller for the default losses related to the pool of assets, while the holders of the debt securities suffer losses for the same value.[120]

Synthetic securitisation without a securitisation corporation occurs when the original asset owner issues credit-linked notes (CLN). CLN are debt securities that are backed by reference assets, such as loans and bonds, with an embedded CDS allowing credit risk to be transferred from the issuer to investors. Investors sell credit protection for the pool of assets to the protection buyer (or issuer) by buying the CLN. Repayment of principal and interest on the notes is conditional on the performance of the pool of assets. If no default occurs during the life of the note, the full redemption value of the note is paid to investors at maturity. If a default occurs, then investors receive the redemption value of the note minus the value of the default losses.

### ii. Processes of securitisation of Islamic assets

Obviously, Islamic securities are structured to comply with the *Sharī`ah* rules and principles, which prohibit the charging of interest. There is also a need, as we have seen, to avoid elements of *Gharar* (uncertainty), *Maisir* (gambling) or *Qimar* (betting), and to observe restrictions against activities which are prohibited (*Haram*) under *Sharī`ah*, such as trading of liquor, arms and pornographic materials.

As earlier discussed, the most widely used instruments for securitisation of Islamic assets are *Sukūk* – which serve the functions of a typical conventional bond or fixed-income instrument; and *Tawarruq* – which serve the functions of a typical overnight money market instrument and/or short-term liquidity management instrument.

#### ***Sukūk***

Quite similar to its conventional cousin, the Islamic securitisation process involves several stages and the following parties: [121]

1. *Originator marking the assets to be securitised:* The originator may have acquired or owned various *Sharī`ah*-compliant assets (e.g. real estate, projects, machinery or other heavy equipment). The portfolio of identified assets will be marked for securitisation. A panel of *Sharī`ah* scholars will vet and confirm the

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[120] In practice, the debt securities issued can be split into different credit-rated tranches, enabling holders with different risk profiles to satisfy their investment criteria. The most senior tranche has the first claim on the securities' underlying assets, with the priority of claims decreasing to the most junior tranche. If a default occurs, the coupon payments to holders of debt securities in the junior tranche are the first to be redirected to the original asset owner. However, in recent years, the tranching practice has also come under scrutiny among *Sharī`ah* scholars, as the general rule under *Sharī`ah* is that investors should rank *pari passu* between one another.

[121] See Muhammad Ayub, *Understanding Islamic Finance*, (2007) Wiley Finance, p. 393.

*Sharī`ah*-compliance aspects of the assets. For example, if the portfolio of assets to be securitised comprises financial and non-financial assets, the *Sharī`ah* scholars' approval will be needed to verify that the ratio between the two are within the tolerance or permissible level as prescribed under the *Sharī`ah* parameters.

2. *Parking the assets with SPV/issuer:* An SPV is established to acquire the assets. In most cases, the issuer SPV is a trust-like vehicle with trust attributes, and the beneficiaries of that arrangement are the *Sukūk* investors.
3. *Issuance of the securities:* The SPV issues *Sukūk* certificates to the *Sukūk* investors in order to fund the acquisition of the assets from the originator (thus becoming the "issuer"). Upon the transfer of the assets to the SPV, it now becomes the owner of the assets, and may immediately enter into an agreement with the obligor to create an income stream as payment of the proceeds of issuance of the *Sukūk* certificates. This can be in the form of, among others, a lease agreement (*Ijārah*) whereby the assets are leased back to the obligor throughout the maturity period, and therefore the investors shall receive rental payments; or a participation agreement (under *Muḍārabah* or *Mushārakah*), whereby the investors shall receive dividend payments.
4. *Collateral:* Security may be made available to the issuer SPV to secure payments on, and repayment of, the *Sukūk*.

It should be noted that, notwithstanding the underlying assets, returns paid to the investors may not be associated with the actual performance of those assets, as the securitisation may be done under a "pay-through"[122] or "pass-through"[123] *Sukūk* structure.

The similarities of processes for securitisation between *Sukūk* and conventional asset-backed structures are, to a certain extent, deliberate, as the *Sukūk* is aimed at offering the same benefits for the Islamic economy as are provided by securitisations for conventional Western economies. In addition, *Sukūk* can meet the appetite of *Sharī`ah*-inclined investors to subscribe to instruments that are compliant with the *Sharī`ah* and which rely less on excessive leverage, and this may open up a larger investor base for the *Sukūk* issuer.

It can be argued that *Sukūk* differ from conventional interest-based debt securities in several ways:[124]

[122] A "pay-through" securitisation structure derives its name from the fact that payments to investors are directed through a securitisation corporation that does not strictly pay the investors only when the receivables are collected by it, but keeps paying on the stipulated dates irrespective of the collection dates. See IFSB-6 at p. 5.

[123] A "pass-through" securitisation structure derives its name from the fact the securitisation corporation passes payments to the investors in the same periods, and subject to the same fluctuations, as those applicable in the actual receivables. See IFSB-6 at p. 5.

[124] For a broader discussion of the differences between *Sukūk* and conventional bonds, see, among others, S. Cakir and F. Raei, "*Sukuk* vs Eurobonds: Is there a Difference in Value at Risk?", IMF Working Paper 7/237 (2007) IMF for an economic profile perspective; O.A. Agha and C. Grainger, "*Sukuk*: Default

- The underlying asset has to be *Sharī`ah* compliant.
- The funds raised through the issuance of *Sukūk* should be applied only to permissible (*Halāl*) assets, projects or businesses. (These two aspects would require a panel of *Sharī`ah* scholars to advise and supervise the *Sharī`ah* compliance aspects of the *Sukūk*.)
- The tradability and negotiability of *Sukūk* is dependent on their structure, as the *Sharī`ah* generally prohibits the sale of debt at a discount. For example, *Murābahah* are based on a cost-plus contract and are usually not transferable, since the *Sharī`ah* rules and principles prohibit the sale of debt at a discount. In another example, one of the mechanisms used to trade *Sukūk* at a variable price is when the *Sukūk* relies on a lease (*Ijārah*) structure whereby the rentals can be changed or revised from time to time.
- The credit rating of *Sukūk* that is backed by a guarantee must ensure that the institutional unit providing the guarantee is not related to the issuer. In this case, the *Sukūk* issuer is allowed to apply a third-party guarantee on the capital invested under the principles of *Muḍārabah* or *Mushārakah*.

In many jurisdictions, including some in which *Sukūk* issuance has taken place, there remain various legal obstacles to the setting up of an appropriate type of SPV for securitisation purposes.[125] In particular, in countries applying civil law and the *Sharī`ah* usually:

- the principle of "unity of ownership" is upheld, whereby separation between "legal" and "beneficial" ownership is generally not recognised. This may pose a problem in transferring beneficial title of the assets from originator to the SPV without perfecting the legal transfer under an asset-based *Sukūk* structure; and
- there is no trust law framework, recognising the role of the trustee in holding the beneficial interest over the asset on behalf of, and in the interest of, the *Sukūk* investors.[126]

### *Tawarruq*

"*Tawarruq*" refers to an arrangement that involves a purchase of an asset based on *Musawamah* or *Murābahah* and a subsequent sale of the same asset to a third party in order to gain cash money. The widest use of *Tawarruq* is to allow some IIFS to supply cash to their clients. The client – the *Mutawarriq* – buys X on deferred payment from the IIFS and sells X for a cash amount less than the deferred price to a third party.

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or No Default", *Credit* (January 2010) for a legal perspective; and T. Uthmani, "*Sukuk* and its Contemporary Applications", paper presented at AAOIFI, February 2008, for a *Sharī`ah* perspective; as well as Bill Maurer, "Form versus Substance: AAOIFI Projects and Islamic Fundamentals in the case of *Sukuk*", *Journal of Islamic Accounting and Business Research*, Vol. 1, No. 1 (2010) at pp. 32–41 for an accounting perspective.

[125] Remember that the setting up of an SPV is especially important for risk mitigation and credit enhancement purposes, whereby an SPV for securitisation purposes is designed to be "bankruptcy remote" from the asset originator.

[126] These issues are discussed in more detail in *Islamic Finance: Global Legal Issues and Challenges*, (2008) IFSB.

*Tawarruq* contracts enable the IIFS to guarantee a predetermined percentage rate of return to its term-depositor, buying XX from him or her on deferred payment then selling XX for cash, the deferred payment being larger than the cash price.[127]

Hence, every *Tawarruq* transaction creates a debt. Furthermore, the debt that a *Tawarruq* transaction creates is invariably larger than the cash it transfers to the client – the *Mutawarriq*, in the first case, and to the IIFS in the second case (mediated in both cases by another transaction). The macroeconomic consequences of both are the creation of new debts and the fact that the debt is larger than the cash received. There is also a potential creation of commercial paper resulting from *Tawarruq*.

As it currently stands, both in the conventional and Islamic financial markets, debt documents, like those resulting from *Tawarruq*, are subject to repeat financial and speculative transactions. What makes this contract popular with bankers is that *Tawarruq* is not only easy to use, but is flexible.[128] In an industry that is very short on *Sharī`ah*-compliant products that provide cash "today", the *Tawarruq* contract is seen as a practical device. Second, it is also possible to roll over the contract, thereby providing additional funding. On the other hand, this is also why *Tawarruq* has come under widespread criticism – at their limit, these transactions sever all links with the real assets with which they should have been associated at the start (assuming the cash so acquired results in the production of wealth). This process leads to an inverted pyramid of financial instruments with a small asset base. The process also moves the transaction of *Tawarruq* from that of the asset market to the money (debt) market, where the underlying signalling and equilibrating mechanisms are no longer linked to the real market.

### iii. Types of property (and purposes, including *Haram* bars)

It goes without saying that to preserve the *raison d'être* of an Islamic securitisation, the underlying assets in Islamic securitisation structures must comply with *Sharī`ah* rules and principles. Following the restrictions imposed on selling debt at a discount (*Bay` al-Dayn*), *Sukūk*, in particular, may not be issued on a pool of receivables, especially if those receivables themselves are not *Sharī`ah* compliant (i.e. having any interest or *Riba* element). Furthermore, the underlying business or activity, and the underlying transactional structures (such as the underlying leases), must be *Sharī`ah* compliant. (The business must not engage in prohibited business activities, for example.) This is among the simplest reason why *Tawarruq* focused on commodities – they are relatively easier to source and structure and, most importantly, meet the *Sharī`ah* requirements as permissible assets.

[127] See N. Siddiqi, "The Economics of *Tawarruq:* How its *Mafasid* Overwhelm the *Masalih*", presented at the Workshop on *Tawarruq*: A Methodological Issue in *Sharī`ah*-Compliant Finance, 1 February 2007.
[128] "Analysis: *Tawarruq* declared impermissible by OIC *Fiqh* Academy", IslamicBanker.com, June 2009.

The AAOIFI provides for 14 eligible asset classes for *Sukūk*.[129] In broad summary, these are securitisations:

1. of an existing or to be acquired tangible asset (*Ijārah* (lease));
2. of an existing or to be acquired leasehold estate (*Ijārah*);
3. of presales of service (*Ijārah*);
4. of presales of the production of goods or commodities at a future date (*Salam* (forward sale));
5. to fund construction (*Istisnā`* (construction contract));
6. to fund the acquisition of goods for future sale (*Murābahah* (sale at a mark-up));
7. to fund capital participation in a business of investment activity (*Muḍārabah* or *Mushārakah* (types of joint ventures)); and
8. to fund various asset acquisitions and agency management (*Wakālah* (agency)), agricultural land cultivation, land management and orchard management activities.

Hence, the underlying assets to be securitised generally comprise physical properties – that is, real estate, commodities, machinery or heavy equipment that can generate leasing income. However, *Sharī`ah* scholars have agreed that the underlying assets may also combine a portfolio of assets comprising different categories of contracts, such as *Ijārah* leased assets, *Murābahah* or *Salam* receivables, *Istisnā`* assets, or equity ownership (*Mushārakah* or *Muḍārabah*). While sales-based *Sukūk* securitisation structures, such as *Murābahah* and *Salam*, are not negotiable, the latter may be combined in a pool with other negotiable contracts, such as *Ijārah,* in order to design a negotiable *Sukūk*, provided that the proportion of other tradable contracts is not less than a certain acceptable ratio.[130] Business ventures organised as *Mushārakah* or *Muḍārabah* partnerships may also be securitised, resulting in *Sukūk* that are negotiable. If the originator wishes to securitise assets which are non-compliant with the *Sharī`ah*, they must first be converted into *Sharī`ah*-compliant assets. In practice, this often applies in particular to financial assets, which can be re-financed with *Sharī`ah*-compliant financing facilities first, before it is pooled with the assets that will be securitised.

### iv. Direct and indirect limitations

Arguably, the prohibition against *Bay` al-Dayn* has naturally limited the potential for the creation of pyramids of debts, such as through the use of derivative products, and the prohibition against "selling what one does not own" has indirectly forbidden IIFS from participating in short-selling activities. These factors have been acknowledged as significant reasons why the Islamic financial services industry was largely shielded from

[129] See SS-17. For underlying assets under Commodity *Murābahah* or *Tawarruq*, see the requirements under SS-30.

[130] Note that there have been criticisms that the end result following such compromise is that all debt obligations are now "sellable"; hence, some scholars have called for a more effective check on such practices.

undue to exposure to "toxic assets" such as those arising from collateralised debt obligations (CDO) and credit default swaps during the recent financial crisis.[131] Despite the eagerness of some institutions to engineer and design "*Sharī`ah*-compliant" forms of CDO and CDS, such products did not receive much response due to the reservations of *Sharī`ah* scholars in the market about endorsing such products. In order to properly understand and appreciate the advantage and limitations of the securitisation structures used for Islamic assets, we need to have an overview of how those structures are applied.

***Sukūk***

***Debt-financing contracts***

***Sukūk al-Ijārah***

*Sukūk al-Ijārah* is the most widely recognised *Sukūk* structure compliant with the *Sharī`ah*.[132] This structure, introduced only in 2001,[133] adapts the basic asset-backed conventional securitisation, by requiring that the underlying asset is a physical asset (usually real estates) and not a financial asset. The original idea behind the structure is to transfer ownership of physical assets – and consequently all risks and rewards of ownership in those assets – from the originator to the SPV (representing investors), which will subsequently justify the returns earned from renting out such physical assets throughout the tenure of the *Sukūk*. Combined with the notions of "true sale" and "bankruptcy remoteness" as associated with a typical asset-backed securitisation, then, *Sukūk al-Ijārah* seemed perfectly placed to mark the arrival of a genuine Islamic financial instrument. However, as we have already noted and discuss later on, due to constraints and restrictions under prevalent property laws and regulations, a majority of *Sukūk al-Ijārah* transactions ended up as asset-based[134] rather than asset-backed.[135]

In essence, the ownership of an SPV held by a trustee in a *Sukūk al-Ijārah* transaction indirectly represents the undivided ownership by the *Sukūk* holders of the physical assets that are leased out by the SPV for the purpose of earning rental income.

[131] See the report on *Islamic Finance & Global Financial Stability*, (2010) IFSB, Islamic Research and Training Institute and Islamic Development Bank; as well as M. Čihák and H. Hesse, "Islamic Banks and Financial Stability: An Empirical Analysis", IMF Working Paper 8/16, (2008) and M. Hasan and J. Dridi, "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study", IMF Working Paper 10/201 (2010).

[132] Note that, nevertheless, the scholars in Sudan generally still have not accepted the *Sukūk al-Ijārah* structure as being compliant with *Sharī`ah.* In Sudan, only *Sukūk* using the participatory structures such as *Muḍārabah* or *Mushārakah* are accepted.

[133] The first *Sukūk al-Ijārah* in the world was issued by Guthrie Group of Malaysia in 2001. In fact, it was then that the word "*Sukūk*" was popularised to replace references to "Islamic bonds" or "Islamic debt securities", which were considered a conventional terminology and thus not pristine enough.

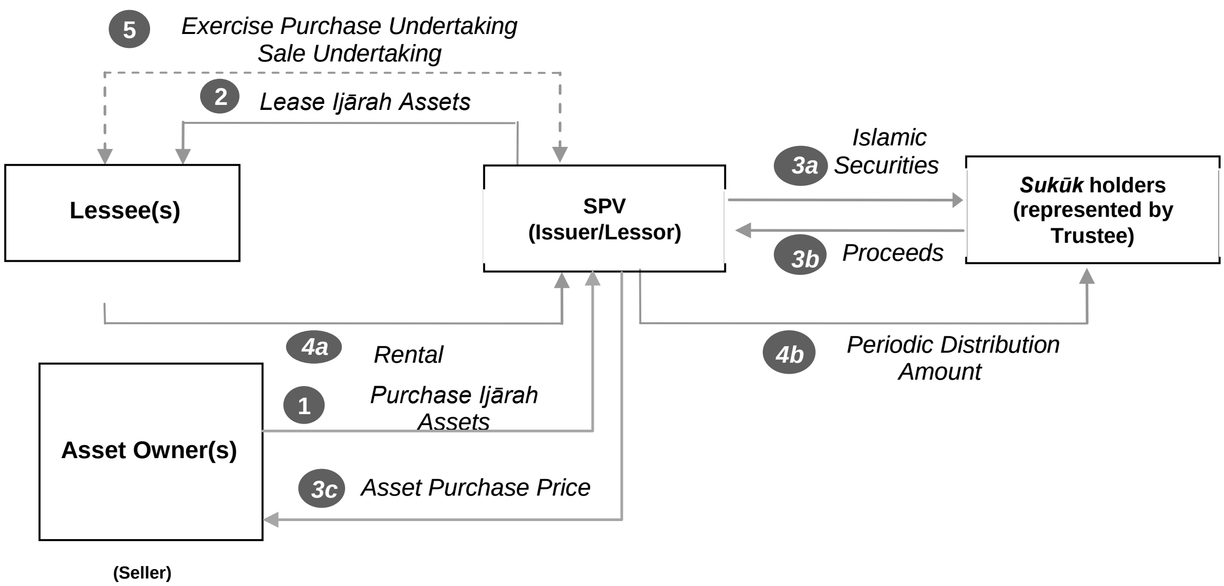
[134] Asset-based structures are found in cases where, given the applicable legal environment, the ownership rights over the underlying asset may not reliably result in an effective right of possession in case of default, and in consequence, the *Sukūk* holders need to have a right of recourse to the originator in case of default. See IFSB-7: "Capital Adequacy Requirements for *Sukūk*, Securitisations and Real Estate Investments", (2009) IFSB.

[135] Asset-backed structures involve ownership rights in the underlying assets (either physical or the usufruct of such assets, excluding all types of receivables or debts except where these form a minority part of a pool of assets), whereas in conventional asset-backed structures the asset backing takes the form of collateral rights, not ownership rights. See IFSB-7.

Consequently, each *Sukūk* holder shares in the rental income on a *pro-rata* basis, thus earning returns on their investments. Therefore, each trust certificate – that is, the *Sukūk al-Ijārah* – represents *pro-rata* ownership of physical assets as against a *pro-rata* share in a financial claim or debt (as usually is the case in a *Sukūk al-Murābahah*). While debt can only be transferred at par – bearing in mind the restrictions under *Bay` al-Dayn* – ownership in physical assets can always be transferred at a mutually negotiated price.

This mechanism is unique in that the investors, as owners of the assets, are arguably exposed to risks associated with ownership of assets and also to default risks associated with rental payments. This again justifies the legitimacy of earning returns on their investment from the *Sharī`ah* perspective, as it is not a purely "lending" activity.[136] Figure 3.2 illustrates the typical features of *Sukūk al- Ijārah* structure.

**Figure 3.2 Typical *Sukūk al-Ijārah* Structure**




[136] At times, a third party is willing to bear or share in such risks, as is the case with *Sukūk al-Ijārah* issued by the Bahrain Monetary Agency. Such a credit enhancement feature further enables *Sukūk al-Ijārah* to spur the creation of a more vibrant secondary market.

| | |
|---|---|
| ***Step 1*** | The Issuer, on behalf of the *Sukūk* holders, shall from time to time purchase certain *Sharī`ah*-compliant leasable assets ("*Ijārah* Assets") from the originator ("Asset Owner(s)") (in such capacity, the "Seller"), pursuant to the Asset Purchase Agreement. |
| ***Step 2*** | The Issuer (on behalf of the *Sukūk* holders) (in its capacity as the "Lessor") shall then, from time to time, lease the *Ijārah* Assets to the orginator (in such capacity, the "Lessee") for a predetermined rental amount ("Rental") and tenure pursuant to the *Ijārah* Agreement. |
| ***Step 3a–3c*** | The Issuer shall declare a trust ("Trust") over, among others, the *Ijārah* Assets, its present and future rights and interest in the *Ijārah* Agreement, the Purchase Undertaking, the Sale Undertaking and the proceeds of the foregoing and other transaction documents (collectively the "*Ijārah* Trust Assets") in favour of the *Sukūk* holders, and shall issue the Islamic Securities to the *Sukūk* holders to represent the *Sukūk* holders' undivided beneficial ownership in the *Ijārah* Trust Assets. The Islamic Securities proceeds shall be utilised by the Issuer to pay the Asset Purchase Price under the relevant Asset Purchase Agreement. |
| ***Step 4a–4b*** | Upon receipt by the Lessor from the Lessee of Rental on the relevant rental payment dates, which would coincide with the Periodic Distribution Dates, the Issuer will use such amounts to make payments of the distributions due under the Islamic Securities (i.e. Periodic Distribution Amount) to the *Sukūk* holders. |
| ***Step 5*** | Pursuant to the Purchase Undertaking, the originator (now as "Obligor") shall purchase the *Ijārah* Assets from the Issuer, on the earlier of: (i) upon the Scheduled Dissolution Date; or (ii) upon declaration of a Dissolution Event (save for a Dissolution Event due to a Total Loss Event) at the relevant Exercise Price and the Islamic Securities held by the *Sukūk* holders shall be cancelled.<br><br>Pursuant to the Sale Undertaking, the originator shall have the right to require the Islamic Securities to be redeemed early on certain dates and accordingly the Issuer shall sell the *Ijārah* Assets to the originator, at the relevant Exercise Price on the Early Redemption Date, if the originator has provided an exercise notice in this respect, and such Islamic Securities held by the *Sukūk* holders shall be cancelled. |

### *Sukūk al-Istisnā`*[137]

*Sukūk al-Istisnā`* has been defined by the AAOIFI as "certificates of equal value issued with the aim of mobilising funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders".[138] As we have seen, *Istisnā`* refers to a construction or manufacturing sales contract for specific assets or

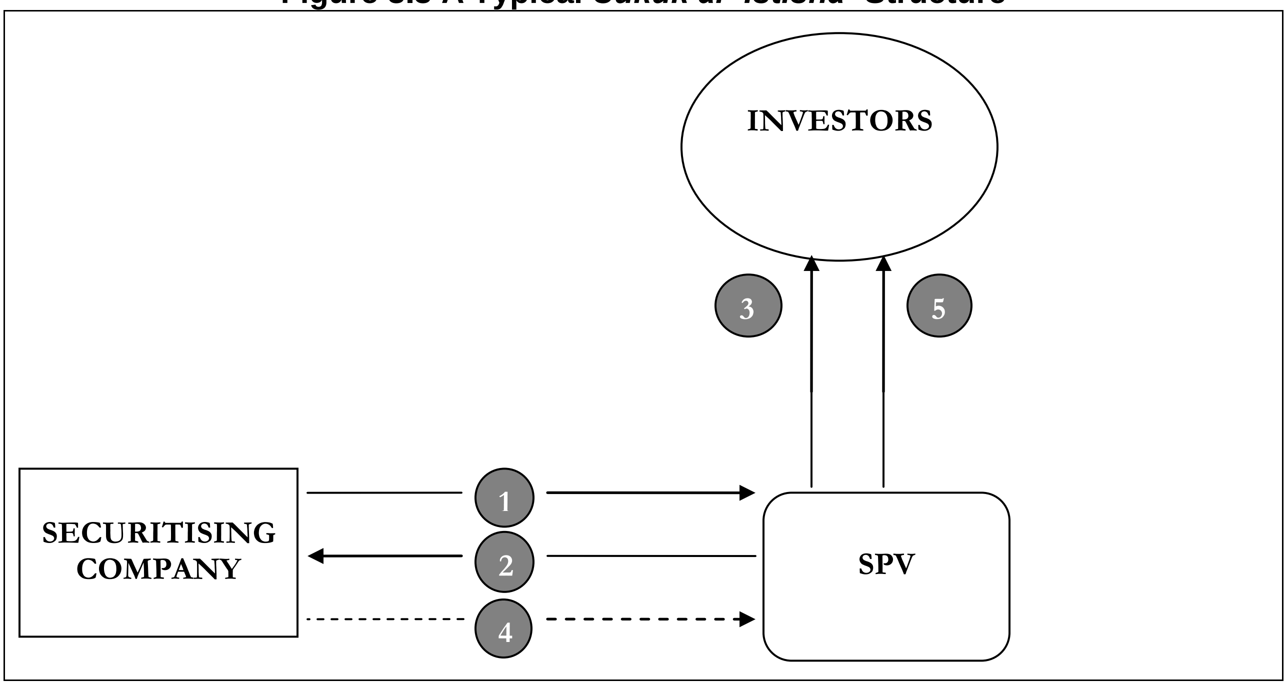
[137] See S. Mokhtar and A. Thomas, "Debt-based *Sukuk*: *Murabahah*, *Istisna`* and *Istithmar (Tawarruq) Sukuk*", in *Sukuk*, (2009) Sweet & Maxwell Asia, p. 137.
[138] See also SS-17.

goods as yet unmade. As such, this *Sukūk* structure has been used almost uniquely to finance large-scale construction or manufacturing projects.

The concept is originally derived from the rules of *Bay` al-Salam* in order to create flexibility for the steps required to make something. In this process, the buyer will place a construction or manufacturing order with the seller/builder/manufacturer for assets or goods that will be delivered in the future. The *Istisnā`* contract provides the terms and conditions, including specifications, price, expected delivery and other pertinent conditions.

The structure of *Sukūk al-Istisnā`* also involves the application of *Bay` al-`Inah*.[139] Figure 3.3 elaborates the structure of *Sukūk al-Istisnā`*. Instead of transacting with two parties (the end-user and the contractor) the structure would involve selling and buying back between the obligor and the SPV.

**Figure 3.3 A Typical *Sukūk al- Istisnā`* Structure**



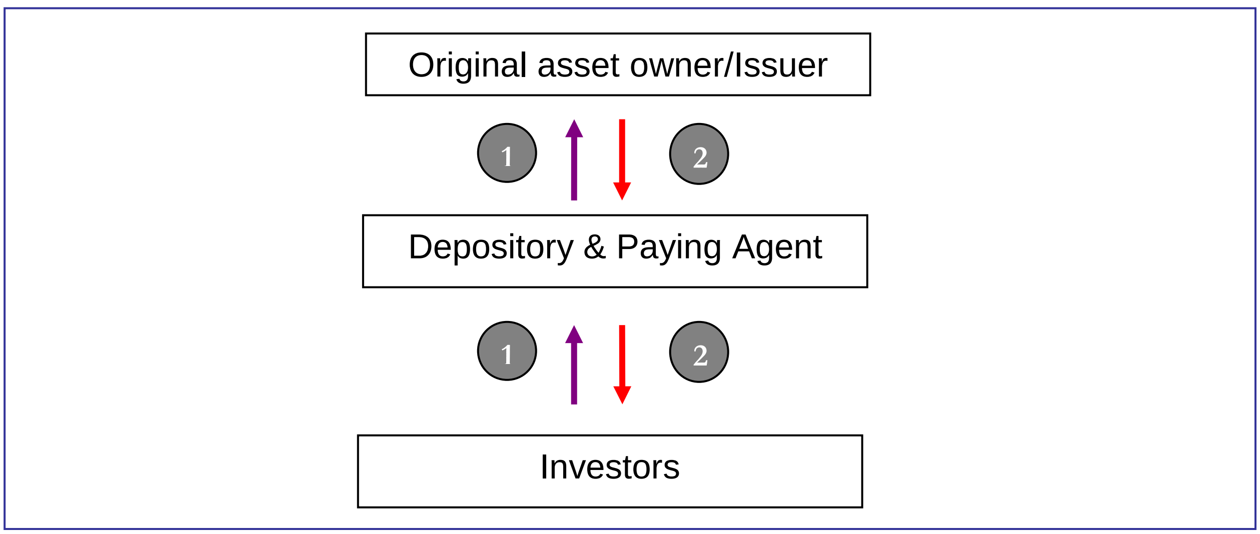

[139] *Bay` al-`Inah* is a form of sale and purchase contract that is considered as a legal trickery (*Hila*) and a back-door to *Riba* by a majority of scholars. However, a small minority of scholars under the Shafi'i school permits it on the basis that it complies with the general conditions for a sale and purchase agreement. Even if the intent of the parties is to circumvent the prohibition against *Riba* by disguising it as a *Bay`*¸ it is to be taken at face value. See further discussion in E.R.A.E. Ali, "Islamic Law Compliance Issues in Sale-based Financing Structures as Practiced in Malaysia", [2003] 3 MLJ lxix–lxxi.

| | |
|---|---|
| ***Step 1*** | The company enters into the first *Istisnā`***:** ordering the issuer or SPV to construct an asset (i.e. SPV is selling the asset to be constructed). Payment of the selling price is deferred. |
| ***Step 2*** | SPV in turn enters into the second *Istisnā`***:** ordering the company to construct the asset (i.e SPV is now buying from the company). The purchase price is the cost to SPV and payment will be made in stages. |
| ***Step 3*** | SPV issues *Sukūk* to raise funds from investors to meet progress payments. |
| ***Step 4*** | Company makes periodic payment of the sale price. |
| ***Step 5*** | SPV distributes payments to investors. |

***Sukūk al-Murābahah* or *Bay` Bithamin Ajil***

The *Sukūk* structure used when IIFS first attempted to invent a financial instrument that serves as a *Sharī`ah*-compliant equivalent of a conventional bond is *Sukūk al-Murābahah*.[140] The structure is primarily trade-based, which means it involves sale and purchase transactions of goods and services. Typically, *Sukūk* under a *Murābahah* or *Bay` Bithamin Ajil* structure results in the transfer of ownership of a physical asset (or a portfolio of several such assets) to the buyer. Figure 3.4 illustrates the typical features of *Sukūk al-Murābahah or al-Bay` Bithamin Ajil.* In practice, the underlying assets that have been used for *Sukūk al-Murābahah* include public infrastructure projects, toll concession agreements, etc.[141]

**Figure 3.4 A Typical *Sukūk al-Murābahah or Bay` Bithamin Ajil***




[140] This is marked by the issuance of *Bay` Bithamin Ajil* by Shell MDS Trading Sdn Bhd in Malaysia in 1990.

[141] In Malaysia, the financing of public infrastructure such as the Light Railway Transit (LRT) systems and the Kuala Lumpur International Airport has benefited from such *Sukūk* structures.

| | |
|---|---|
| ***Step 1*** | The Investors (primary subscribers) purchase, at cash price payable through a depository and paying agent (usually the central bank), certain *Sharī`ah*-compliant assets ("*Murābahah* or *Bay` Bithamin Ajil* Assets") from the originator ("Asset Owner(s)/Issuer") (in such capacity, the "Seller"), pursuant to the Asset Purchase Agreement. |
| ***Step 2*** | The Issuer shall then immediately buy back the *Murābahah* or *Bay` Bithamin Ajil* Assets from the Investors, at a mark-up or cost-plus price, pursuant to an Asset Sale Agreement. The mark-up or cost-plus price is payable on credit terms throughout the tenure of the *Sukūk al-Murābahah* or *Bay` Bithamin Ajil*. |

*Sukūk al-Murābahah* and *al- Bay` Bithamin Ajil* were well received during the early days of Islamic finance in view of their simplicity. However, in the light of the prohibition against selling debt at a discount under *Bay` al-Dayn*, such assets can therefore only be transferred to the SPV at par. Under strict *Sharī`ah* requirements, the transfer of such *Sukūk*, at best, could be done only in the nature of a transfer of debt (*Hawalah-al-Dayn*) and not a sale or *Bay`.* In other words, since each security under the *Sukūk* structure now represents evidence of debt (*Shahadah al-Dayn*), it can only be transferred at par. Therefore, a secondary market in such Islamic debt securities is almost completely ruled out. Having said this, in Malaysia the scholars subscribed to a minority view that such trading can be permissible under certain conditions. It is noted, therefore, that in a similar debt-financing *Sukūk* structure, in the form of *Salam* commonly used by the Central Bank of Bahrain, the *Sukūk* will be held until maturity by the investors, instead of being traded. Unfortunately this may defeat the objective of having what should be a liquid instrument. Consequently, *Sukūk al-Salam* has not been issued in Malaysia.

**Equity-financing structures**

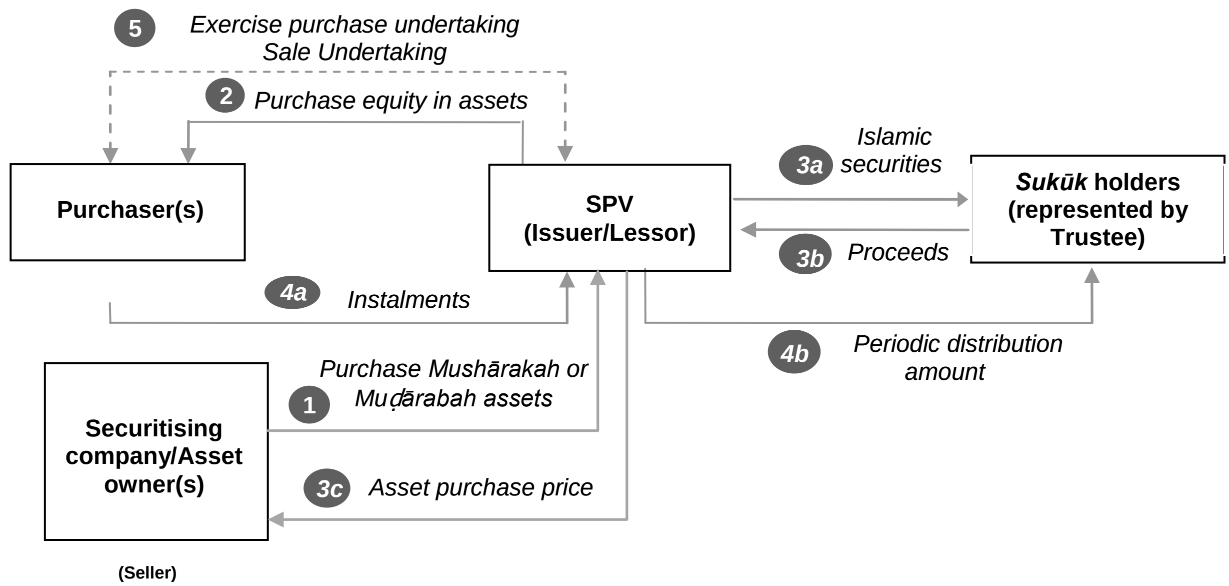
Equity or partnership-based assets account for a very small percentage of the total assets of IIFS for a variety of reasons, but mainly because of information asymmetry and moral hazard problems arising from such ventures. If genuine profit-sharing and loss-bearing arrangements are to be adopted, investors would have to incur higher costs for monitoring the financed party. To this extent, there is a perception that participatory structures *Sukūk* such as under *Muḍārabah* and *Mushārakah* principles are less efficient. Naturally, IIFS consider debt-financing *Sukūk* structures as the preferred choice.

***Sukūk al-Muḍārabah* and *al-Mushārakah***

This *Sukūk* structure is designed as a variation of the *Murābahah*-based or *Bay` Bithamin Ajil*-based securitisation—it still involves a process of sale and buy-back, but not of the assets directly, but rather equity or shares in those assets. At the first layer, the assets are sold by the originator to an SPV organised as a *Muḍārabah* or *Mushārakah,* and at the second layer, those assets then are bought back by the originator, at a premium on a deferred payment basis. The higher deferred income is then passed on to the investors as returns on investments on a pro rata basis (in proportion to their stake in the *Mushārakah* i.e. the SPV).

Where the SPV is a *Mushārakah* company of investors, the *Mushārakah* securities would represent part ownership of this pool of assets. The flow of the structure is illustrated in Figure 3.5.

**Figure 3.5 A Typical *Sukūk al-Mushārakah or Muḍārabah* Structure**




| | |
|---|---|
| ***Step 1*** | Securitising company identifies and pools physical assets, and sells them to SPV (*Mushārakah* or *Muḍārabah)* on a cash basis. |
| ***Step 2*** | Securitising company agrees to progressively buy back from the SPV equity in the *Mushārakah* or *Muḍārabah* assets on deferred payment basis. |
| ***Step 3a–3c*** | SPV collects funds from investors, issues securities to investors against the *Mushārakah* or *Muḍārabah* asset, and pays to the securitising company in cash the sale price of assets. |
| ***Step 4a–4b*** | SPV receives payments by company in future and passes on payments by company to investors after deducting *Mudārib* share or *Wakālah* fee. |
| ***Step 5*** | Pursuant to the purchase undertaking, the securitising company (as “Obligor”) shall purchase the *Mushārakah* or *Muḍārabah* assets from the SPV, on the earlier of: (i) upon the scheduled dissolution date; or (ii) upon declaration of a dissolution event (save for a dissolution event due to a total loss event) at the relevant exercise price and the Islamic securities held by the *Sukūk* holders shall be cancelled. |

### ***Tawarruq***[142]

The IFSB has explained that the use of *Tawarruq* contracts can be categorised into several main areas,[143] including:

1. interbank market (more-or-less informal) and central bank involvement;
2. extending financing based on *Murābahah* where the counterparty immediately sells the commodities; and
3. receiving funding from a counterparty in the form of liabilities.

However, while operating in the commodities sector, IIFS are exposed to the full spectrum of prudential risks arising from significant and concentrated exposure. This may, in turn, expose them to substantial counterparty credit risk and have a significant influence on liquidity and prices in the specific segments of the commodities market in which they are investing. It has been observed that, as a financial instrument, *Tawarruq* (also popularly referred to as "commodity *Murābahah* transactions", or CMT) was mainly developed for the purpose of *Sharī`ah*-compliant interbank transactions, whereby IIFS having an excess of liquid funds may invest such funds with other such institutions having a deficit of such funds (or vice versa). However, the expansion of its use into other areas, such as deposit taking and raising funds, has raised a number of issues for IIFS and their supervisory authorities. It is noted that some central banks/supervisory authorities have served as facilitators of *Tawarruq*/CMT for specific purposes, such as by providing a platform (i.e. liquidity management infrastructure) for effective management of liquidity positions in the Islamic financial system, and by using *Tawarruq*/CMT in central bank operations with IIFS, such as those undertaken as a *Sharī`ah*-compliant lender of last resort (SLOLR).

As we have already noted, *Tawarruq* has also taken the form of a regulated commodity trading platform through *Bursa Suq al-Sila* in Malaysia.

### Controversy surrounding *Tawarruq*

The legality and permissibility of *Tawarruq* from the *Sharī`ah* perspective have been widely debated in recent years, with some influential *Sharī`ah* scholars openly questioning the views of bodies such as AAOIFI and the OIC *Fiqh* Academy on this issue. Such debate is unlikely to be resolved in the short term. The key arguments have centred on the notion that *Tawarruq* in the context of its classical application is permissible, but in the context of its contemporary application is prohibited.[144] Scholars

[142] See also S. Nagaoka, "Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on *Murābahah* Contracts and Islamic Debt Securities", *Kyoto Bulletin of Islamic Area Studies*, 1–2 (2007), pp. 72–91; and M. Kafh, "Outlines of a Brief Framework of *Tawarruq* (Cash Procurement) and Securitization in *Shariah* and Islamic Banking", paper at an AAOIFI Seminar in Bahrain, 15 February 2004.

[143] See GN-2: "Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity *Murābahah* Transactions", IFSB (2010).

[144] For a more detailed discussion on the criticisms against *Tawarruq,* see, among others, Dr S.H. Khan, "Why *Tawarruq* Needs To Go – AAOIFI and the OIC *Fiqh* Academy: Divergence or Agreement?", *Islamic Finance News*, (2009) Vol. 6, Issue 35, IIBF London, October 2010; Dr A.R.Y. Ahmad, "*Tawarruq*: Its Concepts, Its Practices and Its Economics Implications on its Promotion by Islamic Banks"; I.F. al-Dabu,

who criticise *Tawarruq* have mainly condemned its similarities to *Bay` al-`Inah* and the fact that all the parties involved in the structure (including the third-party agents) are prearranged and known to the first seller – that is, the customer.[145] They also highlight the likelihood that the structure will encourage the creation of a pyramid of debts, as the same set of commodities will be traded repeatedly, time and again, without creating any true productive value in the real economy. In the broader picture, when offered on a large scale to the extent that the bank's main portfolio of business comes from this activity, the organised *Tawarruq* is considered to facilitate a debt-funded lifestyle which contravenes the five objectives (*Maqāsid)* of *Sharī`ah* as promulgated by Imam Al-Ghazali and Shatibi.[146] Notwithstanding these and other criticisms by a majority of scholars, some of whom go as far as to pronounce it as non-compliant with the *Sharī`ah*, *Tawarruq* is still being used as a key instrument for liquidity management of IIFS, for the simple and pragmatic reason that some other scholars still consider it as *Sharī`ah* compliant and there is no other instrument, at the moment, that can serve the liquidity management needs of IIFS. It is noteworthy that it is only in Malaysia that some form of interbank Islamic money market has been created.

To this extent, scholars who are in support of *Tawarruq* point out that there is an urgent and imminent need (*Dharurah*) to compromise and to allow IIFS to continue using *Tawarruq,* as the implications of prohibiting it may cause a shock wave for the industry, considering that the value of *Tawarruq* transactions has reached trillions of dollars, while at the same time there is no equally simple and effective product structure that can replace its role.[147]

### v. Title and transfer of title

It should be noted that, as aforementioned, IFSB-7 distinguishes three types of *Sukūk* structures: an asset-backed structure; and two asset-based structures ("pay-through" and "pass-through" structures). In asset-backed *Sukūk,* the *Sukūk* holders will bear any losses due to impairment of the assets. In other words, in asset-backed *Sukūk*, the *Sukūk* holders have direct recourse to the asset and not the originator. On the other hand, under the two types of asset-based *Sukūk*, the pay-through *Sukūk* utilises a purchase undertaking from the originator, while the pass-through *Sukūk* has a guarantee from the issuer in case the originator defaults on its obligations. It follows that asset-based *Sukūk* imply that the *Sukūk* holders have recourse to either the originator (via the purchase undertaking) or the issuer (via the guarantee). Hence, it can be

"*Tawarruq*: Its Reality and Types", W. al-Zuhaili, "*Tawarruq*: Its Essence, and Its Types – Mainstream *Tawarruq* and Organised *Tawarruq*", N. Siddiqi, op cit. All these papers were presented at the 19th OIC *Fiqh* Academy meeting during their deliberation on *Tawarruq* held in Sharjah, UAE on 26-30 April 2009.

[145] It is considered important for the parties involved in the transaction to be unarranged or be unknown to each other in order to negate the suspicion of the *Tawarruq* transaction being entered into simply as a legal trickery in order to legitimise a payment of usury.

[146] *Maqāsid as-Sharī`ah;* these are the protection and preservation of one's faith, life, intellect, posterity and wealth.

[147] It is noted that a mechanism of interbank liquidity arrangement based on *Wakālah* has been developed in recent years, but has not gained much momentum in reducing IIFS's reliance on *Tawarruq.*

observed that asset-backed *Sukūk* involve full transfer of legal ownership of the underlying asset, while asset-based *Sukūk* involve recourse to the originator or the issuer (but not the asset).

Based on the data retrieved from Islamic Finance Information Service's *Sukūk* database, as of 5 August 2009 there have been only 11 deals that are considered to be asset-backed *Sukūk*. Out of these *Sukūk* issuances, seven were issued in Malaysia, while the remaining four are global issuances.[148] This indicates the dominance of asset-based structures in the industry in recent times. This has triggered concerns about how these *Sukūk* structures can satisfy the strict *Sharī`ah* requirements regarding ownership and the transfer of ownership, bearing in mind the generally restrictive land laws and the lack of any real economic incentive for securitising parties to actually depart with their prized assets.[149]

**The question of *Qabd* (ownership)**

The issue of the buyer taking possession of the sold goods is known in Islamic jurisprudence as *Qabd*. One of the fundamental conditions of a sale contract is that the *Mahal al-`Aqd*[150] (i.e. the object of the sale) must exist and be owned by the seller at the time of the contract.[151] This is important, because the purpose of a sale contract is to transfer ownership of the object of the sale to the buyer and ownership of the price to the seller. If this condition is not fulfilled, the sale contract is deemed to be an invalid sale (*Bay` Fāsid*). It is more specifically known as *Bay` Ma`dūm* (selling something that does not exist), certain details of which have been a matter of longstanding contention among jurists.

The transfer of merely beneficial ownership of the underlying asset, and the appointment of a trustee to represent the interest of the *Sukūk* holders, indicates that parties to a *Sukūk* have no intention to effectively transfer the possession or control over the *Sukūk* asset. The same may be argued with regard to the IIFS and its buyer of a commodity in the case of *Tawarruq Munazzam* arrangements, as the customer has no intention of taking possession of the underlying goods.

The lack of good faith or *bona fides* in the intent as well as action surrounding such purchases certainly raises doubts about the sanctity and integrity of contracts entered into by IIFS. In Malaysia, when disputes arising from Islamic financial contracts were tried before the court, several of the judges questioned this lack of good faith by the

[148] See A.W. Dusuki and S. Mokhtar, "Critical Appraisal of *Sharī`ah* Issues on Ownership in Asset-Based *Sukūk* as Implemented in the Islamic Debt Market", ISRA Research Paper No. 8/2010.
[149] Note that while the concept of "temporary separation of ownership" may be usual for any conventional asset-backed securitisation, such a notion is alien to the *Sharī`ah* and therefore any "separation of ownership" under *Uqūd al-Mu'awadat* has to be absolute and permanent, especially to remove any *Gharar* (uncertainty) in the contract.
[150] Also known as the *Ma'qūd 'Alaih* in Arabic.
[151] A.W. Dusuki and S. Mokhtar, op cit at p. 12.

banks as reflected in their documentation and operational processes.[152] The judges highlighted that, in an Islamic financing facility using contracts of exchange (*Uqud al Mmu'awadat*) mechanisms such as *Murābahah* and *Bay` Bithamin Ajil*, a *bona fide* sale and purchase is necessary to ensure that the profit is not an element not approved by the *Sharī`ah*. Excessive profiteering may also raise doubts about the *bona fide* intent of the bank, as the court was of the view that the interpretation of the selling price must not impose a heavier burden than in a loan with interest. Otherwise, the profit element will be contrary to the intent and purpose of removing hardship from the party incurring the liabilities. In short, if the sale under a *Murābahah* or *Bay` Bithamin Ajil* facility is not *bona fide*, the deferred payment of the sale price is effectively credit or a loan extended, and any profit would be prohibited as *Riba*. Furthermore, since the sale under a *Murābahah* or *Bay` Bithamin Ajil* facility is not a sale *simpliciter,* the bank should not be entitled to demand the payment of the full sale price unless it performs its part of the bargain – that is, permitting the customer to enjoy the full tenure of the facility notwithstanding any delay in payments.

In the case of *Tawarruq,* the question of *bona fide* intent is raised higher, as sometimes the suitability of the commodities used as an underlying asset is also doubtful. In a normal and genuine commodity trading contract the subject matter must meet all the specifications for good commodities – that is, be goods for and capable of consumption or proper use. In certain cases involving *Tawarruq*, the scholars investigating the warehouse found that the commodities used were spoilt items.[153] Definitely, this kind of transaction would not meet the test of any scholar, not because of the *Tawarruq* contract but because of its failure to meet the necessary requirement of a valid subject matter of the trading contract.

Another great concern in the practice of *Tawarruq* relates to delivery of the subject matter. In principle, all sale contracts must result in delivery of the subject matter from the seller to the buyer. Therefore, any clause that indicates that there is no intention by the buyer to take delivery would render the contract invalid, simply because the buyer is, by default, the owner of the commodity and as such is entitled for delivery. He is free to do what he wants with the commodity, for his own use or to sell to someone else. Therefore, if he asks for delivery, the commodity shall be ready for delivery. If he sells the commodity to someone else, then it shall be delivered to that person. In some *Tawarruq* transactions, the ability of delivery has been a subject of doubt. The seller was not prepared to deliver, even if the buyer asked for it. Again, this indicates the lack of *bona fide* intent of the parties.

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[152] See, for example, the judgments of Wahab Patail J in the case of *Taman Ihsan Jaya Sdn Bhd*, op cit*;* Hamid Sultan J in *Majlis Amanah Rakyat (MARA) v Bass bin Lai* [2009] 2 CLJ 433; and Rohana Yusuf J in *Bank Islam Malaysia Bhd v Azhar bin Osman & 8 Ors* [2010] 5 CLJ 54.

[153] For instance, the eminent scholar Sheikh Ali Qurrah Daghi revealed that he has come across a case whereby the commodity sold was "spoilt" aluminium from Russia that had been in storage for more than ten years. In fact, the broker said that the commodity could not be sold elsewhere.

**Instant sale-repurchase,[154] or *Bay` al-`Inah***

A good businessman most likely would know how to buy an asset from a supplier on deferred payment terms and how to sell it almost instantly for a profit – and for cash. He would then not only make money, but also hold the consideration in his possession before his payment or instalment to the supplier is due. He would have cash as working capital at his disposal. But such would only be the case for a genuine businessman in relation to a genuine business transaction. A shrewd client and a financier could instead arrange a simple two-party understanding, which combines a deferred payment sale with an instantaneous cash resale that effectively produces the same result as a regular interest-bearing loan. In practice, the scenario is quite simple: the client buys a commodity from the financier on deferred payment terms, and resells that same commodity instantly back to the financier on cash terms. The result:

- nothing really happens to the commodity (it is still with the financier where it originated); BUT
- the client now holds some cash received from the bank (from the second sale); and
- the financier can now expect to receive deferred payments from the client (from the first sale) together with a margin of profit.

Obviously, the lack of a *bona fide* intent by both parties to exchange ownership of the commodity and, thus, bear the risks associated with it indicates that the parties are only interested in legitimising the creation of a usurious debt. In *Fiqh al-Muamalat*, such a transaction is called "*Bay` al-`Inah*" and is prohibited by the majority of scholars in all schools of thought. In principle, *Tawarruq* is a small departure from *Bay` al-`Inah* in that, although the whole transaction is similarly instantaneous, an independent third party intervenes as another layer in the flow of sale and purchase of the commodity, thus justifying the sale as *bona fide*.

Another variation in such a transaction is the custody sale/trust sale, or *Bay` al-Wafa* (sometimes also called "*Bay` al-Uhda*"). Here, the client will sell the asset to the financier in return for a cash settlement of the price. Just as above, the latter acquires the ownership rights, but the difference is in the fact that the financier does not acquire the right to alienate/sell the asset further down the line. In that sense, it is not a perfect and complete sale, because that important right stays with the client.

The instantaneous exchanges through which *Tawarruq Munazzam*, *Sukūk al-Murābahah* and *Bay` Bithamin Ajil* take place are one of the main reasons why their compliance with the *Sharī`ah* has been debated. This is especially in view of the wider rejection of *Bay` al-`Inah,* even in the classical context. However, until new solutions that can overcome these issues are reached, the industry does not in practice have much choice but to continue with the devices at its disposal. It should be noted that, only after a decade of using *Sukūk al-Murābahah* and *Bay` Bithamin Ajil* (which the

[154] See P. Wouters, "The Use of Contract of Sale in Islamic Finance: The General Concepts", *Law Gazette*, No. 9 (2009).

market was fully aware may have limited tradability under the constraint of *Bay` al-Dayn*), financial engineers in Malaysia managed to develop new *Sukūk* structures that are tradable, using principles such as *Ijārah*, *Muḍārabah* and *al-Mushārakah*. The reality is that, since the Islamic financial services industry is still nascent and relatively small, it will take more time for it to develop and fulfil its true potential.

### vi. Multiple and derivative interests (including trust-related issues)

The lack of a legal and regulatory infrastructure for securitisation of Islamic assets in most jurisdictions poses several challenges in terms of preserving the integrity of such structures.

***Sukūk***

***Questions regarding the SPV's ownership of the underlying asset***

As has been empirically studied, most Islamic securitisation deals are done on an asset-based, rather than an asset-backed basis. Consequently, whether a *Sukūk* is under an *Ijārah* structure, whereby ownership of the underlying asset is transferred to the SPV (on behalf of the investors) based on the concept of a lease, or is under an *Istisnā`*, *Salam*, *Murābahah*, *Muḍārabah* or *Mushārakah* structure, whereby ownership of the underlying asset is transferred to the SPV (on behalf of the investors) based on the concept of a sale, there will often be a transfer of only the beneficial ownership from the originator to the SPV and/or investors. Very rarely will the "true sale" requirement of the *Sharī`ah*, whereby there is a perfection of legal transfer of ownership of such assets, be fulfilled.

In a common law jurisdiction where the separation between beneficial and legal ownership, and the holding of properties by a trustee in favour of beneficiaries (under trust laws), are well recognised, *Sukūk* holders will be deemed to be joint beneficial owners of the asset under the SPV's control. They will be exposed to both the ownership risk of the asset as well as the credit risk of the securitising company (which plays the role of lessor under *Sukūk al-Ijārah* or of purchaser on credit terms in most other *Sukūk* structures). Any profit or loss derived from the joint ownership of the underlying asset will be distributed or borne by each *Sukūk* holder in proportion to their contributions of capital to the relevant asset. The risk of loss is mitigated through an undertaking to purchase by the securitising company given to the trustee (on behalf of the *Sukūk* holders), pursuant to which the securitising company shall purchase the *Sukūk* holders' interests in the asset upon the declaration of any dissolution event under the *Sukūk* legal documents.

However, as discussed earlier, in a jurisdiction applying purely the civil law, unmitigated by specific legislation, or the *Sharī`ah* law system whereby there is no trust law framework and no recognition of separation between legal and beneficial ownership, the rights of *Sukūk* holders over the asset would certainly come into question.

Without due registration of title and/or a caveat to prove the rights of the *Sukūk* holders over the underlying assets, as it is only covered under trust, there is a possibility that a multiple set of investors, unknown to one another, will have to contest the right to have claim over the same assets. There will be a need for the trustee, on behalf of the *Sukūk* holders, to monitor consistently the usage and/or control over these *Sukūk* assets in order to avoid a situation arising whereby the assets are already claimed by others without the trustee being aware of it. Consequently, this may incur heavy monitoring costs on the part of the trustee and result in greater costs. It is possible that the transfer of real property will in fact be explicitly prohibited or restricted by the sort of law to which we have already referred. Hence, the *Sukūk* holders need to ensure that the securitising company agrees to indemnify the SPV and *Sukūk* holders against failure to effectively transfer ownership of the assets to them.

***The Sukūk could be limited-recourse obligations***

Asset-backed *Sukūk* are not debt obligations of the SPV. Instead, they represent a beneficial interest solely in the asset. Recourse to the SPV in respect of the *Sukūk* is limited to the asset, and the proceeds of such assets are the sole source of payments on the *Sukūk*. Upon the declaration of a dissolution event, the sole rights of the trustee (and, through the trustee, the *Sukūk* holders) will be against the securitising company to perform its obligations under the transaction documents. Hence, under an asset-backed structure, the *Sukūk* holders will otherwise have no recourse to the securitising company in respect of any shortfall in the expected amounts due in regard to the asset. In the absence of any wilful misconduct or negligence by the SPV, *Sukūk* holders have no direct recourse to the securitising company and there is no assurance that the net proceeds of a realisation of, or enforcement with respect to, the asset will be sufficient to make all payments due in respect of the *Sukūk*.

On the other hand, in an asset-based *Sukūk* structure, whereby the legal transfer of the assets is not perfected via registration, the securitising company is generally obliged to make certain payments under the transaction documents directly to the issuer SPV, and the trustee will have direct recourse against the securitising company to recover such payments due to the issuer SPV pursuant to the transaction documents. Quite often, the obligations of the issuer SPV in respect of the *Sukūk* are not secured in any way and the *Sukūk* are unsecured instruments, and under no circumstances (including the occurrence of a dissolution event) shall the issuer SPV, the trustee or any *Sukūk* holder have (i) any right to cause the sale or other disposition of any of the assets except pursuant to the transaction documents, or (ii) any other recourse against the asset, except the right to receive distributions derived from the asset in accordance with the *Sukūk* programme. The sole right of the issuer SPV, the trustee and the *Sukūk* holders against the asset and the securitising company shall be to enforce the obligation of the securitising company to perform its obligations under the transaction documents.

***Tawarruq***

As has been explained above, in an organised *Tawarruq* the commodities used to underpin the transaction could be stored in a warehouse somewhere without the seller and the buyer ever coming to investigate its quality, condition and measure. The same set of commodities could be repeatedly used by different parties to a *Tawarruq* transaction without any of the parties realising the existence or having notice of the other. We have already emphasised that the possibility of redundancy in the trading of commodities used in this way is a genuine concern, due to the absence of proper monitoring of the commodities storage. Indeed, it has been reported that some commodity brokers refuse to allow the client to undertake an audit or survey, which tends to give credibility to the belief that the commodities are in practice sold back to the original broker, ready to be traded again. Such suspicions cannot be substantiated without proper investigation, but concealing the matter by refusing an audit is sufficient to raise doubts over the practice of churning. A regulated trading platform such as that operated by Bursa Malaysia as *Bursa Suq al-Sila,* among others, ensures that traders in that market will not be using the same commodities multiple times without each of the transactions being duly completed first.

### vii. Valuation issues

The assets used for any Islamic securitisation have to comply with the requirements of *Sharī`ah* rules and principles. However, in trying to comply with the *Sharī`ah*, which fundamentally restricts the mobilisation of financial assets (receivables) to underpin any securitisation, often the securitising company has to opt for physical assets such as its own headquarters, or assets which are core to its business activities. For example, a petroleum company may use its oil rigs as the underlying asset. It is not uncommon to find that the valuation of the assets is subject to debate and scrutiny, as the physical assets may have a limited market or, for that matter, no realistic market whatsoever. In such circumstances it is difficult to know the appropriate market price or the fair value. For example, the buildings owned by a sovereign government may well never be offered for sale due to restrictions under the law and, thus, be extremely difficult to value in any commercial sense.

The valuation becomes a more crucial issue in a “total loss event”. That is, the asset is totally lost, or destroyed, or the assets become permanently unfit for any economic use and the repair or remedial work in respect thereof is wholly uneconomical. Although it is usual under the transaction documentation that the counterparty (e.g. the lessee under an *Ijārah* agreement) is required, among other things, to insure the asset and/or procure new properties on the date of occurrence of the total loss event, *Sukūk* investors should be aware that:

- rental under the lease (if any) will cease automatically upon the occurrence of a total loss event and, accordingly, the periodic distribution amount received by *Sukūk* holders will reflect this fact; and
- there may be a delay in the trustee receiving the proceeds of insurance or *Takāful* (or shortfall amounts from the securitising company) and therefore in *Sukūk* holders receiving the full dissolution distribution amount in respect of their *Sukūk*, and no additional periodic distribution amount will be paid in respect of this delay.

The securitising company may be required to top up any shortfall in *Takāful*/insurance proceeds in a total loss event, so as to ensure that the lessor receives the amount equivalent to the nominal value of the outstanding *Sukūk* and all profit thereon. However, the lessor would still be exposed to the risk of the securitising company, for whatever reason, not topping up the shortfall. Furthermore, in an asset-backed *Sukūk*, notwithstanding that the *Sukūk* holders may have direct recourse to the asset, the asset may become impaired over time and, thus, suffer from a reduction in value. The difficulty in valuing the assets and replacing the impaired assets with other assets of equal value poses a real market risk to the *Sukūk* investors.

### viii. SPVs and solvency issues

We have noted the important role played by the specially created SPV in *Sharī`ah*-compliant structures. The SPV in Islamic securitisation may take the form of *Muḍārabah* comprising investors with the securitising company as the *Muḍārib.* The *Muḍārib* may legitimately claim its share in the surplus. Alternatively, the securitising company may act as an agent, or *Wakīl*, of all the investors (which are organised as a *Mushārakah* company).

**Functions of special purpose vehicles**[155]
SPVs are formed as separate legal entities for the specified purpose of managing the securities issue. As such, an SPV is supposedly capital- and tax-efficient; it should not add to the cost of the transaction. The SPV's main objective is to act as an administrator for the payments (generated from the revenue for the *Sukūk*) and as a vehicle to acquire the asset on behalf of the investors.

***SPV as issuer***[156]
Certain characteristics are desirable for the issuing entity of the *Sukūk* to optimise the independence of the issuer from the obligor, both for the obligor (in terms of liability and tax status) and for the investors (to ensure the SPV issuer is not involved in any insolvency proceedings against the obligor). To maximise the independence and insolvency remoteness of the issuer from the obligor, in most transactions the issuer of the *Sukūk* will be an SPV. Although it plays a pivotal role in the *Sukūk*, it has no function or powers outside the transaction.

***SPV as a separate legal entity***
The SPV is a separate legal entity from the obligor, both in terms of its ownership and its management. This separation means that the SPV is not treated as a subsidiary of the obligor and therefore its balance sheet is separate from that of the obligor. This is necessary to ensure that its capacity and function is not affected by the insolvency of the obligor. In most cases, the shares in the SPV will be held in trust by persons unrelated to the obligor. In as far as reasonably possible, the directorship of the SPV should be independent of the obligor.

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[155] M. Ayub, *Understanding Islamic Finance*, (2007) Wiley Finance, p. 394.
[156] R. Ali, "Legal Certainty for *Sukuk*", in *Sukuk*, (2009) Sweet & Maxwell Asia, p. 101.

***SPV functions as an insolvency-remote entity***

The aim when setting up the SPV is to isolate the *Sukūk* assets, as well as the *Sukūk* obligations, from the obligor. By its constitutional documents the SPV will be set up specifically to issue the *Sukūk* and participate in and execute the transaction documents. It will not be permitted to enter into any other business or to incur any liabilities outside the transaction. It will have no employees and its capitalisation will be as low as possible, limiting the possibility that it might enter into any other business.

It is desirable to ensure that the risk that the SPV will be declared insolvent is as low as possible, by placing restrictions on third parties who contract with the SPV. This is to eliminate the risk of them commencing insolvency proceedings against it. This can be done by adding “limited recourse” wording to prevent such counterparties taking enforcement action against the SPV’s assets.

### ix. Structuring (including management)

Any institution planning to structure the securitisation of Islamic assets will need to be familiar with the following contracts under the *Fiqh al-Muamalat*:

1. *Uqūd al-Mu’awadat* (contracts of exchange) comprising contracts such as *Murābahah, Ijārah, Salam and Istisnā`.* The majority of jurisdictions only use *Ijārah* as a contract of exchange for *Sukūk* because *Murābahah, Salam and Istisnā`* contracts cannot be traded as underlying assets. Notwithstanding, some *Sharī`ah* scholars have permitted the partial composition of *Dayn* (debt) as the underlying assets, as in the case of asset-backed securitisation.

   The most common form of *Sukūk Ijārah* involves the sale of the underlying assets by the originator to an SPV, which in turn issues *Sukūk* to investors. The SPV leases back the assets to the originator, thus providing the SPV with periodic lease rental payments. Depending on the legal framework, if an issuer defaults, there could be a possibility that its legal standing would be equivalent to an unsecured creditor.

2. *`Aqd Wakālah* (contract of agency) has been widely used for fund management. Many *Takāful* companies are now taking up the *Wakālah* model over *Muḍārabah*. Of late, there has been a shift to *Wakālah* for *Sukūk* in the GCC countries. Its popularity is due to the ease of *Sharī`ah* application where the fee has been made clear upfront.

3. *Uqūd al-Isytirak*, or contract of participation, in the form of *Muḍārabah* and *Mushārakah* as the platform. *Uqūd al-Isytirak* has been the preferred structure, even during the time of Prophet Muhammad (PBUH) as a means to fund a business or venture that involves risk-sharing. *Muḍārabah* and *Mushārakah* are premised on profit-sharing and equity-sharing, respectively. Risks are shared

among the originator and the investors, with the likelihood of fluctuations in dividend/profit payment and capital redemption. The whole presentation of the structure is one where investors are meant to receive a share of the profits and not interest on debts – two different obligations.

However, if financial instruments were structured purely on an *Uqūd al-Isytirak* basis, they would be less attractive to banks as their portfolios require that their assets be largely made up of capital-protected instruments. Thus, *Sukūk* practitioners have developed innovative ways to achieve this: First, through the incorporation of *Tanazzul*, or waiver upfront, if actual profits exceeded expected profit. Second, where there is a shortfall from the expected profit, the originator provides for funds to be drawn from a reserve account or liquidity facility. Third, the purchase undertaking price has been predetermined as being equivalent to the par value. The purpose of these three applications is to ensure investors a fixed profit payment and redemption at par value.

While each of the above sets of contracts may be used in a combination through several layers or series of contracts, one must bear in mind that the *Sharī`ah* explicitly prohibits hybridisation of contracts by blatantly combining multiple contracts into one, as this may create uncertainty. Hence the structuring of any Islamic securitisation must not overlook that every contract within the whole structure must adhere to the body of rules and principles applicable to it under the *Sharī`ah*, and the sequence of completion of each contract must not create uncertainty as to which contract comes first and which will come later.

To preserve the integrity of the structure, especially with respect to bankruptcy remoteness of the SPV, the management of the trustee and the SPV should be independent from the originator and the obligor. As is clear from the case of *MIDF Investment Bank Bhd and 9 Ors v Pesaka Astana (M) Sdn Bhd and 8 Ors*, the trustee and arrangers of the securitisation must undertake appropriate due diligence to protect the interests of the investors.

### x. Synchronisation and timing (particularly series transactions)

As the *Sukūk* market is still relatively small compared to the conventional bond market, we have not seen many serial issues that consistently seek to raise funds in this market; therefore, the need for any issuer to synchronise and time its series of issuance is perhaps not yet important. In practice, there are only a handful of repeat issuers of *Sukūk*. These include the Central Bank of Bahrain, Bank Negara Malaysia and Cagamas Berhad, which is the mortgage corporation in Malaysia. Nevertheless, the International Islamic Liquidity Management Corporation (IILM), which was established on 25 October 2010 through the IFSB's initiative, is envisaged to undertake serial issuance of short-term, high-quality and highly liquid *Sharī`ah*-compliant instruments in a more synchronised manner. This initiative is welcomed, as the growing Islamic financial services industry desperately needs a more coherent and reliable platform to facilitate liquidity management needs, as we have already emphasised in our general discussion.

In ensuring effective synchronisation and timing for a serial issuance of *Sukūk*, the relevant issuers need to draw up a clear plan in accordance with their own funding needs and capability. These plans and calendar should be shared with their key stakeholders so that each of them can anticipate every series of the issuance far in advance and therefore ensure that appropriate infrastructures are in place to support such issuance.

### xi. Documentation (acceptability – electronic and verification issues)

The documentation for Islamic securitisation fundamentally depends on the structures used and the governing laws. As explained earlier, lawyers in a common law jurisdiction who are experienced in establishing SPVs and who have the advantage of developed trust laws are in a better position. Nevertheless, in each securitisation transaction the lawyers, whether acting for the issuer or arranger, should be able to provide a legal opinion on the capacity and capability of the parties to enter into the transaction, as well as on the enforceability of the documents to preserve the rights and obligations of the parties. Therefore, the acceptability of the documentation, including in terms of electronic signing and delivery of documents, as well as verification of certain terms and conditions of the *Sukūk*, depends heavily on the governing law and regulations applicable to the *Sukūk* transaction*.*

An important aspect of the drafting of the legal documentation is the challenge in observing, as much as possible, the two sets of laws that govern the *Sukūk* documentation – namely, the law of the relevant jursidiction (if it is not based on a *Sharī`ah* legal system), as well as the *Sharī`ah.* Marrying the two is not always easy, as we have seen. For example, in some countries, the consumer protection law says that any financing document must prescribe clearly the rate of interest imposed on the customer, notwithstanding that no such rate can be imposed in a *Sharī`ah*-compliant document. In another example, the law may prescribe that an automatic rate of interest penalty shall apply to a debt defaulted on by the customer, albeit the *Sharī`ah* rules and principles prohibit the financing party from benefiting from any penalty based on interest.

For the purpose of illustration, a summary of a typical set of documents used especially in *Sukūk al-Ijārah* is set out below.

**Purchase agreement**
Pursuant to the purchase agreement, the seller will sell to the issuer the beneficial title to the *Sukūk* asset. Often, as only beneficial title to the assets will pass to the issuer, the seller will remain the registered proprietor of the assets. Pursuant to a declaration of trust, the seller will declare that it is the registered proprietor of the *Sukūk* assets only as trustee for and on behalf of the Issuer.

**Lease agreement**
Under the terms of a master *Ijārah* agreement between the issuer as lessor and the asset originator as lessee, the issuer and the originator agree to execute consecutive, semi-annual leases to lease the usufruct of the assets to the originator during the term of the *Sukūk*.

**Service agency agreement**
Under the terms of the service agency agreement, the originator (in this capacity, the "service agent") will, *inter alia*, be responsible on behalf of the issuer for the performance of all major maintenance in respect of the *Sukūk* assets, payment of proprietorship taxes and the procuring of a *Takāful* (Islamic insurance) policy for the assets. This will help to minimise the monitoring cost on the part of the *Sukūk* investors while efficiently ensuring that the originator will also be responsible for the reasonable "wear and tear" of the assets.

**Declaration of trust**
Pursuant to the declaration of trust, the issuer will declare that it will hold the *Sukūk* assets upon trust absolutely for the holders of the *Sukūk pro rata* according to the face amount of *Sukūk* held by each *Sukūk* holder in accordance with the declaration of trust and the terms and conditions of the *Sukūk*.

**Purchase undertaking**
The asset originator will undertake irrevocably to purchase from the issuer the beneficial title to the *Sukūk* assets at the exercise price (as defined):

1. on the date specified by the trustee to *Sukūk* holders in accordance with the condition for redemption of the certificates following a dissolution event; or
2. on the scheduled dissolution date.

**Sale undertaking**
The issuer will undertake irrevocably to sell to the asset originator the beneficial title to the *Sukūk* assets at the exercise price:

1. on the periodic distribution date, provided that the asset originator has given not more than a certain number of days' written notice to the issuer and that no dissolution event has occurred and is continuing; or
2. on any periodic distribution date, subject to relevant terms and conditions.

Note here that the purchase and sale undertakings are undertakings that are contingent upon certain events taking place, and therefore from the *Sharī`ah* point of view fall under a unilateral promise (*Wa`d*).

In such a case, under strict *Sharī`ah* principles governing *Wa`d*, although the promise is binding on the maker, it is not legally enforceable by the beneficiary of the promise. Indeed, in the contract law of most countries, because "contracts" are defined to be an exchange of offer and acceptance with "consideration", a unilateral promise categorically does not fall within the ambit of a "contract" and hence may not be considered legally enforceable. In practice, parties to a *Sukūk* transaction proceeded with accepting the undertakings nevertheless, because under the common law generally a unilateral promise can be enforced by the beneficiary.

### xii. Settlement, transfer and multiple claims

As we have seen, with the exception of Malaysia, which is the largest *Sukūk* market, there is little evidence of trading in the secondary market. Most *Sukūk* investors instead hold the instrument until maturity and enjoy the fixed returns made from the *Sukūk*. In view of the lack of trading, therefore, issues relating to settlement, transfer and multiple claims over *Sukūk* payments have rarely arisen. *Sukūk* that are offered in the international markets and are issued in international currencies often use the same settlement and transfer platform as used by conventional bonds, such as Euroclear and Clearstream.

In Malaysia, a local platform – namely, the Scripless Securities Trading System (SSTS) – is operated by Bank Negara Malaysia. To complement this, a real-time gross settlement/delivery-versus-payment system, through which sovereign and unlisted corporate bonds are registered, cleared and settled, is operated via the Real-time Electronic Transfer of Funds and Securities (RENTAS), Malaysia's scripless book-entry securities trading and funds transfer system. SSTS also maintains securities accounts for financial institutions.

The Bursa Malaysia has been active in promoting the listing of *Sukūk* under its "exempt regime", which means that the *Sukūk* will not actually be listed and traded on the exchange. The purpose of the "exempt regime" is only to promote visibility and profiling between the *Sukūk* issuer and the Bursa. Nevertheless, this is a positive way of encouraging more *Sukūk* to make their presence felt in the market. In addition, a commodity trading platform such as *Bursa Suq al-Sila* provides the full spectrum of settlement and transfer for market participants. Other jurisdictions that wish to develop their own markets would do well to consider adopting, with appropriate modifications, the experience of Malaysia in this regard.

### xiii. Derivative paper

**General prohibition against derivatives**[157]

Most *Sharī`ah* scholars hold the view that conventional derivative instruments such as forward and futures contracts, put and call options, as well as currency and interest rate swaps, do not fulfil the rules and principles of *Sharī`ah*. This, to a large extent, limits the ability of institutions offering Islamic financial certificates from hedging the risks they are exposed to, compared to their conventional counterparts. The lack of *Sharī`ah*-compliant derivative instruments is well recognised as a risk management problem in Islamic financial markets. Indeed, this may well result in IIFS holding too much cash, due to a lack of *Sharī`ah*-compliant short-term instruments to place it in.

Current objections to futures and options constitute the most discouraging form of religious censure. *Sharī`ah* scholars take issue with the fact that these derivatives are valued mostly by reference to the sale of a non-existent asset or an asset not in the possession (*Qabd*) of the seller, which violates the *Hadīth* "sell not what is not with you" (narrated by Al-Bukhari). As we have seen, the *Sharī`ah* requires creditors (or protection sellers) to actually own the relevant asset at the inception of a transaction. Consequently, most commentators and scholars question the permissibility of trading in futures. That said, the prospect of failure to deliver (and the resultant notion that a purchase or sale cannot be effected for a future date) might have been more relevant to the condition of asset ownership in the past, when then simple and unorganised capital markets implied considerable counterparty risk on contractual performance.

Futures and options also continue to be rejected by a majority of scholars on the grounds that "in most futures transactions delivery of the commodities or their possession is not intended",[158] which would invalidate their use under the *Sharī`ah*. Furthermore, derivatives almost never involve delivery by both parties to the contract. Often parties reverse the transaction and cash settle the price difference only, which transforms a derivative contract into a paper transaction without the element of a genuine sale.

Besides the lack of asset ownership at the time of sale, scholars have raised concerns as to whether derivatives can be compliant with the *Sharī`ah*. These include:

- the selection of reference assets that are non-existent at the time of contract;
- the requirement of *Qabd* (i.e. taking possession and/or bearing ownership risks of the subject matter prior to resale);

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[157] See, among others, A. Salehabadi and M. Aram, "Islamic Justification of Derivatives", *International Journal of Islamic Financial Services*, Vol. 4, No. 3 (2002); M. Obaidullah, "Islamic Financial Options", *International Journal of Islamic Financial Services*, Vol. 1, No. 1 (1999); B. Obiyathullah, "Derivative Instruments and Islamic Finance", *International Journal of Islamic Financial Services*, Vol. 1, No. 1 (1999).
[158] T. Uthmani, "Futures, Options, Swaps and Equity Investments", *New Horizon*, (1996) Institute of Islamic Banking and Insurance, No. 59 (June), 10.

- mutual deferment of both sides of the bargain, which reduces contingency risk but turns a derivative contract into a sale of one debt for another; and
- excessive uncertainty or speculation that verges on gambling, resulting in zero-sum payoffs of both sides of the bargain.[159]

It has been conceded that even in the contemporary form of futures trading, "some of the underlying basic concepts as well as some of the conditions for such trading are exactly the same as [the ones] laid down by the Prophet Mohammed (*sallallāhu `alayhi wasallam*) for forward trading". It was also attested that the associated risk of exploitation and speculation belies the fundamental precepts of the *Sharī`ah*.[160] For the same reasons, several scholars also consider options to be in violation of Islamic law. Nonetheless, one of the most comprehensive studies on the subject so far[161] finds that "there is nothing inherently objectionable in granting an option, exercising it over a period of time or charging a fee for it", and that "options trading like other varieties of trade is permissible *Mubāh*, and as such, it is simply an extension of the basic liberty that the *Qur'ān* has granted". It has been said that the strong opposition of some to the acceptability of derivatives under Islamic law fails to take proper account of the fact that derivatives are a new phenomenon in an Islamic context. The governance of derivatives has no parallel in the conventional law of *Muamalat*, and should therefore be guided by a different set of rules. Nevertheless, in recent years there have been attempts to address this.

**Attempts at standardising – Ta'Hawwut Master Agreement**

The demand for *Sharī`ah*-compliant derivatives is on the rise and the critical constraint, as we have seen, is the lack of standardisation in legal documentation. In this regard, the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) have recently launched the first globally standardised documentation for privately negotiated Islamic derivatives.

The ISDA/IIFM Ta'Hawwut (Hedging) Master Agreement ("Ta'Hawwut Master Agreement)" is designed for institutions operating under *Sharī`ah* principles that want to enter into hedging transactions. The growth of the Islamic finance market has increased the need for IIFS and corporate borrowers to hedge interest-rate and currency exposures. It is also hoped and expected that the Master Agreement will give an important boost to the growth and liquidity of the Islamic derivatives market. Taking an approach similar to that of ISDA's 2002 Master Agreement, but adapted for *Sharī`ah* compliance, the Agreement is a framework agreement under which a range of Islamic products (such as *Murābahah* and *Wa`d*) can be documented. It is anticipated that the Ta'Hawwut Master Agreement will meet the requirements of market participants across

[159] M.H. Kamali and Mohammad Hashim, "Commodity Futures: An Islamic Legal Analysis", *Thunderbird International Business Review*, Vol. 49, No. 3 (April 2007), pp. 309–339.
[160] M.F. Khan, "Islamic Futures and Their Markets", Research Paper No. 32, (1995) Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi-Arabia, p. 12.
[161] M.H Kamali, *Islamic Commercial Law – An Analysis of Futures and Options*, (2001) Islamic Texts Society, Cambridge, UK, Ch. 10.

geographical regions, regardless of the market participant's adherence to a particular school of thought.

The Ta'Hawwut Master Agreement sets out a framework of terms common to all transactions, including the governing law and events amounting to default. It also promotes risk management by providing an early termination mechanism that aggregates the transactions (netting). Like ISDA's 2002 Master Agreement, the Ta'Hawwut Master Agreement is a multiproduct agreement, although the intention is that it should be used only with *Sharī`ah*-compliant transactions. The Ta'Hawwut Master Agreement has hardwired into it a mechanism that uses two types of confirmations: those documenting existing, live transactions (Confirmations), and those documenting transactions that are designated to occur in the future (DFT Terms Confirmations). This concept is particularly relevant to transactions such as profit rate swaps.

**Guidelines regarding the sorts of transaction that may be entered into under the ISDA/IIFM Ta'Hawwut Master Agreement**

For the purposes of *Sharī`ah* compliance:

- Transactions entered into under the Ta'Hawwut Master Agreement should only be for the purpose of hedging actual risks of the relevant party.
- Transactions entered into under the Ta'Hawwut Master Agreement should not be for the purposes of speculation.
- Transactions must be real transactions, involving the actual transfer of ownership of real assets, actual risk and real settlement.
- The asset itself must be *Halāl*.
- Interest must not be chargeable under the transaction.

**New representations**

The representations in the Ta'Hawwut Master Agreement are very similar to those in the ISDA 2002 Master Agreement with the insertion of additional representations relating to *Sharī`ah* compliance. The IIFM *Sharī`ah* Advisory Panel has given *Sharī`ah* approval to the Master Agreement only, and no approval by the Panel has been given to the underlying transactions whatsoever.

Although it is intended that *Sharī`ah*-compliant derivatives be documented under the Agreement, the onus is on each of the parties to the Agreement to seek independent confirmation from its own *Sharī`ah* advisers or panel, and any amendments and additions made to it and each transaction traded under it.[162] However, such compliance confirmation is only required "*insofar as it wishes or is required for any reason"*. There is also a non-reliance undertaking whereby each party represents that it has not relied on

[162] Section 3(h) of the ISDA/IIFM Ta'Hawwut Master Agreement reads: "Satisfaction as to compliance with *Shariah* compliance: Each party represents it has satisfied itself as to the *Shariah* compliance of the Agreement, each Transaction, each DFT Terms Agreement (and each Designated Future transaction under it)."

the other party or on any document (including a pronouncement/*Fatwa*) prepared by or on behalf of the other party for the purposes of determining whether the Agreement, each transaction and each DFT Terms Agreement is *Sharī`ah* compliant. Having regard to the case of *The Investment Dar v Blom Developments Bank SAL*, where an IIFS itself raised the contention that the Islamic product it offered was in fact not *Sharī`ah* compliant and thus, *ultra vires* its power under the company's constitution, there is a risk that such contention may be raised in the application of the Ta'Hawwut Master Agreement. Since the onus to ensure *Sharī`ah* compliance rest with each party to the Agreement, one can only hope that neither party will look back and disclaim *Sharī`ah* compliance or argue that the Master Agreement is void due to non-compliance with *Sharī`ah*.

Practitioners have also pointed out that a number of clarifications are needed regarding the Ta'Hawwut Master Agreement, especially with reference to the caveats as to *Sharī`ah* compliance with the agreement, and especially in the case of a non-Muslim party in a transaction which may wish to exclude the representation that a party is only obliged to confirm that the transaction is *Sharī`ah* compliant as far as it wishes or is required to do so.

**Governing law and enforcement of foreign judgment**

Another area that is potentially of concern is the election of New York State law or English law as the governing secular law for the Ta'Hawwut Master Agreement. There is no reference to *Sharī`ah* in the governing law clause. Parties may elect either English law or the law of the State of New York as the governing law of the Agreement and each transaction and designated future transaction made thereunder. Both parties at the outset have the flexibility to elect whether dispute resolution should take place through litigation or arbitration.

Under the English law, as several of the cases involving IIFS and their clients have shown, it is for each party to satisfy themselves that the substantive terms of the underlying contract comply with *Sharī`ah* principles. The English court may be very reluctant to examine deeper the merits of any *Sharī`ah*-based contention, since they are not an expert in this field. As we have seen, although there are a few precedents from the English courts, the precedents are not conclusive or necessarily helpful to the development of Islamic finance. We have already considered the case of *Shamil Bank of Bahrain (EC) v Beximco Pharmaceuticals Ltd*, where the English court considered the status of a purportedly dual "*Sharī`ah* and English" governing law clause. The Court of Appeal ruled that because *Sharī`ah* law was not the law of any individual country and there was too much uncertainty as to its terms for it to be a binding system of law, English law was the sole governing law. Due to such controversy, parties to any Islamic finance agreement are advised to ensure that any *Sharī`ah*-compliant arrangements and mechanisms included within their agreements also conform to the chosen national law.

Another issue of concern is the enforceability of judgments made in another jurisdiction. If parties are from different countries, they must ensure that there is a reciprocal enforcement treaty in place between both countries, as we have noted in our earlier discussion of the relationship of different legal systems. There should also be caution in selecting different legal systems and the institutions available to administer justice, in that a state might not have the expertise and, perhaps, sensitivity to handle issues pertinent to Islamic jurisprudence and practice. In this regard, some flexibility should be given to the Ta'Hawwut Master Agreement whereby the parties may elect other law apart from English and New York State law which they trust would be more suitable and accommodating to the Islamic finance agreements.

**Netting of transactions**

The Master Agreement adopts the same position in respect of netting of payments as provided for in the ISDA 2002 Master Agreement (payments in the same currency, due on the same date in respect of the same transaction will automatically be netted, with the ability to opt for multiple transaction payment netting).

Parties may elect to have cross-transaction payment netting apply. However, in the case of bankruptcy of a party, there could be an enforceability issue here with respect to the netting of amounts under existing transactions versus amounts in respect of future transactions, particularly to the extent that future transactions may contemplate delivery of assets rather than payment of money. This will also be affected by whether, and to what extent, netting is enforceable as a matter of bankruptcy law in the jurisdictions of the parties to the Ta'Hawwut Master Agreement. It is important that parties consider netting in the relevant jurisdictions, particularly when netting a cash claim against an obligation to deliver an asset.

The introduction of the Ta'Hawwut Master Agreement is, indeed, timely, as participants in the Islamic financial markets recognise that the lack of such documentation up to this point has been one of the main impediments to further development. The Ta'Hawwut Master Agreement is a step forward in demystifying Islamic finance by using an accepted standard document as a common practice. However, its use will need to be monitored, and there remain certain issues that may arise in its application that will need to be carefully considered. It could be a pathfinder for further standardised documentation in the Islamic financial market.

### xiv. Accounting issues

As most jurisdictions adopt the International Financial Reporting Standards (IFRS), with very few jurisdictions applying the AAOIFI accounting standards, it is widely observed that, generally, the IFRS also apply to Islamic securities. To this extent, it can be broadly argued that the application of accounting standards that do not take into consideration the specificities of Islamic securities may result in inaccuracy in the measurement, reporting and comparability of financial instruments used in the Islamic financial markets. However, it cannot be denied that specificities of Islamic securitisation may not be so obvious, especially considering that in many circumstances they are similar to the economic profile of a conventional securitisation. For example, the institutional units that usually issue Islamic securities remain, generally, the governments, financial corporations (including deposit-taking corporations and the central bank) and non-financial corporations. *Sukūk* basically can be classified by the type of underlying contract, such as *Murābahah, Ijārah, Salam, Istisnā`, Mushārakah, Muḍārabah,* and *Wakālah.* Most of the other classifications described for conventional debt securities – that is, currency, maturity and market – may also be applied to Islamic securities.

With regard to classification by interest rate, as noted earlier, *Sharī`ah* rules and principles prohibit usurious payment (*Riba*), including predetermined returns on borrowed funds for specific terms. Furthermore, some *Sukūk* structures, such as *Mushārakah* or *Muḍārabah*, may not reflect the exact variation in the real return from the business venture. Therefore, the returns cannot be predetermined at the time of issue. This situation makes the pricing of these securities difficult, as does the lack of benchmark profit rates and the diverse types of *Sukūk* securitisation structures. Thus, in order for the *Sukūk* pricing mechanism to be efficient and credible, further initiatives have to be undertaken to develop benchmark indicators. For example, if the *Sukūk* issue is based on the *Ijārah* principle, where a property is used as its underlying asset, the actual rate of return on the underlying asset may be used to determine the rate of return of the *Sukūk*. The price of the *Sukūk* would then fluctuate in line with the supply and demand in the market for that underlying asset.

AAOIFI has classified *Sukūk* into three main categories: those held for trading purpose; those held for sale; and those held to maturity.[163] The use of AAOIFI's classification of investment into three types would be more desirable and useful to users of accounting information, as it provides an additional classification that distinguishes the intention or purpose of the investment. However, there is an issue raised in the classification of investments adopted by AAOIFI. The issue of intention of the investor is difficult to determine and may also be subject to change due to changes in the environment and situation. To resolve this issue, the AAOIFI needs to develop a specific measurement or some guidelines to conclude whether or not specific intention on the part of investors is established.

AAOIFI has further recommended that investments in *Sukūk* and shares shall be recognised on the acquisition date and shall be measured at cost. Although there is an increasing pressure to use fair market value, the standard prefers the historical cost method. It is argued that historical cost does not always provide relevant information, even though it is reliable and is free of bias compared to the fair market value principle. Nevertheless, for many financial instruments (including *Sukūk*), quoted market prices may not always be available. Market prices are normally used as the basis of measuring

[163] See FAS-17: Financial Accounting Standard No. 17, "*Investment*s", AAOIFI Standards, (2008) AAOIFI; and M.E.A. Sukor, R. Muhamad and A.Y. Gunawa, "Malaysian *Sukuk*: Issues in Accounting Standards", *Shariah*, Vol. 16, No. 1 (2008), pp. 63–74.

fair market value. Thus, when the market price is not available, generally, the conventional method measures the securities based on other valuation techniques, including the net present value. However, some of these techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding the risk characteristics of various financial or capital market instruments. The uncertainties include the arbitrary use of discount rates, future cash flows, expected loss and other factors. Thus, the idea behind AAOIFI's FAS-17 favouring historical cost rather than fair value is to eliminate the uncertainties involved in the use of fair value for capital market instruments. This is also due to the fact that the objective of Islamic valuation should be to provide users of financial statements with both relevant and reliable values in order to be able to make useful judgments and decisions.

However, at the end of the accounting period, investment in *Sukūk* held for trading purposes and available for sale will be measured at their fair value. This is because there may be a diminution in the value of *Sukūk*. Therefore, it has to be measured at its fair value to take into account profits or losses made from the proceeds. The unrealised gains or losses, as a result of re-measurement, need to be recognised in the income statement under the "investment fair value reserve". This reserve account will reflect the net gain or loss at the end of the year. Moreover, the AAOIFI's FAS-17 mentions that the difference between the book value and the net cash that resulted from the sale of the investment is to be measured as the realised profits or losses from the sale of a particular investment.

The standard also makes a provision that in case an institution has reserves created by appropriation of profits from previous financial periods to meet future investment risks, it is recommended that unrealised loss resulting from re-measurement of investment at fair value shall be deducted from this reserve.

The standard also requires that the different types of investment must be shown separately according to the three classifications, as noted earlier. Again, this is essential in order to give clarification of which type of investment the profit resulted from. As a result, this will enable users to compare profitability between different types of investments and, hence, this information will add more value in terms of decision-making by users. In the case of dividends received from investment in shares and *Sukūk*, the standard points out that dividends should be acknowledged at the declaration date in the income statement, rather than when the cash is received. Thus, this shows that in case of recording dividends on investment in shares and *Sukūk*, the accrual basis of accounting is used. The use of the accrual basis in this case is required to reflect the actual or fair income at the point when it is realised.

Another requirement in realising profit from sale of investment and dividends received is the need to differentiate between the portion to be shared by owners' equity and depositors or investors. The rationale for this requirement is similar to the case of treatment of profit on re-measurement of investment at fair value, as discussed above, as it ensures that sufficient information is provided to users of accounting information, particularly on the distribution of profit between equity holders and depositors so that the clarity and integrity of the information can be maintained.

The main issue highlighted in the preceding discussion is the need to recognise that a portion of income from *Sukūk* requires the application of proper treatment and the disclosure of profit and sharing distribution. In accounting for *Sukūk*, it is important that there is transparency in method, ratio and process to disburse profit, as well as to comply with the *Sharī`ah* requirement of ensuring fair and just profit-sharing and distribution between shareholders and depositors. In the case of *Sukūk* investments, AAOIFI's FAS-17 has clearly specified certain requirements of how *Sukūk* investments should be disclosed. One requirement is to disclose the party guaranteeing *Sukūk* and the nature of the guarantee. Another requirement is for the contractual relationship between the issuer and the holders of a particular *Sukūk* to be disclosed. The disclosure shall be made by the issuer of *Sukūk*. Another disclosure required with respect to investment in *Sukūk* is the classification of *Sukūk* according to their maturities.

The main idea of the disclosure requirements outlined by the AAOIFI's FAS-17, as stated above, is that IIFS have to maintain transparency in disclosing financial information relevant to securities investment, especially *Sukūk*. Thus, this will enable users of financial statements to make better judgments, as all the necessary information is disclosed. In the case of *Sukūk*, the disclosure of the potential returns and the associated risks, as well as disclosure of the contractual relationships between the parties involved, are equally important in order to be able to judge whether or not the investment has complied with *Sharī`ah* requirements.

#### xv. Tax issues (including stamp/transfer/gains, etc.)

*Sukūk* are exposed to major direct and indirect tax hurdles in many jurisdictions. Realising the importance of developing *Sukūk* markets in their respective jurisdictions, many countries have enacted tax laws to facilitate and provide specific relief for *Sukūk* structures. Many tax authorities in countries which are considering the introduction of *Sukūk* in their respective capital markets are currently evaluating *Sukūk* structures and focusing on the substance of the transaction, rather than the form, in determining the appropriate tax ramifications.

The range of tax exposure of *Sukūk* includes the classification of the nature of payments to *Sukūk* holders as dividends, interest on principal and the applicability of withholding taxes on these payments. There may be issues even as to the nature of the transactions, such as whether it is an equity investment, loan or a sale of asset, depending on the associated legal documents.

In the absence of *Sukūk*-specific tax legislation,[164] the efficiency of raising funds via *Sukūk* as opposed to via conventional debt instrument would surely be doubtful from a tax perspective. For example, the dual transfer of underlying assets to and from the SPV under a *Sukūk al- Ijārah* structure may attract double stamp duty and/or property transfer tax. *Ijārah* rentals payable under such a *Sukūk* may attract value-added tax (VAT) as opposed to the VAT exemption enjoyed by interest, thus impacting the pricing. Furthermore, interest paid by a bond issuer on a conventional debt does not attract any withholding tax under most tax systems, while *Ijārah* rentals may be exposed to such a tax.[165]

Where the structure spans the territorial borders of different jurisdictions, analysis of treaties for relief from double taxation would inevitably be a part of the process. There will be a need to check whether cross-border payments to *Sukūk* investors are to be governed by the tax framework applicable to dividends, interest or business profits, and whether the cross-border cash flows may be exposed to withholding tax laws. These payments would also have to comply with the respective Exchange Control Regulations.

Do *Sukūk* investors create a permanent establishment in the other jurisdiction by virtue of *pro-rata* holding of beneficial ownership in underlying assets transferred by the originator to the SPV? The *Sukūk* holders in another territory receive their fractional entitlement of revenue from these assets by virtue of the certificate. This again raises the question of what sort of tax treatment shall apply. Other tax issues often raised with regard to *Sukūk* include:

- the amount of stamp duty payable on each stage of the transaction – in particular, the possible multiple transfers of assets under *Murābahah*, *Bay` Bithamin Ajil* or *Istisnā`*;
- the taxable gain on disposition of the asset at maturity;
- withholding tax on payments of rent or on *Sukūk* distributions;
- taxable income in the issuer SPV; and
- treatment of *Sukūk* distributions in the hands of investors.

In recent years in many jurisdictions (including France, Korea, Japan, Hong Kong, Singapore and Australia), there has been widespread recognition that in normal circumstances Islamic financial contracts may attract more taxes and stamp duties compared to conventional financial contracts. Thus, these jurisdictions have made attempts to provide a framework that assures neutral tax treatment for Islamic financial

[164] Among countries that have enacted *Sukūk*-specific tax legislation are Malaysia, the UK, Republic of Ireland and Luxembourg. Japan, South Korea, France and Australia are among countries which have announced initiatives to introduce *Sukūk*-specific tax legislation.
[165] See, for example, discussions by M. Amin, "The New UK Tax Law on *Sukuk*", *New Horizon* (October–December 2007); S.R.I. Perera, "*Ijara*: A More Compassionate Form of Leasing", *Islamic Finance Today* (October–December 2008); and "Islamic Finance – The New Mainstream Alternative", *Investors Offshore* (August 2010).

contracts vis-à-vis its conventional cousin. Without such understanding and tax accommodation to Islamic financial contracts, the tax and/or duties imposed will increase the cost of offering Islamic financial services and products, thereby putting them in a less competitive position compared to their conventional counterparts. Levelling the playing field in terms of tax treatments will go a long way in allowing *Sukūk* to be competitively offered alongside conventional bonds in any market.

**Example of tax reforms**

Malaysia seems to be a leading jurisdiction in introducing *Sukūk*-specific legislation to ensure a more conducive tax regime that can facilitate growth. Since the inception of Islamic banking in Malaysia in 1983, various initiatives have been undertaken to ensure that the laws that govern taxation (including the Income Tax Act 1967, Real Property Gains Tax Act 1976 and Stamp Duty Act 1949) are duly revised and amended to support the development of Islamic financial transactions. For example, the issuance of *Sukūk* in Malaysia generally does not attract any stamp duty. Furthermore, schemes that involve the sharing of profits and losses and which apply the *Mushārakah* and *Muḍārabah* concepts will not be considered as a partnership for tax purposes.[166]

Table 3.1 lists examples of some of the *Sukūk*-specific tax legislation.

**Table 3.1 Tax Regime for Islamic Finance in Malaysia**

| Capital market sector | Recipient | Incentives | Legislation |
|---|---|---|---|
| *SUKŪK* | Issuer/SPV | As the special-purpose vehicle is established solely to channel funds, the SPV issuing the *Sukūk* is exempted from income tax | i. Income Tax (Exemption) (No. 14) Order 2007 – 3 May 2007<br>ii. Finance Act 2007 – Amendment to the Income Tax Act 1967 – New section 60I |
| | Issuer/Originator | The company that established the SPV is also given a deduction on the cost of issuance of the *Sukūk* incurred by the SPV. | i. Income Tax (Deduction on the Cost of Issuance of the Islamic Securities) Rules 2007 – 26 April 2007<br>ii. Finance Act 2007 – Amendment to the Income Tax Act 1967 – New section 60I |

[166] Hakimah Yaacob, "Tax Incentives of Islamic Finance in Malaysia", [2010] 1 LNS(A) iii

| Capital market sector | Recipient | Incentives | Legislation |
|---|---|---|---|
| | Issuer | Extension of deduction of expenses for *Sukūk* issued under *Mushārakah, Muḍārabah, Ijārah* and *Istisna`* for another 3 years until the year of assessment 2010. | Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2007 – 11 January 2007 |
| | Investor | Profit paid or credited to non-resident companies in respect of Ringgit-denominated *Sukūk* (exclude convertible loan stock) approved by the SC is exempt from income tax. | Income Tax Act 1967 – Schedule 6: section 33A |
| | | Profit paid or credited to any individual, unit trust and listed closed-end fund in respect of *Sukūk* (exclude convertible loan stock) approved by the Securities Commission is exempt from income tax. | Income Tax Act 1967 – Schedule 6: section 35 |
| | | Profit paid or credited to any person in respect of non-Ringgit *Sukūk* originating in Malaysia (exclude exchangeable loan stock) and approved by the Securities Commission is exempt from income tax. | Finance Act 2007 – Amendment to the Income Tax Act 1967 – Amendment of Schedule 6: section 33B |
| | Issuer | To ensure tax neutrality with conventional products, any additional tax or duty is exempted or given specific treatment provided that the Islamic capital market products are approved by the *Sharī`ah* Advisory Council and the Securities Commission. | i. Income Tax Act 1967 – section 2(8)<br><br>ii. Stamp Act – Schedule 1 “General Exemptions” |

Elsewhere, policy-makers in the UK have undertaken tax reforms through Finance Acts 2005 and 2006 to demonstrate their commitment to the elimination of tax barriers for this alternate mode of financing. Tax reforms such as the Alternate Finance Investment Bond (AFIB) in the UK, introduced by the Finance Act of 2007, have also successfully resolved the uncertainties that prevailed in the trading of *Sukūk* by deeming *Sukūk* as “securities” for tax purposes and the elimination of VAT and stamp duty on transfer of certificates. Meanwhile, the expansion of the Qualifying Debt Securities (QDS) Scheme in Singapore to cover “Islamic debt securities” further creates a conducive environment for the development of *Sukūk* hubs. It is submitted that with more jurisdictions addressing the tax issues relating to *Sukūk*, the more competitive it will be in terms of costs and therefore the faster it can grow.

### xvi. Integrity/conflict issues

As far as integrity of the *Sukūk* market players in addressing any conflict issues are concerned, they are generally governed by the same ethical rules and market conduct rules as govern conventional bond market players. To this extent, arguably, *Sukūk* investors can expect the same level of protection as provided to conventional bond investors.

An added dimension, nevertheless, is that parties to a *Sukūk* transaction must also comply with the moral and ethical rules set out by the *Sharī`ah*. In this respect, inevitably the broader group of stakeholders in the *Sukūk* market relies a lot on the competence and commitment of the *Sharī`ah* scholars as a key whistle-blower and ombudsman for the *Sukūk* market in particular and the Islamic financial services industry in general.

In recent years, as we have seen, there have been concerns over the integrity and independence of some *Sharī`ah* scholars. In particular, controversy has arisen in regard to certain *Sharī`ah* endorsements given to debatable products. The lengthy arguments about the permissibility of certain *Sukūk* structures, as well as the severe disagreements regarding *Tawarruq,* have left many industry stakeholders calling for more transparency and accountability in the *Sharī`ah* governance framework. We have already mentioned the case of *Investment Dar v Blom Developments Bank SAL* in which an Islamic bank itself undermined the *Fatwa* issued by its *Sharī`ah* board.

As we have seen in our comments on *Sharī`ah* boards, the potential for conflicts among *Sharī`ah* scholars is real. Except in Malaysia, Indonesia and Pakistan, where *Sharī`ah* scholars are limited by regulation from sitting on so many *Sharī`ah* boards, such scholars generally (especially the eminent ones) sit on the boards of numerous institutions which are operating in the same market, offering the same products and services, and competing with one another. There is also a lack of clarity in the form of the regulatory and governance framework to restrict *Sharī`ah* scholars from holding shares in or receiving financing facilities from the institutions they are serving, as well as requirements to declare any possible related-party transactions involving family members of the *Sharī`ah* scholars.

While the IFSB and AAOIFI have each produced standards aimed at promoting sound *Sharī`ah* governance in IIFS,[167] the reality is that these bodies do not have enforcement powers and their standards are only to be adopted voluntarily by the respective institutions. Without a stronger and proactive intervention by central banks and

[167] See for example IFSB-3, IFSB-6 and, in particular, IFSB-10, as well as AAOIFI Governance Standards Nos. 1–5.

supervisory authorities, there may not be sufficient push for the market to improve its *Sharī`ah* governance framework. In view of the imminent systemic reputational risks to which the IIFS are exposed when it comes to *Sharī`ah* compliance, the time has come for central banks and supervisory authorities to impose a more comprehensive *Sharī`ah* framework in their markets.

### xvii. Issues relating to trading of securitised property

Although one of the aims of securitisation is to create a more liquid instrument that can be traded in the secondary market, Islamic securitisation has not been very successful in achieving this objective. This is due to the following, among other things:

- The relatively small number and size of Islamic securities compared to the conventional securities means that there is a scarcity of supply. Most holders of Islamic securities would rather hold their papers until maturity than trade them on the secondary market.
- The restrictions on sale of debt at a discount (*Bay` al-Dayn*) mean that Islamic securities issued under the principle of *Murābahah*, *Bay` Bithamin Ajil*, *Salam*, *Istisnā`* and *Tawarruq* generally are not tradable. Only Islamic securities issued under *Ijārah, Muḍārabah* and *Mushārakah* structures are widely accepted as tradable.

It appears that in many jurisdictions, especially among members of the OIC, the development of an infrastructure for a vibrant financial market is still in the future. Referring to Malaysia, given its position as the largest *Sukūk* market, as a benchmark, it can be observed that:

- Most other countries still depend heavily on the banking sector for their financing needs, without any real drive to develop the capital market. Many still do not even have a stock or financial exchange.
- The traditional market for any fixed-income instrument comprises the insurance companies and fund managers, as they need such a portfolio in diversifying their investments. Malaysia, in particular, has a well-developed *Takāful* sector alongside its capital market, thus creating an almost natural demand for *Sukūk* issuances.[168]
- Malaysia also has a few large state-managed funds, such as the Pilgrimage Fund (Tabung Haji), the Employees Provident Fund (EPF) and Perbadanan Nasional Berhad (PNB), which have a large appetite for *Sharī`ah*-compliant instruments, including *Sukūk*.

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[168] Perhaps Indonesia has a similarly strong potential to benefit from an almost natural demand for *Sukūk* issuances from its domestic market, as it already has five full-fledged Islamic banks, 27 Islamic business units (windows), two full-fledged *Takāful* companies, one general *Takāful* company, 13 insurance companies with Islamic branches, 19 general insurance companies with Islamic branches, 3 reinsurance companies with Islamic branches, and 39 Islamic mutual funds. See C.M. Hakim, "Development of *Sukūk* in Indonesia", presentation made at IFSB Legal Seminar 2010, Jakarta, 3 December 2010.

- Islamic finance has always been promoted as a value-proposition, rather than a religious obligation, in multiracial Malaysia. As a result, Islamic finance products and services are used not only by Muslims but also by non-Muslims. In other words, the whole market has become familiar with Islamic finance propositions, including *Sukūk*, to the extent that multinational companies in Malaysia such as Shell, Tesco, GE, AEON and Toyota have also raised funding through *Sukūk* in this market.
- The monetary policies are friendly and accommodating for *Sukūk* issuance in the local currency. Ringgit *Sukūk* have been issued even by multilateral organisations such as the Islamic Development Bank, the Asian Development Bank and the International Finance Corporation, which is a member of the World Bank Group. The Ringgit market is also independent from the global bonds market generally and has barely been affected by the recent financial crisis.

In summary, the development of a vibrant secondary market for *Sukūk* requires an "ecosystem" which is conducive, and such an ecosystem can only come into being with proper infrastructure, capacity building and continuous creation of awareness over time.

**A regulated Commodity *Murābahah* trading platform: *Bursa Suq al-Sila'***
As an initiative to encourage a more vibrant and regulated form of trading among IIFS, Bursa Malaysia, through its wholly-owned subsidiary, Bursa Malaysia Islamic Services Sdn Bhd, launched *Bursa Suq Al-Sila'* ("commodities market") on 17 August 2009. It was previously known as Commodity *Murābahah* House.

*Bursa Suq Al-Sila'* claims to be the world's first *Sharī`ah*-based international commodity platform. It is fully electronic and facilitates commodity-based Islamic financing and investment transactions under the principles of *Murābahah*, *Tawarruq* and *Musawamah*. *Bursa Suq Al-Sila'* enables lenders to create financing transactions which involve specific assets, fulfilling the *Sharī`ah* requirement that all deals must involve real economic activity. When an IIFS uses commodity *Murābahah*/*Tawarruq* to give out financing, it will first buy an asset and then sell it to the customer. The customer then sells the commodity to a third party using the bank as its agent, and receives payment, which secures the financing it had sought. All transactions done via *Bursa Suq Al-Sila'* will involve a true sale with a real transfer of ownership and goods that can be delivered.

To begin with, crude palm oil[169] will be used as the launch commodity. It will then be expanded to other *Sharī`ah*-approved commodities, covering both soft and hard commodities. As an international commodity trading platform, *Bursa Suq Al-Sila'* is multi-currency, allowing more choices, access and flexibility for international financial institutions to participate in this market.

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[169] Malaysia is one of the largest producers of palm oil in the world, with a number of the largest palm oil plantation companies, including Sime Darby and FELDA. The Bursa cooperates with them in order to ensure a steady supply of the commodity.

*Bursa Suq Al-Sila'* has now gained a footing in the GCC markets, as more cross-border Islamic finance transactions have been witnessed. This platform received recognition in the GCC with recent trades being undertaken by CIMB Islamic, AlRajhi Bank and several GCC institutions. Through these trades, Bursa Malaysia hopes to meet the increasing demand for *Sharī`ah*-based commodity financing and liquidity management in the GCC countries and globally.

### xviii. Ratings and consistency

*Sukūk* is a new type of instrument which rating agencies generally are still trying to understand. Not many rating agencies have transparently disclosed or shared their rating methodology for *Sukūk,* raising concerns about whether *Sukūk* are duly and accurately evaluated based on their risk profiles.

Of course, a rating is not a recommendation to purchase, hold or sell *Sukūk*. *Sukūk* investors have to be cautious that, although a *Sukūk* issuer may endeavour to maintain its credit ratings, it will not be under any obligation to do so throughout the tenure of the *Sukūk* programme and there is no assurance that the ratings will remain in effect for any given period of time or that they will not be lowered or withdrawn entirely if circumstances in the future so warrant.

*Sukūk* investors should further be aware that in the event that the ratings initially assigned to the *Sukūk* are subsequently downgraded or withdrawn for any reason, no person or entity will be obligated to provide any additional credit enhancement with respect to the *Sukūk*. Any downgrade or withdrawal of a rating normally will not constitute an event of default or an event obliging the issuer to prepay the *Sukūk*.

While in most jurisdictions ratings for *Sukūk* are not mandatory, in Malaysia, for example, the regulatory framework places a strong emphasis on having a rating. Thus, institutional investors generally are required by their internal investment parameters to invest only in *Sukūk* with good ratings, while potential issuers are required under the Securities Commission's Guidelines to obtain a rating from a recognised rating agency (albeit exemptions can be applied for in very limited circumstances).

**Ratings of *Sukūk*: Case study of Malaysia**
There are two rating agencies in Malaysia, namely the Rating Agency of Malaysia (RAM) and Malaysia Rating Corporation (MARC); both have a lot of experience of rating *Sukūk* issuances in the country. Both have recognised that the methods employed in the rating of *Sukūk* are only slightly different from those used in evaluating the default risk of conventional debt instruments. The reason lies in the philosophy behind the introduction of Islamic financing instruments in Malaysia, whereby, for the most part, IIFS such as Tabung Haji have had few avenues to deploy funds. Conventional financial instruments contravene *Sharī`ah* principles, and this curtails investment opportunities. Therefore, the introduction of *Sukūk* was meant, more than anything else, to mobilise Islamic funds and increase their participation in the capital market. To this end, *Sukūk*

are designed to simulate conventional debt papers. In fact, purely from a cash-flow perspective, *Sukūk* in Malaysia are based on known conventional debt instruments.

**Rating analysis of *Sukūk***

Analysis of *Sukūk* is principally restricted to evaluation of the impact of the instrument on the financial risk profile of the issuing company. The business risk of a corporate is independent of the method of financing employed by that corporate.

Financial risk analysis is conducted by segregating the financial characteristics of the company into several categories and assigning scores to each category. The scores on what are deemed important categories, which may vary from case to case, will guide the overall financial risk marking to the level appropriate for the company undertaking the issue.

Generally, at rating agencies in Malaysia such as RAM and MARC, the financial characteristics that are looked at are:

1. Accounting systems
2. Trend analysis of past financial performance and a look at possible scenarios involving the following variables over the tenure of the debt instrument:
    i. Profitability
    ii. Financial leverage
    iii. Interest and debt coverage
    iv. Liquidity
3. Future cash flows:
    i. Stability
    ii. Adequacy
4. Financial flexibility

The type of *Sukūk* structures that the company uses will influence these characteristics, which will in turn influence the rating.

**Analysis of the financial characteristics**

<u>1. Accounting systems</u>

The focus in this area is to ascertain the extent to which accounts may be relied upon as an accurate indicator of the corporation's financial position. Ultimately, the aim is to arrive at a conclusion on the viability of using the accounts for rating analyses as they have been presented to the rating agencies. It is appropriate to restate the accounts in a manner that would be more meaningful for conducting a rating exercise. For example, accounting entries may need to be reclassified in order to facilitate a comparison between different companies in the same industry.

## 2. Past and future financial performance

Analysis of the financial performance will require a study of the track record and the likely future performance of the company. This analysis, taking into consideration the business and operating risk profile of the company, can be grouped under the following categories:

1. Profitability
2. Financial leverage (capital and debt structure)
3. Interest and debt coverage
4. Liquidity

### *i. Profitability*

There are essentially three bases against which profitability is measured. Ratios taking the following forms are generally used to measure the relative profitability of a company. They are:

- Net profit/Operating income
- Net profit/Shareholders' funds
- Net profit/ Total assets

The numerator, net profit, can be defined in such a way as to include or remove the impact of funding and investing costs. More popular definitions of net profit include:

- Gross profit (Operating income less Cost of sales);
- Operating profit before depreciation, interest and tax, or EBITDA in analyst parlance;
- Operating profit before tax; and
- Adjusted profit before tax (operating profit before tax plus other non-operating income).

Depending on which definition is used, different conclusions can be drawn in the rating agencies' analysis of a company's relative profitability.

### *ii. Financial leverage*

Rating agencies often use gearing ratios to analyse the riskiness of the funding structure of a company. The most often used ratios are related via the equation:

$$\frac{\text{Short-term debt}}{\text{Shareholders' fund+Minority interest (MI)}} + \frac{\text{Long-term debt}}{\text{Shareholders' fund+MI}} = \frac{\text{Total debt}}{\text{Shareholders' fund+MI}}$$

$$\text{Short-term gearing (x)} + \text{Long-term gearing(x)} = \text{Gearing(x)}.$$

In analysing financial leverage, the computation of total debt must take into account: (a) off-balance sheet liabilities – that is, contingent claims and possibility of crystallisation of these claims; and (b) treatment of certain quasi debt-equity items such as preferred stock with characteristics such as fixed redemption dates and dividend payments which ought to be treated as debt.

#### *iii. Coverage*

This area looks at the number of times that the fixed charges incurred by the company are being covered by its earnings. Some of these fixed charges include interest, lease rentals and preference dividends. Debt service coverage, or the ability of the company to service debt obligations falling within a one-year period, is also looked at.

#### *iv. Liquidity*

The analysis of the liquidity position of the company is subtler. Ratios can quite often be misleading, and rating agencies tend to eschew strict adherence to ratio benchmarks when considering liquidity. When considering how to mark the liquidity position of the company, it is paramount that short-term funding mismatches and avenues are considered to plug these differences.

### 3. Future cash flows

Rating agencies often look at stability and adequacy. A company's cash flow can be considered stable if it is not susceptible to large year-on-year fluctuations. Adequacy is a quantitative measure of the company's ability to finance the redemption of its debts vis-à-vis its cash-generating capacity.

### 4. Financial flexibility

If the projected cash flow looks like it is likely to fall short of the debt repayment requirements, then rating agencies examine the other avenues available to the company. Financial flexibility can come in the following forms:

- the ability of the company to secure borrowings to finance its debt obligations;
- the ability of the company to raise equity capital to finance its debt obligations;
- support from a parent company;
- ability to defer capital commitments; and
- reliance on the conversion of warrants which are issued together with the debt.

*Sukūk* come in various forms and are so diverse in their structure that it is not possible to adopt a general financial risk-rating approach for all of them. Rating agencies make general observations on broad classes of debt instruments to assess their impact on the financial risk categories defined earlier.

## *F. Examples of Effective Islamic Financial Market Regulation*

For a legal and regulatory framework for the Islamic financial markets to be considered effective, it is submitted that it should be able to uphold the rule of law and meet certain formal, institutional and procedural criteria.[170] This means the framework generally needs to incorporate the following three elements:

1. The presence of legally binding rules. These substantive rules should be promulgated to the masses in advance and be clear, stable and coherent. Modification of these rules should be guided by law according to disclosed and fair procedures.
2. The existence of appropriate processes for rule-making, rule-enforcing and rule-changing. There should be clear procedures on how laws and rules are being enacted, enforced and changed.
3. The existence of well-functioning public institutions applying the laws fairly and independently.[171]

An effective legal and regulatory framework that caters for the growth and sustainability of Islamic financial markets actually needs to take into consideration various issues that may not be so relevant to its conventional counterpart, in addition to other similar concerns about the soundness and stability of the financial system. There are at least three common hurdles in establishing an effective legal and regulatory framework for the market:

1. Ensuring a harmonised interface between *Sharī`ah* principles, which form the backbone and *raison d'être* of the Islamic financial services market, and the existing legal framework.

Countries have had varying degrees of success in attracting Islamic financial activity. However, in those that have succeeded, at least in some measure, their legislators and regulators have had to evaluate and understand the intrinsic differences in philosophy and emphasis behind each right and obligation in Islamic financial contracts, compared to conventional banking and finance. It is even necessary, as we have seen, to oversee the alignment of macro and micro development of the Islamic market with the *Maqāsid* (objectives) of *Sharī`ah*, which includes preservation of religion, life, intellect, honour and wealth.

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[170] See N.N. Thani and A. Othman, "The Effectiveness of Legal and Regulatory Framework for the Islamic Financial Services Industry", *Islamic Finance: Global Legal Issues and Challenges*, (2008) IFSB.

[171] See further Amr Daoud Marar, "Saudi Arabia: The Duality of the Legal System and the Challenge of Adapting Law to Market Economies", 19 *Arab Law Quarterly* (2004) No.1 and 2 at pp.100–101, citing Ibrahim Shehata, "Good Governance and the Role of Law in Economic Development", in A. Seidman, R. Seidman and T. Walde, *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance*, (1999) Kluwer Law International; and "The Role of Law in Business Development", 20 *Fordham International Law Journal* (1997) 1577.

The existing legal definitions of banking and financial services often do not recognise Islamic financial transactions due to their nature as trade and investment vehicles. Consequently, as we have pointed out, many constraints and, indeed, difficulties are to be expected if the country's general laws are to be applied directly to Islamic financial transactions and services.

2. Implementing a tax regime that does not penalise consumers of Islamic financial services

In many jurisdictions, taxation laws have been developed in a fragmented and often pragmatic manner. As we have seen, until relatively recently, in relatively few jurisdictions has any real thought been given to better accommodating Islamic financial transactions and services. This is not a criticism, because until recently Islamic finance was not a major issue, particularly in non-Muslim societies. The practices which are commonly adopted as Islamic financing modes, such as sale and purchase, leasing and profit-sharing investments, would most unlikely be recognised as financing activities as opposed to direct lending and borrowing under these laws. Consequently, the structuring of Islamic financial instruments, which often comprise multiple transactions and additional parties compared to conventional ones, will almost always attract higher taxation. This means higher costs of operation for providers of Islamic investment services, making it difficult for them to compete on an equal footing with conventional businesses. Moreover, it unfairly penalises the consumers of Islamic financial products who simply wish to meet their financial needs while complying with certain ethical principles to which they subscribe. It follows that relevant supervisory authorities need to proactively consult and convince the relevant tax authorities to ensure that a neutral tax treatment should apply to Islamic financial transactions so that the Islamic financial services industry is not be at a competitive disadvantage.

3. Strengthening the sustainability and competitiveness of the Islamic financial services industry as a business

The increased use of information and communication technology (ICT) in the global financial sectors is another factor of immense practical importance. Participants in the Islamic financial markets need to be ICT-literate so that they can provide more efficient services, expand their customer base and take full advantage of global markets.

We have already laboured the point that the existing areas of uncertainty in Islamic financial law exacerbate the problems for those operating in the sector. This is a particular problem when the relevant issues arise in a non-Islamic jurisdiction, but need to be resolved in accordance with the *Sharī`ah.* With these common hurdles in mind, countries developing their Islamic financial markets, or those planning to do so, must ensure that their legal and regulatory framework includes the necessary measures to ameliorate these difficulties.

The *Report on Islamic Finance and Global Financial Stability* (April 2010) prepared by the joint task force established by the IFSB and the Islamic Development Bank (IDB) observes that the distinctions and value propositions inherent in the Islamic financial model have proven to be more resilient during the recent global financial crisis (GFC), whereby:

1. Finance can only be extended to projects, trade, economic and commercial transactions. Financial assets can therefore grow in proportion to the growth in real economic activities and hence minimise the possibility of excessive leverage.
2. “Don’t sell what you don’t have” is one of the fundamental principles of *Sharī`ah*, which restricts the possibility of excessive speculation, especially through short selling.
3. Investments in public and private equities have to pass a set of screening processes where social and ethical responsibilities are an integral part of investment decisions.
4. Preserving genuine liquidity (as opposed to synthetic liquidity) further adds to the stability of IIFS.
5. Managing procyclicality (such as dynamic provisioning) is strongly encouraged where the concept in fact has been narrated in the *Qur’ān*.

Nevertheless, due to its close connection with real economic activities, Islamic finance is not entirely immune from the impact of the GFC as the global economy has also deteriorated. In particular, the *Sukūk* market is experiencing massive defaults for the first time, and uncertainties over how Islamic financing can be restructured or recovered due to the largely untested legal framework have contributed to a slowdown in *Sukūk* issuance.

Among the incidents affecting investors’ confidence in *Sukūk* include:[172]

- the proclamation by a prominent *Sharī`ah* scholar, Sheikh Taqi Usmani of Pakistan who also chairs the *Sharī`ah* Board of AAOIFI, that 85% of non-*Ijārah Sukūk* issues were not actually in compliance with the *Sharī`ah*;
- defaults on *Sukūk* obligations starting to take place, among others involving The Investment Dar and Global Investment House, two major investment houses in Kuwait, East Cameron Partners in the US, and Golden Belt/Al-Saad Group of Saudi Arabia; and
- one of the largest *Sukūk* issues, US$3.52 billion issued by Nakheel (a company owned by the government of Dubai), required a bail-out programme in order to avoid default.

Furthermore, if we examine the recent defaults of *Sukūk* and bonds, they are by no means unique to the past financial crisis. Similar traits were present in the following cases:[173]

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[172] See *The Zawya Collaborative Sukuk Report* (February 2010).
[173] See “Mega *Sukuk* Default – Acid Test for Islamic Finance?”, *Malaysian ICM* (December 2009).

- Property bubble: The ample liquidity driven by petro-dollars receipts had channelled funds to finance infrastructure and properties – a preferred *Sharī`ah* choice for investments. This scenario of a property bubble was no different from the mortgage crisis in the US.
- Large single exposure to a single group: If financing was grouped, it ultimately led to a single entity. The banks relied on implied government support. Still, the banks were overzealous, considering the magnitude of the financing.
- Reliance on foreign liquidity: Enormous liquidity was being channelled into the GCC market. It was thought that petro-dollars would sustain any negative economic elements. It was unfortunate that the steep decline in petrol prices played a role in some of the banks' failings.

Nonetheless, an inherent problem for *Sukūk* that had never been severely tested until recently is the legal framework – or the lack of it. In some jurisdictions, there is a misconception that *Sukūk* investors have proprietary rights. Most *Sukūk* have purchase undertakings with rights reverted back to the obligor on maturity or default, to enable the creation of an "amount owing" to investors. Thus, in reality, asset-based *Sukūk* do not grant investors absolute proprietary rights over the assets but, instead, beneficial ownership. The legal standing of investors is, therefore, akin to that of creditors.

Where the legal framework is unclear, complexity arises, such as when a *Muḍārabah* or *Mushārakah* issuer is not generating profit. If *Sharī`ah* principles are to be adhered to, then the originator or obligor should not have to pay investors because there are no profits to be distributed. For *Ijārah* structures, when the issuer is unable to pay lease-rentals, investors may have a problem of disposing of the assets if the beneficial interest cannot be enforced. Issuers could take the initiative to explore all options; for example, the lack of standardisation means that default interest may not be contractually payable, or it could lead to non-payment of such "challengeable" profit-payments. In most cases, however, the obligation is clear and unambiguous – the obligations are subject to civil code jurisdictions where the *Sharī`ah* may be incorporated as a source of law, but is not the governing law applicable to commercial transactions – and, ultimately, enforcement under local law is required.

Islamic instruments and markets have, indeed, shown a dramatic expansion over the recent past and continue to generate strong interest by new issuers and investors, in Muslim and non-Muslim countries alike. Given the existing intensity of investor interest in *Sharī`ah*-compliant assets, and the relative resilience of the Islamic financial services industry in surviving the financial tsunami, the potential of Islamic instruments and markets is likely to strengthen, especially given increasing opportunities from financial innovation. While the continuous growth of overall *Sukūk* issuance is expected to be somewhat depressed in response to the fallout from the US sub-prime markets crisis and the legal uncertainty surrounding the recent *Sukūk* defaults, sovereign *Sukūk* especially are likely to gain in popularity as more governments in both Muslim and non-Muslim countries explore options for diversifying their traditional debt portfolios. The latest examples of this trend are efforts in Japan and Thailand to establish a *Sukūk* issuance program and Indonesia's law on Islamic debt financing (April 2008), which positions the government well to fund large parts of its budget deficit by issuing *Sukūk*.

That said, some critical constraints arising from continued legal uncertainty and regulatory divergences still need to be overcome. As issuers weigh the costs and benefits of *Sukūk* issuance in a broad policy context, continued efforts will be required to overcome a series of economic, legal and regulatory issues. In this regard, the lessons learned from both seasoned and newer issuers and investors provide valuable guidance going forward. The positive market response to current standard-setting initiatives aimed at curbing concerns about contract enforceability caused by diverse interpretations of *Sharī`ah* principles is encouraging, but future growth of global *Sukūk* issuance will depend on how easily these new structures are accepted and understood.

## *G. Case Studies*

Hitherto in our discussion of the legal and regulatory issues pertinent to the development of sound and efficient markets and service in *Sharī`ah*-compliant investments, we have referred to specific jurisdictions as and when relevant by way of example. As we have already pointed out, there is a great diversity of experience and, indeed, approach even in those jurisdictions where the *Sharī`ah* is applicable law. The situation is further complicated by the complex relationship, which we have attempted to explore, between different legal systems and within a legal system between the *Sharī`ah* and the ordinary law. Consequently, even in the context of our survey, it is difficult and on occasion problematic to attempt generalisations on the basis of observations and comments that may not always be properly or comprehensively placed in their legal and institutional context. Therefore, we have presented three country case studies to assist in the clarification of the general and specific issues that we address in this study. In selecting Malaysia, Indonesia and the UAE, we have attempted to cover a spectrum of development and diversity.

### i. Case 1: Malaysia[174]

As a leading international hub for Islamic financial services, among others, proven by its dominance over 60% of the world *Sukūk* market, Malaysia has always been seen as a jurisdiction that has successfully established its own unique model and set new benchmarks for the regulatory and supervisory framework for Islamic financial market. Albeit very rarely mentioned, indeed, the success of the Malaysian model is even more outstanding considering that, compared to other Islamic countries which are members of the OIC, it is a truly diverse nation in terms of race, culture and religion, and its Muslim populace control less than 30% of the nation's wealth.

[174] See M. Hussain, "Regulatory and Supervisory Approach: The Malaysian Model", *The Global Islamic Finance Report 2011*, (2011) BMB Islamic.

This section summarises the Malaysian model of regulating and supervising Islamic financial markets, covering its historical development, strategic framework and foreseeable trends, moving forward.

**The Malaysian regulatory and supervisory approach**

For the purposes of this section, “the Malaysian regulatory and supervisory approaches” refers to the various frameworks purposefully and strategically put in place by the respective Malaysian authorities to deal with specific areas such as: the licensing of Islamic finance institutions; requirements for capital adequacy, risk management, *Sharī`ah* compliance and corporate governance among institutions in the Islamic financial market; and the establishment of infrastructures such as capital and money markets, dispute resolution forums and talent enrichment institutions, as well as short-, medium- and long-term strategies for the Islamic financial services industry generally. This conceptual understanding is important to ensure that one appreciates and recognises the complex and sophisticated interface between different levels of the regulatory and supervisory frameworks for the Islamic financial market in Malaysia. These frameworks are developed through cooperation between different bodies and agencies, including:

- *statutory authorities*, such as the Ministry of Finance (MoF), Bank Negara Malaysia (BNM – the central bank), Securities Commission of Malaysia (SC), Labuan Financial Services Authority (Labuan FSA) and the Inland Revenue Board (IRB);
- *exchange authorities*, such as Bursa Malaysia (BursaMal) and Labuan Financial Exchange (LFX); and
- *self-regulatory bodies and industry associations*, such as Association of Banks in Malaysia (ABM), Association of Islamic Banking Institutions Malaysia (AIBIM), Malaysian Investment Banking Association (MIBA) and Malaysian *Takāful* Association (MTA).

As may be observed in the later sections, the regulatory and supervisory approaches for the Islamic financial market in Malaysia have been developed with clear strategic objectives, including among others:

- ensuring public confidence in the soundness and competitiveness of the Islamic financial system;
- meeting local needs without compromising on international standards and best practices;
- addressing the market’s various short-term and long-term needs, depending on the stage of its development;
- providing a conducive environment for business development and talent enrichment; and
- expanding the width and depth of the industry through internationalisation of local players and liberalisation policies that attract the participation of foreign players.

**Historical development**

The story of Malaysia's development is both interesting and instructive. Although Malaysia's first fully *Sharī`ah*-compliant financial institution – Tabung Haji (the Pilgrimage Fund) – was established as early as 1963, a real drive towards establishing the infrastructures needed for a proper Islamic financial services industry to flourish only began about 20 years later, marked by the enactment of an Islamic Banking Act (IBA) in 1983. From then onwards, the framework for the Islamic financial services industry in Malaysia underwent three main phases of development.

***First phase: 1983–1992***

Early initiatives were focused on building the necessary legal and infrastructural foundations that would enable Islamic Banking and Finance (IBF) to be gradually introduced and developed without causing any disruption to the existing conventional banking system. As opposed to (for example) Iran, Pakistan and Sudan, which attempted to "Islamise" the whole financial system through radical reforms at around the same period, Malaysia deliberately opted for a dual-banking system approach whereby IBF can co-exist with its conventional cousins and offer an alternative range of products and services to the Malaysian people. When the IBA was enacted, it was not only Malaysia's first piece of Islamic banking legislation but was unique in the world. The *Takāful* Act 1984 followed a year later, which again marked the first legislation in the world tailor-made to govern the *Takāful* business.

During this period, Bank Islam Malaysia Berhad (BIMB) was the only full-fledged Islamic bank; a second full-fledged Islamic bank, Bank Muamalat Malaysia Berhad (BMMB), was only licensed in 1999. Although it seems as if the government deliberately granted a monopoly to BIMB to dominate the Islamic financial services market throughout those years, it was also possible that the authorities simply wished to ensure that they had an adequate understanding of the business model of an IBF institution before increasing the numbers of such institutions in the market.

***Second phase: 1993–2000***

Within ten years after BIMB was established, more than 20 Islamic banking and financial products became available in the Malaysian market. Consequently, the authorities considered the Islamic financial services market was ready for the second phase, which was designed to increase the number of players, thereby adding more competition as an incentive to improve efficiency and enhance the viability of the market. This phase witnessed, among other initiatives:

- permission granted to conventional banks in 1993 to offer Islamic banking and financial products and services through a "window" concept known initially as the "usury-free banking scheme" and later as the "Islamic banking scheme". Although the Islamic "window" branches are owned by conventional banks, the operation and sources of funds of the "window" operations are completely separated from those of their holding conventional banks;

- the development of an Islamic capital market marked by the issuance of the first Islamic securities (now more popularly known as *Sukūk*) by Shell MDS in 1990; and
- the establishment of a National *Sharī`ah* Advisory Council (NSAC) at both the SC and BNM (in 1996 and 1997, respectively).

The opening of Islamic "windows" by conventional banks was made possible legally as a result of a legislative amendment; specifically, section 124 of the Banking and Financial Institution Act 1989 (BAFIA). This provision is consistent with the Government Investment Act 1983 (GIA), which was introduced earlier, and section 129 of the Development Financial Institution Act 2002 (DAFIA), which was introduced later.

By 1994, Malaysia had advanced its Islamic financial market to the next step by setting up the Islamic Interbank Money Market to enable transactions in the wholesale money market on an Islamic basis.

***Third phase: 2001–2010***

The third phase of the Islamic financial services industry in Malaysia saw it making concerted and dedicated initiatives towards becoming a truly global Islamic financial centre. Two strategic documents, namely the BNM's Financial Sector Master Plan (FSMP) and the Securities Commission's Capital Market Master Plan (CMMP), were intended to be roadmaps for the following decade. Their common intention is to promote Islamic banking and finance, together with the Islamic capital markets, into the mainstream of Malaysia's economy. Among other actions, the plans aimed at:

- the liberalisation of the market through licensing of foreign Islamic banks;
- the launch of the Malaysia International Islamic Financial Centre (MIFC) initiative, which is a community network of financial and market regulatory bodies, government ministries and agencies, financial institutions, human capital development institutions and professional services companies that are participating in the field of Islamic finance with the aim of positioning Malaysia as the preferred international Islamic finance hub;
- the selection of Malaysia to be the host country for the Islamic Financial Services Board (IFSB) and the International Islamic Liquidity Management Corporation (IILM), which are two supranational organisations critical to the development of the global Islamic financial services industry;
- the setting up of the Malaysian Deposit Insurance Corporation (MDIC), which also covers Islamic deposits; and
- the establishment of various talent development and research institutions dedicated to IBF, including the Islamic Banking and Finance Institute Malaysia (IBFIM), the International Centre for Education in Islamic Finance (INCEIF), the International *Sharī`ah* Research Academy for Islamic Finance (ISRA), the Securities Industry Development Corporation (SIDC) and the SC's ICM-Capital Market Development Fund initiatives.

Notwithstanding intense and high-calibre competition from other financial centres around the world aspiring to be the preferred hub for Islamic finance, Malaysia has so far, in the perception of many, been able to remain at the forefront in the provision of Islamic financial services and products.

**Strategic framework**

As aforementioned, Malaysia has adopted a "dual" financial system that allows harmonious co-existence of an Islamic financial system alongside the conventional financial system. In this respect, the authorities attempted to provide for the Islamic financial services industry an enabling legal framework, whereby anything that the conventional system offers has an Islamic parallel or alternative. This is evident by the introduction of separate legislation and regulations to cover matters of a similar nature, as reflected in Table 3.2.

**Table 3.2 Laws and Regulations for Conventional and Islamic Financial Products/Systems in Malaysia**

| **Laws and Regulations** | |
|---|---|
| **For conventional products/system** | **For Islamic financial products/system** |
| BANKING AND FINANCE BUSINESS | |
| • Banking and Financial Institutions Act 1989 (BAFIA) | • Islamic Banking Act 1983<br>• Section 124 of BAFIA and section 129 of DFIA permits the establishment of Islamic "windows". |
| • Development Financial Institutions Act 2002 (DFIA) | |
| Malaysia Deposit Insurance Corporation Act 2005 (MDICA) also covers Islamic deposits. | |
| INSURANCE BUSINESS | |
| • Insurance Act 1996 | • *Takāful* Act 1984 |
| CAPITAL MARKET ACTIVITIES | |
| • Guidelines on the Offering of Private Debt Securities | • Guidelines on the Offering of Islamic Securities |
| • Guidelines for Real Estate Investment Trusts (REITs) | • Guidelines for Islamic REITs |
| Guidelines on Unit Trust Funds and Guidelines on Exchange-Traded Funds contain specific requirements for Islamic unit trust funds and ETFs. | |

The importance and clarity of the law and regulations as listed above cannot be over-emphasised, because they form the backbone of every aspect of Islamic financial market operation in Malaysia. In other words, the development of activities of every Islamic financial services player is guided and dictated by the strong backing of law and regulations, leaving nothing to mere assumptions and/or chance. The emphasis is on certainty and clarity.

**Strengths and advantages of the Malaysian model**

In addition to its ability to grow the Islamic financial market sector amidst a very diverse populace and within an economic environment strongly dominated by non-Muslims, which are daunting challenges on their own, it is also worth mentioning that the Malaysian model has proven its resilience in the wake of two financial crises – namely, the Asian financial crisis in 1998 and the recent global financial crisis. The Malaysian model has gone from strength to strength and can provide useful benchmarks for other jurisdictions that aspire to develop their own Islamic financial market. The strength and advantages of the Malaysian model are numerous and each may deserve a lengthy analysis; however, the more obvious advantages of the Malaysian model are summarised below.

***Sound and clear Sharī`ah compliance and governance framework***

The existence of a structured and powerful National *Sharī`ah* Advisory Council (NSAC), initially concerned to ensure clarity in terms of *Fiqh al-Muamalat* practices, but today possessing the authority as a final arbiter on *Sharī`ah* issues in any commercial disputes arising from Islamic financial contracts,[175] places the Malaysian model in a unique position to ensure coherence and validity of pronouncements by *Sharī`ah* scholars. In most other jurisdictions, the status of *Sharī`ah* pronouncements for Islamic financial contracts remains vague and ambiguous when it comes to enforcement under the law.

***Tax accommodations***

As we have already seen, in Malaysia there has long been awareness of the dangers of additional or inappropriate taxes rendering Islamic products uncompetitive. The tax authorities, namely the MoF and the IRD, have always cooperated with BNM and SC to ensure that, in a worst-case scenario, there will be tax neutrality between what has to be paid under an Islamic finance transaction and what would be paid under a conventional financial transaction. In certain best-case scenarios, special tax incentives – including remittances and rebates – are given to encourage the use of IBF structures by market players.

***Strong credit-rating framework***

In addition to recognising international rating agencies, Malaysia has two local credit-rating agencies – namely, Malaysia Rating Corporation Berhad (MARC) and Rating Agency Malaysia (RAM). As noted earlier, the major institutional investors such as Employees Provident Fund (EPF), Permodalan Nasional Berhad (PNB) and Tabung Haji have strict investment parameters that permit them to invest only in high-quality

[175] Under a new Central Bank of Malaysia Act 2009 that replaces the Central Bank of Malaysia Act 1959, a provision under section 57 has been inserted to require the court and arbitrator to refer questions on *Sharī`ah* matters arising from any Islamic banking and finance disputes to the NSAC and accept the pronouncement of the NSAC in response to such reference as binding upon them. Similarly for disputes arising from the Islamic capital market contracts, the new section 316 of the Capital Markets and Services Act 2007 replicates such powers for the *Sharī`ah* Advisory Council of the SC.

instruments. This forces the issuers to observe rating requirements in order to be able to tap funds from the strong state-managed funds.

High-quality issuers may apply to BNM for approval for their *Sukūk* to qualify as Tier 2 capital under the BNM capital adequacy regulations. AAA-rated issuers may issue under the “exempt/deemed approved” regime.

The Securities Commission’s Practice Note on Recognition of Credit Rating Agencies (CRAs) (January 2006) incorporates the IOSCO’s Code of Conduct Fundamentals for Credit Rating Agencies. The recognition system seeks to ensure that CRAs exercise high standards of professionalism and due diligence in rating and monitoring corporate bonds, and provide adequate and timely dissemination of rating information.

***Certainty and predictability of dispute resolution outcomes***

By virtue of the common law system inherited from the British Empire, the Malaysian courts apply the doctrine of judicial precedent and publicly report landmark decisions, therefore facilitating the development of certainty and predictability of dispute resolution in Islamic finance cases. Malaysia has a Reciprocal Enforcement of Foreign Judgments Act, which generally recognises the decisions made in courts of other common law jurisdictions such as the UK, Hong Kong and Singapore. Consequently, there is certainty and predictability as to the enforceability of judgments obtained from the courts in these jurisdictions, including matters involving Islamic financial products and services. Malaysia, most importantly, has a clear insolvency regime that permits speedy debt recovery and liquidation of assets, including for IIFS.

To add further depth to these capabilities the Kuala Lumpur Regional Centre for Arbitration (KLRCA) provides a convenient alternative dispute resolution platform by having a specific rule to govern dispute settlement involving Islamic finance matters. The Rules for Arbitration (Islamic Banking and Financial Services) 2007 was specially drafted and introduced to provide a customised platform and mechanism for the resolution of disputes in the Islamic financial services sector.

***Talent enrichment and thought leadership infrastructures***

Central to its ambition to be a preferred international Islamic financial centre, Malaysia appreciates the importance of ensuring that its Islamic financial market sector is supported by a sizeable pool of competent human capital. It has established numerous unique institutions dedicated to talent enrichment and thought leadership, including:

<u>2001: Islamic Banking and Finance institute Malaysia (IBFIM)</u>

This institution is one of a kind. It is owned by the IBF institutions and its primary role is to provide continuous training and consultancy services. It focuses on programmes related to Islamic banking and finance, as well as Islamic capital markets. IBFIM’s mandate can be best described by referring to the FSMP, in which it is stated that the role of the IBFIM is as follows: “to increase the pool of bankers and *Takāful* operators who are knowledgeable and competent, efforts will be directed to promote human capital development to support the envisaged growth of the industry via establishing an industry-owned institution on Islamic banking and finance dedicated to train and supply a sufficient pool of Islamic bankers and *Takāful* operators as required by the industry. Similarly the CMMP mentions that IBFIM is to develop local expertise to ensure the availability of a pool of skilled professionals who are well-versed in Syariah matters and are able to provide a range of relevant high quality value-added advisory and intermediation services. “

### 2003: International Centre for Leadership in Finance (ICLIF)

BNM realises that there is a need to start grooming and supplying leaders for the country’s Islamic financial services industry, especially if it wishes to see Malaysia become a world-class Islamic finance hub. Hence, it introduced a well-structured development programme focusing on leadership capacity building for financial institutions and business corporations known as ICLIF. ICLIF is mandated to provide training and development programmes for young and intermediate leaders by offering two- to four-week courses. The programmes are designed to address specific needs – for instance, for mid-level managers who are expected to be promoted in the near future. ICLIF is supported with resources from various prestigious institutions around the world, including Harvard Business School, Stanford Graduate School of Business, Drucker School of Management, University of California Los Angeles (UCLA) and University of California at Berkeley (UC Berkeley).

### 2006: International Centre for Education in Islamic Finance (INCEIF)

INCEIF is a university offering expertise and postgraduate education in various related disciplines in Islamic financial services and the Islamic financial market. Students come from a number of countries and not just Malaysia. INCEIF graduates are trained to become professionals in Islamic finance. Its programmes are offered at three levels: a Chartered qualification, Masters and PhD. INCEIF received a generous grant of RM500 million from the Malaysian government to realise its vision to become the knowledge leader in Islamic finance industry worldwide. While having done much, it remains to be seen when this ambition will be convincingly achieved.

### 2008: International *Sharī`ah* Research Academy for Islamic Finance (ISRA)

Unlike the above institutions, which focus on developing human capital, ISRA was established to provide and enhance literature and research on *Sharī`ah* and *Fiqh al-Muamalat*. It provides an international platform to encourage discourse among *Sharī`ah* scholars, academicians, regulators and practitioners. To date, it has organised many programmes and published various materials on the IBF industry.

***Depth and width of its capital market***

Following the Asian financial crisis at the end of 1990s, the Malaysian authorities recognised that one of the weak links within its financial system was the heavy dependence of the economy on borrowing from financial institutions to spur further growth. Since then it has consciously developed its capital market, including the Islamic segment. Bonds and *Sukūk* issued in the local currency, Ringgit Malaysia (**RM**), have developed their own strength and reputation, enabling issuers whether local or foreign to raise capital and make investments in a cost-efficient manner. Thus, the RM *Sukūk* market was hardly impacted upon (notwithstanding the slowdown and difficulties in the *Sukūk* markets elsewhere) during the recent global financial crisis.

***Deposit insurance protection***

Malaysia is the only country in the world with a deposit insurance corporation that covers both conventional and Islamic deposits. The innovation made by the MDIC in this respect has clearly helped in strengthening public confidence in IIFS.

**A word of caution**

Notwithstanding its relative success, and thus its attraction as a model for other countries, the Malaysian model arguably requires a consistent, stable and strong political leadership with clear objectives. Fortunately for the development of Islamic financial services and products, Malaysia has managed to achieve this over what is now a considerable period. It remains to be seen whether the Malaysian Islamic financial services industry and market can remain robust and vibrant if the government decides to take more of a backseat and leave the next stage of development entirely to the market players and consumers. As it has deliberately decided to adopt a “dual” financial system, the Islamic financial market sector in Malaysia is also under constant pressure to remain competitive compared to its conventional counterpart and, hence, it also remains to be seen whether the Islamic financial market players can withstand such pressure without the intervention of a helping hand from the authorities in the form of regulatory “green lane” or tax incentives.

**Foreseeable trends, moving forward**

***Law Harmonisation Committee***

The BNM has established a Law Harmonisation Committee, chaired by the highly respected former Chief Justice of the Federal Court of Malaysia, Tun Abdul Hamid Mohamad. The Committee is established with the following objectives:

- to create a conducive legal system that facilitates and supports the development of the Islamic finance industry;
- to achieve certainty and enforceability in the Malaysian laws in regard to Islamic finance contracts;
- to position Malaysia’s laws as the reference law for international Islamic finance transactions; and
- for Malaysian laws to be the law of choice and the forum for settlement of disputes for cross-border Islamic financial transactions.

We have already noted that this is in the current context of English law being the preferred reference law for international Islamic finance law, supported by the perception of documentary and practical pre-eminence of lawyers in the City of London. Consequently, the objective of the Committee is arguably very ambitious. Considering that English law has a long tradition of being the reference law for international contracts and English courts command enormous respect in the international arena for their impartiality and independence, there are many reasons for people to be sceptical as to the viability of the Committee's aspirations.

On the other hand, if Malaysia is simply offering a value proposition whereby parties to an international Islamic finance contract are comfortable that:

- the jurisdiction is neutral and impartial to all parties in the contract;
- the Malaysian law offers absolute certainty and predictability with regard to *Sharī`ah* issues, as the NSAC is the final arbiter on such matters – which no other jurisdictions can offer; and
- the Malaysian courts and arbitration centre are competent in dealing with disputes arising from Islamic finance contracts;

then, the possibility exists of making Malaysian law the reference law of choice in an Islamic financial contract. In fact, it would be an interesting and valuable proposition to have a set of governing laws that are evidently more accommodating than English law in order to help parties to an Islamic financial contract resolve their disputes in a more predictable manner, especially from the perspective of the *Sharī`ah*.

***Initiatives to govern the Sharī`ah scholar profession***

ISRA has announced its plan to come up with the first global certification for *Sharī`ah* scholars, seeking to bolster the industry's reputation and make it easier for banks to find qualified advisers. We have already remarked on the fact that the *Sharī`ah* compliance and governance framework in Malaysia is already highly regulated – at least compared to anywhere else in the world – with the BNM and SC each issuing specific guidelines on the appointment of members of a *Sharī`ah* committee and imposing various fit and proper requirements comparable to any other regulated profession.

Through its annual *Muzakarah Cendekiawan Sharī`ah Nusantara* (Regional *Sharī`ah* Scholars Symposium), ISRA is progressively building consensus among scholars in the South-East Asia region. If ISRA manages to build on this and expand the scope and strength of the dialogue platform to other parts of the world, especially in the Middle East and Africa, there is a higher possibility for this initiative to turn into a more globally accepted professional association of *Sharī`ah* scholars that can provide a recognised certification and governance regime for this important group of gatekeepers in the Islamic financial services industry.

It is well acknowledged that the *Sharī`ah* profession is largely fragmented into various schools of thought. We have already noted the problems that arise as a result of differences in interpretation and even application of the law. Consequently, it remains problematic as to whether standardisation of *Sharī`ah* best practices for the global Islamic financial services industry is achievable in the relatively near future. However, ISRA has the appropriate government backing and a strong team that has already achieved much in establishing a respected forum in the international arena. Hence, there are reasons to be optimistic that it can contribute positively towards establishing a better regime for the *Sharī`ah* scholar profession in the future.

Furthermore, in October 2010, BNM issued the *Sharī`ah* Governance Framework for Islamic Financial Institutions (2011) "in light of the new developments in Islamic finance as well as higher expectation of the key stakeholders of the Islamic financial institutions pertaining to the *Sharī`ah* compliance process". The objective of this new framework is to strengthen the *Sharī`ah* governance framework of the Islamic financial institutions for them to attain a "*Sharī`ah*-based operating environment". This new Framework, which takes effect from 1 January 2011, replaces the Guidelines on the Governance of *Sharī`ah* Committee for the Islamic Financial Institutions of 2004.

**Conclusion**

Malaysia has shown that, with proper planning and effective strategies, it has managed to overcome many challenges in developing its Islamic financial services industry and market, including more-or-less withstanding two devastating periods of financial crisis. It has undertaken thoughtful and carefully calculated proactive as well as reactive steps in bringing Islamic finance as a value proposition to the global stage. Its ability to establish cutting-edge regulatory and supervisory frameworks that cater to local needs, but also meet emerging international demands, is certainly commendable. If there is a single lesson that can be summarised from its long and occasionally arduous journey to establish itself as a leading Islamic financial centre, it is the fact that it continuously learns to adapt its regulatory and supervisory approaches to the challenges it faces and innovates expeditiously and generally wholeheartedly.

### ii. Case 2: Dubai[176]

Dubai has seen a rapid development of its financial markets throughout the last decade, but nevertheless it is still a relatively young jurisdiction. Having said this, the Dubai Islamic Bank – established in 1971 – was the world's first modern Islamic bank. Hence, Dubai may be justifiably proud of being among the pioneers when it comes to the development of the Islamic financial services industry.

Recent events have had a significant impact on the reputation of Islamic financial products and services which may or may not have long-term implications. On 25 November 2009, the financial world was shocked when a company owned by the

[176] For more case studies on *Sukūk* issued in Dubai, see M.J.T. McMillen, "Asset Securitization *Sukuk* and Islamic Capital Markets: Structural Issues in these Formative Years", *Wisconsin International Law Journal,* Vol. 25, No. 4 (2008). Also see Omar Salah, "Dubai Debt Crisis: A Legal Analysis of the Nakheel *Sukuk*", *Berkeley Journal of International Law*, Vol. 4 (Spring 2010).

Government of Dubai called Dubai World requested a restructuring of US$26 billion in debts.[177] The restructuring request caused much distress among the *Sukūk* holders, because in the view of certain lawyers acting for Dubai World and its creditors the *Sukūk* holders would probably not be able to rely on the level of protection they had expected. This raised questions about the soundness of *Sukūk* structures and the legal issues underlying these structures. Although, until November 2009, the impact of the credit crisis on the Islamic financial markets had seemed rather small, this incident changed the whole world's perception as to the reliability and soundness of Islamic markets.

It is important to realise, however, that in reality the problems had little to do with the financial industry in Dubai. The main legal issues had nothing to do with the Islamic financial structure underlying the Nakheel *Sukūk*; the predominant legal concerns were more inherent to the legal system of the UAE.[178] In common with the other jurisdictions in the GCC, the UAE and Dubai legal system is largely a civil law system, albeit based on *Sharī`ah*. We shall see later in this discussion that, besides the lack of several important legal and regulatory devices to accommodate *Sukūk* issuance, such as the lack of an effective trust law framework and the restrictions on transferability of properties to non-citizens, the expansion of the *Sukūk* market in Dubai prior to the global financial crisis was mainly driven by real estate projects and hence was directly linked to an asset bubble.

**Regulatory framework**

In Dubai, investors need to be aware of the application of two different sets of regulatory schemes – namely, the UAE-wide framework and the framework under the Dubai International Financial Centre (DIFC). In this respect, there are three regulatory and supervisory authorities who oversee the financial markets in Dubai – namely, the UAE Central Bank, the Emirates Securities and Commodity Authority (ESCA) and the Dubai Financial Services Authority (DFSA).

***The DIFC***

In 2002, the Dubai government issued a decree to establish DIFC and established an independent regulatory and supervisory authority for DIFC, the DFSA. DIFC is an onshore financial centre, offering a convenient platform for leading financial institutions and service providers. DIFC has been established as part of the vision to position Dubai as an international hub for financial services, and as the regional gateway for capital and investment.

The DFSA regulates all financial and ancillary services conducted in or from the DIFC; as well as licensing, authorising and registering businesses to conduct those services. The DFSA's regulatory framework was developed by a team of experienced regulators

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[177] This debt standstill caused much disturbance in capital markets and became known as the "Dubai Debt Crisis". The main concern was the delay in the repayment of the US$4 billion *Sukūk*, of Dubai World's developer Nakheel, which was especially known for the construction of the Dubai Palm Islands.

[178] See Omar Salah, op cit.

and legal experts drawn from internationally recognised regulatory bodies and major financial institutions around the world and is based on the practices and laws of the world's leading financial jurisdictions.

The DIFC laws are exceptional in that they form a separate framework based on the English common law system, in order presumably to provide more comfort for international financial institutions and players. The DIFC even has its own court staffed by international judges. Its legal system therefore attempted at departing from the existing UAE and Dubai legal system which is a civil law system based on *Sharī`ah.*
An example of the DIFC's attempt at providing a more conducive legal environment to support the growth of an Islamic financial market is that, while the UAE and Dubai law does not have any trust law framework, the DIFC itself has published a dedicated framework for the registration of special-purpose vehicles for *Sukūk* issuers with all the trust features in place. Thus, while many earlier *Sukūk* structures in Dubai had to resort to setting up their SPVs in common law-based offshore centres such as the Cayman Islands and British Virgin Islands, they can now establish such SPVs under the DIFC regime.

Islamic finance companies within the DIFC are expected to adhere to AAOIFI standards and guidelines, in particular for their accounting practice and *Sharī`ah* compliance. The Dubai financial market has seen *Sukūk* being listed on NASDAQ Dubai. NASDAQ Dubai enables public listing of *Sukūk* issuances. The listing rules cover eligibility; admission procedures; sponsors; continuing obligations; suspensions, delisting and calculations; appeals and governing law and jurisdiction. They are to be read in conjunction with the DFSA's offered securities rules (OSR), which cover prospectus content, continuing obligations and corporate governance. Minimum requirements are established that must be met by all companies applying to list their securities on the exchange. These requirements meet international standards without being unduly onerous. The listing rules are currently being revised; a draft has been produced which will shortly go to the consultation stage. *Sukūk*-specific requirements include those relating to Islamic-financed structures such as the need for a *Fatwa* to have been issued and the continuing obligation to inform relevant parties when any changes are made to the *Fatwa*.

***Central Bank of the UAE***

The Central Bank of the UAE, established in 1980, is the governing body that regulates and supervises all banks operating in the UAE. It has supervisory responsibility for all banking institutions in the UAE.

The UAE Central Bank does not act as a lender of last resort, a role which tends to fall on the individual emirates. Federal Law No. 10 of 1980 grants the Central Bank powers to:

- exercise currency issue, stabilisation, valuation and free convertibility;
- direct credit policy for balanced growth of the economy;

- organise and promote an effective banking system with private banks and institutions;
- advise the federal government on financial and monetary issues;
- maintain the federal government's reserves of gold and foreign currencies;
- act as a bank for the federal government and other banks operating in the UAE; and
- act as the federal government's financial agent with the IMF, the World Bank and other international financial organisations.

Since 1999, regulated banks in the UAE have been required to report in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board. Islamic banking institutions and activities outside the DIFC are supervised by the UAE Central Bank. However, the UAE Central Bank supervises only prudential matters, and the appointment of *Sharī`ah* committees on Islamic banks depends on the approval of the Ministry of Islamic Affairs instead.

**Legal framework**
In addition to the uncertainties that exist surrounding the still largely untested trust law framework and the restrictions on transferability of properties, which may impact on the effectiveness of Islamic asset securitisation in Dubai, there are other issues relating to the broader legal system that give rise to concerns as to legal risk in the context of *Sukūk* issuance in Dubai.

***Lack of binding judicial precedents***
There is no application of the doctrine of judicial precedent in Dubai. Under the civil and *Sharī`ah* legal system applied in Dubai, every case deserves to be tried on its own merits. This means the higher court's decisions will not bind the lower courts' decisions, and earlier decisions on cases that have similar facts will not necessarily bind later decisions. While arguably this judicial approach may be fair and have subjective advantages for the parties, there is a cost in terms of predictability and, of course, potentially costs. In addition, there is no formal system of reporting court decisions in the UAE and not all laws, regulations, instructions and orders promulgated under Dubai law are widely published. Therefore, there may be laws (including regulations, orders or directives) having force of law that *Sukūk* investors may not be aware of. Furthermore, there has been little, if any, complex commercial litigation in Dubai in particular, and in the UAE generally. It follows that it is difficult to determine with any degree of certainty how the terms of *Sukūk* transaction documents will be interpreted and/or applied by the Dubai courts.

***Dubai courts***
*Sukūk* investors in Dubai need to be aware that an agreement as to the exclusive jurisdiction of courts other than the Dubai courts or other courts of the UAE may be unenforceable. There are several reasons for this:

- By an order issued on 6 February 1988 by His Highness Sheikh Maktoum Bin Rashid Al Maktoum, the then Crown Prince and Deputy Ruler of Dubai (the "Instructions"), Dubai law shall apply to any contract entered into by the government, its departments, establishments and public authorities and a contract entered into by these entities shall not stipulate the application of any other law. Any provisions to the contrary in such a contract are void and not binding.
- UAE legislation provides that the courts of the UAE have jurisdiction to hear actions brought against UAE citizens, UAE corporate entities, or expatriates having an address or place of residence in the UAE irrespective of any agreement between the parties in respect of jurisdiction and applicable laws.

However, while Dubai law generally recognises the principle of freedom of contract, which theoretically extends to choice of law provisions, in practice, the Dubai courts are reluctant to recognise the choice of a foreign law as the governing law of an agreement on the grounds of public policy. Even if Dubai courts are prepared to recognise the parties' choice of a foreign law, that law would need to be proven as an issue of fact. Therefore, even if the governing law is accepted, there is no certainty that the Dubai courts will give effect to such documents in the manner that parties intend. Moreover, if parties to a contract agree to grant jurisdiction to a non-UAE court when the Dubai courts would have had jurisdiction, then, as a matter of public policy, the Dubai courts may not uphold the agreement between the parties to provide jurisdiction to the non-UAE court. Therefore, it is likely that Dubai courts would apply Dubai law in any action against the Government of Dubai brought before it. There have been cases where a UAE court has found a foreign judgment to be unenforceable against UAE nationals on the basis that the defendants in question were domiciled in the UAE.

In the event that a matter arising out of the *Sukūk* transaction documents is referred to the Dubai courts, it is difficult to predict with any degree of certainty how any of those documents would be interpreted and applied by the Dubai courts. If proceedings were commenced, much would depend upon the facts of a particular case, the reasonableness, ambiguity (or absence) of the terms of the document in question, and the then current legislation. The Dubai courts are unlikely to enforce a foreign court judgment without re-examining the merits of the claim and may not observe the choice by the parties of foreign law as the governing law of the *Sukūk*. In addition, even if foreign law is accepted as the governing law, the Dubai courts will not honour any provision of foreign law that is contrary to public policy, order or morals in the UAE, or to any mandatory laws of, or applicable in, the UAE. This may mean that the Dubai courts may seek to interpret foreign law-governed documents as if governed by UAE law and there can therefore be no certainty that in those circumstances the Dubai courts would give effect to such documents in the same manner as the parties may intend. Notwithstanding that a judgment may be obtained in a foreign court, there is no assurance that the Government of Dubai has or would at the relevant time have assets in the foreign jurisdiction against which such a judgment could be enforced.

The rights of a trustee to initiate proceedings against the Government of Dubai may be delayed pursuant to Law No. 3 of 1996 on Government Lawsuits, which provides that proceedings may be brought against the Government of Dubai before the Dubai courts, provided that the relevant claimant has given details of such claim to the Attorney General and has entered into settlement negotiations for a period of two months. If the parties are unable to reach a mutually acceptable settlement at the end of the two months, the claimant shall be entitled to commence proceedings against the Government of Dubai.

***Claims for specific enforcement; damages***

In the event that the *Sukūk* issuer in Dubai fails to perform its obligations under the *Sukūk* transaction documents, the potential remedies available to the investors include obtaining an order for specific enforcement of the issuer's obligations or a claim for damages. There is no assurance that a court will provide an order for specific enforcement, which is a discretionary matter. The amount of damages which a court may award in respect of a breach will depend upon a number of possible factors, including an obligation on the issuer to mitigate. No assurance is provided on the quantum of damages that a court may award in the event of a failure by the *Sukūk* issuer to perform its obligations set out in the transaction documents.

***Insolvency***[179]

Investors of *Sukūk* issued by a Dubai entity may be subject to limitations arising from applicable laws relating to insolvency, bankruptcy, administration, moratorium, reorganisation, liquidation or other laws or analogous circumstances relating to or affecting the enforcement of creditors' rights generally. There is no centralised public register or public record in existence in the Emirate of Dubai in relation to corporate or other insolvencies, liquidations, dissolutions or administrations or the equivalent, and hence it is difficult to monitor or confirm whether any petition for insolvency (or any equivalent proceedings) of *Sukūk* issuers has been presented. Therefore, any provision in any transaction documents or the *Sukūk* which confers or waives, or purports to confer or waive, a right of set-off or a similar right may be ineffective against a liquidator or similar officer or creditor.

In this respect, one should note that there is no equivalent in Dubai of the US's Bankruptcy Chapter 11 or UK administration procedures that would be relevant to the restructuring of the financial obligations of Dubai World or Nakheel.[180] Many of Dubai World's and Nakheel's creditors, particularly those with higher exposure, may seek to work with Dubai World in an orderly restructuring rather than risk legal action in an uncertain environment.

[179] See P. de Cordova, J.N. Rich, T. Griffiths and Dr S. Konrad, "Creditors' Rights in the UAE", *K&L Gates Newstand*, 3 December 2009.

[180] D.H. Jones and A.V. Petersen, "Dubai World Debt and Nakheel *Sukuk* – Apocalypse Now?", *K&L Gates Newstand*, 10 December 2009.

### Restructuring of some *Sukūk* in Dubai

In light of the severe financial difficulties faced by the Dubai World Group in 2009, the Government of Dubai intervened, in the interests of the wider economy, to protect all stakeholders and to start rebuilding the financial strength of the Dubai World Group. On 25 November 2009, Dubai World, with the support of the Government of Dubai, announced its intention to seek a "standstill" (*Moratorium*) with the lenders of the Dubai World Group (the "Lenders") in respect of the indebtedness of the Dubai World Group and appointed a Chief Restructuring Officer to lead the restructuring process to ensure the continuity of the Dubai World Group's business operations. Subsequently, a coordinating committee (the "CoCom") of seven banks was formed to represent the interests of the Lenders. Since 25 November 2009, Dubai World Group companies have, with financial support from the Dubai Financial Support Fund (DFSF),[181] continued to fund certain interest and hedging payments to the Lenders pursuant to the terms of existing credit facilities and have benefited from a de facto standstill from the Lenders.

#### *Decree No. 57 of 2009 relating to any Future Restructuring of Dubai World Group*

On 13 December 2009, the Ruler of Dubai issued Decree No. 57 for 2009 establishing a tribunal to decide disputes related to the settlement of the financial position of Dubai World and its subsidiaries ("Decree No. 57").

Dubai World is a Government Related Entity (GRE) established pursuant to a decree issued by the Ruler of Dubai. On account of its status as an entity formed by decree, the existing provisions of Part 5 of Law No. 18 of 1993 (the "UAE Commercial Transactions Law"), which govern the insolvency and restructuring of other companies and traders throughout the UAE, do not apply to Dubai World. To address this situation, the Ruler of Dubai enacted Decree No. 57, which provides a modern legal framework for any future restructuring of Dubai World. Decree No. 57 is intended to facilitate the restructuring of a Dubai World Group company (a "DW Company") by allowing a DW Company to continue to manage its own affairs under the supervision of a judicial tribunal and pursue a restructuring through a procedure known as a "Voluntary Arrangement".

Decree No. 57 establishes a tribunal (the "Tribunal") that is empowered to supervise a Voluntary Arrangement or any liquidation proceedings relating to a DW Company initiated by the Tribunal. The Tribunal presently consists of three senior judges of the Dubai International Financial Centre Courts (the "DIFC Courts"). Even though the Tribunal consists of judges from the DIFC Courts, the Tribunal is not a DIFC Court. Decree No. 57 adopts, with modifications, the insolvency laws and regulations of the DIFC (the "DIFC Insolvency Laws") as the basic legal framework for its law.

[181] The DFSF was established as an autonomous entity to provide support to strategic entities that require financial assistance but are able to demonstrate sustainable business plans, ongoing support of their existing financial creditors and realistic prospects of fulfilling their repayment obligations. Assistance provided by the DFSF is provided on arm's-length terms.

### *DFSF interim funding of the Dubai World Group*

On 14 December 2009, the Government of Dubai announced a set of actions in relation to the Dubai World Group. The Government of Dubai announced that the Government of Abu Dhabi had agreed to provide funding of up to US$10 billion to the DFSF. The Government of Dubai confirmed that such funds would be used to satisfy a series of upcoming obligations of the Dubai World Group, including the repayment of US$4.1 billion worth of obligations owed under Nakheel Development Limited's 2009 *Sukūk*.

### *Dubai World and Nakheel restructuring plans*

On 25 March 2010, the Government of Dubai, Dubai World and Nakheel publicly announced proposals for the restructuring of the liabilities of Dubai World and Nakheel. The Government of Dubai's announcement further explained that the DFSF will support the restructuring proposals with significant financial resources. Dubai World has been in discussion with its lenders and has presented a proposal to all its creditors for the restructuring of its debts. On 28 November 2010, Dubai World announced that it has finalised its restructuring after obtaining approval from 100% of its creditors. On 12 December 2010, as part of the restructuring process, the Ruler of Dubai also issued a decree for setting up a new board of directors of Dubai World. Nakheel has been in discussion with its creditors and has announced comprehensive proposals for the restructuring of its outstanding debt obligations. Meanwhile, *Sukūk* issued by Nakheel Development Limited and Nakheel Development 3 Limited, which matured in December 2009 and May 2010, respectively, were redeemed using funds provided by the DFSF.

### Conclusions

As we have noted, the legal issues of the Nakheel *Sukūk* were not peculiarly connected to the legal structure of Islamic financial instruments as such, but rather were inherent to the legal structure of this particular transaction and to the legal environment in which it was set up.[182] In other words, a conventional bond issued out of Dubai in the same manner would be facing the same risks. The *Sukūk* investors in this transaction had not adequately considered the UAE's and Dubai's financial legislation; in particular, they failed to take into account the legal framework in Dubai concerning specific requirements for granting security rights such as the rights created in a mortgage agreement. The strong legal protection and specific legal limitations concerning governmental entities under UAE law also had a major impact on the legal options of parties. Lastly, private international law, and the enforcement of (foreign) judgments in the UAE in particular, formed what would have been a big obstacle if legal proceedings had ensued. The lessons learned from the impact of the Dubai debt crisis on the Nakheel *Sukūk* may be valuable when structuring *Sukūk* transactions in the future. Furthermore, some of these lessons may also be valuable for structuring other financial and commercial transactions in Dubai, because the legal system of the UAE and Dubai, in particular, was at the root of the legal complications of the financial structure of Nakheel *Sukūk*. What all this gives emphasis to is the concerns repeated throughout this chapter for thought to be given to the operation of Islamic law and structures in the context of the wider legal environment.

[182] See Omar Salah, op cit.

### iii. Case 3: Indonesia[183]

Indonesia is considered to be a ripe market for asset securitisation in the coming years due to its abundant economic potential. To begin with, it has almost endless infrastructure development requirements. This is due to the vastness of its area and the size of its population. Many infrastructure projects are waiting for funding and a significant proportion of these are potential areas for *Sukūk*, including city development (MRT, monorail, highways), mining (exploration, refining), housing (low-cost flats, middle-class apartments), plantation (rubber, palm oil), telecommunication and shipping.[184]
Indonesia is yet to have a specific regulation for *Sukūk* except for sovereign issues. Nevertheless, corporate issues continue to take place on the basis of the existing regulatory framework, notwithstanding that it is not tailored, or always well suited, to accommodate such structures.[185] Generally, Indonesia lacks the legal framework for complex financial innovations. The development of the Indonesian *Sukūk*, in particular, is hampered, as explained in previous sections, by various shortcomings in the legal system. These include the difficulty of assigning and transferring partial interest in ownership – namely, equitable ownership of the income-generating assets – and the lack of legal protection for the holders of non-straightforward debt.

This issue necessitates a legal framework that can accommodate the splitting of ownership of a real asset into equitable and legal ownerships. However, as the separation will affect the fundamental nature of Indonesian legal tradition, some reform should be introduced. The reform is needed in regard to the unitary principles in property ownership, in the sense that the ownership is no longer unitary if viewed or dealt with in different realms.

**Early securitisation in Indonesia**
Although Indonesia was one of the “hot” markets for asset-backed securitisation before the Asian financial crisis – with at least six deals in a couple of years – no deals have emerged since, as arrangers have found it difficult to structure a product that meets the originators’ needs.[186] Indonesian corporates have been keen to issue asset-backed

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[183] For a broader discussion on Islamic finance in Indonesia, see E. Rajagukguk, “Harmonisation of ‘Syariah’ and Civil Law: A Study of the Indonesian Syariah Banking”, paper resented at the International Conference on Harmonisation of Syariah and Civil Law, International Islamic University, Kuala Lumpur, 29–30 June 2005. For a more specific discussion on *Sukūk*, see R. Djojosugito, “Necessary Legal Reforms to Create Legal Basis for Effective Islamic Asset Securitization (*Sukūk*) in Indonesia”, paper presented at the Harvard Islamic Finance Forum 2006; and *A Study on Sukuk Issuance in Indonesia*, (2010) IIFM. See also B. Rider and P. Herra-Davila, *Doing Business in the Philippines and Indonesia*, (1977) Macmillan, in regard to the legal culture in business and commerce.
[184] C. Maskanulhakim, “Development of *Sukūk* in Indonesia”, paper presented at the IFSB Legal Seminar 2010, 3 December 2010.
[185] The basis for the market to start looking at issuance of *Sukūk* was the *Fatwa* by the National *Sharī`ah* Board on Islamic *Muḍārabah* bonds in 2002. Since then, many companies have tried to tap the fund from *Sukūk* issuance, especially when a fixed-return structure in the form of an Islamic *Ijārah* bond was approved by the National *Sharī`ah* Board in 2004.
[186] “Indonesia at Last, but Slowly”, *IFR Securitisation*, (2005).

securities, but are cautious of engaging in offshore deals because of currency risks or being unable to find banks willing to provide swaps. The alternative – issuingdomestic asset-backed securities denominated in rupiah – was also impossible because certain laws and tax regulations have until very recently raised doubts as to whether it was possible to have a genuinely bankruptcy-remote, tax-free structure. The rich tapestry of Indonesian legal traditions has not helped in promoting entrepreneurial activity in this regard. After the first asset-backed transactions surfaced in 1995, Badan Pengawas Pasaran Modal (BAPEPAM) – the capital market regulator – in 1996 began drafting regulations and took the position that because securitisations involve selling a pool of assets and issuing assets backed by securities, they are similar to mutual funds. The problem with the collective investment contract format, at least in the Indonesian context, has been that it was not a clear-cut bankruptcy-remote structure. Furthermore, at the time, the Indonesian tax authorities were unclear as to whether or how the collective investment contracts were to be taxed.

**Market expansion**

In early 2005, Bank Indonesia (BI) released guidelines regarding securitisations, which stated that Indonesian banks can participate in securitisations either as originators or investors as long as they can show that the structure is a "genuine" asset-backed securitisation structure. The BI regulations are written in a way that gives flexibility in terms of packaging securitisations. In essence, they leave it up to the market to decide how the final product can be packaged, so long as the structure meets BI's guidelines. It follows, therefore, that BI's regulations do not prohibit rupiah securities being issued by an offshore entity. Complications arose, however, as to the impact and relevance of separate regulations from BAPEPAM. However, as BAPEPAM regulations only apply to public offerings, they could be avoided by issuing securities as private placements.

*Sukūk* makes its presence felt in the Indonesian market with the first domestic issuance in 2002, structured as *Sukūk* al-*Muḍārabah* and issued by PT Indosat, Tbk.[187] Since then, the company has played an active role domestically, issuing rupiah-denominated *Sukūk*. In March 2005, BFI Finance Indonesia surfaced with a deal that sought to take advantage of the new environment. The three-year 108 billion rupiah (US$11.5 million) MTN deal, which was backed by rupiah-denominated heavy equipment leases, is a private placement and, for tax reasons, makes use of an SPV based in the Netherlands, as the Netherlands has a tax treaty with Indonesia. The deal, structured and arranged by Kiran Resources and underwritten by Danareksa Sekuritas, is considered a domestic transaction given that everything, except the offshore SPV, is Indonesian. Nevertheless, all of the *Sukūk* issuances in Indonesia have been domestic issues, with only one global sovereign *Sukūk* issued in 2009 for US$650 million (7,030 billion rupiah), which was structured as *Sukūk Al-Ijārah*. The market for securitisations also was given a lift in February 2005, when President Susilo Bambang Yudhoyono signed a decree for the government to create the Secondary Funding Facility, which is to start a market in secondary mortgages.

[187] See "A Study on *Sukuk* Issuances in Indonesia", *A Series of Studies on Sukuk Issuances from Different Jurisdictions*, (August 2010) International Islamic Financial Market.

### *Islamic securitisation and Islamic banking*

Indonesia has had for quite some time laws relating to *Sharī`ah* banking. Indonesian laws have adopted a dual banking system through the promulgation of Law No. 10 of 1998 concerning amendments to the banking law,[188] which forms a legal basis for the development of Islamic banking in Indonesia, and through Law No. 23 of 1999[189] concerning BI, which paved the way for the creation of the *Sharī`ah*-based regulatory and supervisory frameworks. The attempt to create a *Sharī`ah* environment was considered to be quite promising, and Bank Indonesia has been very active in this regard. Soon after the promulgation of the Law No. 10 of 1998, which gives BI the power to supervise and regulate the banking sector in Indonesia,[190] it promulgated several BI Regulations that are intended to regulate Islamic banking. The regulatory regimes are quite comprehensive. They cover almost every facet of the administrative aspects of Islamic banking. However, this is not the case for other financial institutions. Other *Sharī`ah* financial institutions or instruments such as asset securitisation do not enjoy the same privileges as Islamic banks do. Other *Sharī`ah* financial institutions or instruments have to rely on laws for the conventional system. Unfortunately, the law is not always very compatible with *Sharī`ah*.

### Laws related to assets securitisation

Despite the fact that asset securitisation is one of the most important mechanisms for finance, Indonesia has not passed any comprehensive law on asset securitisation. There is, however, a current attempt by the government to create such a law. Unfortunately, the draft law, if not modified, is thought to be not entirely compatible with *Sharī`ah.* For example, one provision of the draft law that may present a difficulty with *Sharī`ah* is the statement that only debts can be securitised. There are also complications, actual and potential, that arise as a result of rules being promulgated at different levels of the legal system. This is a particular concern in regard to the capital market. The Indonesian capital markets are regulated by the Ministry of Finance through the BAPEPAM. Under the Capital Market Law of 1995, BAPEPAM may set policy guidelines and regulations and is responsible for the day-to-day supervision of the capital markets. In essence, it has the power to interpret laws and legislation on matters within its jurisdiction and to frame rules and issue independent decrees. In regard to assets securitisation, BAPEPAM has issued regulations No IX.K.1 on Asset-Backed Securities. These govern the elements of a typical asset securitisation. However, there remain issues that are not favourable to the issuance of Islamic asset securitisation, which we examine in due course. While many problems are perhaps a result of lack of coordination or consistency over time, the result is often the creation of uncertainty and therefore risk.

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[188] State Gazette No. 182 of 1998.

[189] State Gazette No. 66 of 1999.

[190] See Article 24-35 of Law No. 23 of 1999. It is to be noted that under the previous banking regime in Indonesia, despite the fact that BI sets and administers the operative rules and regulations related to banking operations, it was the Ministry of Finance that had the ability to enforce the rules, through its authority to issue and revoke banking licences. See A. Nasution, "An Evaluation of the Banking Sector Reforms in Indonesia, 1983–1993", 1 *Asia Pacific Development Journal* (June 1994) p.78.

The BAPEPAM in 2007 issued a regulation describing in detail Islamic principles on which *Sukūk* should be based, such as *Muḍārabah*, *Mushārakah*, *Ijārah*, etc. The regulation provides that it is optional for an issuer whether or not they have a *Sharī`ah* board for their *Sukūk* issuance. Nevertheless, the market seemingly requires the engagement of such a board in practice. By 2008, there were 28 Islamic bonds issued based on either *Mudāraba* or *Ijārah*. The *Sukūk* Act 2008 was a turning point in the *Sukūk* market in Indonesia. It is the equivalent of the conventional Securities Act, which had been enacted the previous year. The *Sukūk* Act enables the government to issue sovereign *Sukūk*. It accommodates many Islamic financial features, such as Islamic *Muamalat* contracts, underlying assets, the profit–loss sharing principle and others. Since the enactment of *Sukūk* Act 2008 the government has issued three series of *Sukūk*.

**A snapshot of Indonesian global *Sukūk* (US$650 million)**

Indonesia issued its global *Sukūk al-Ijārah* in April 2009. The *Sukūk* was launched under a separate legal entity – the "Perusahaan Penerbit SBSN Indonesia 1", which acts as a trustee on behalf of the government. It was issued on the back of an SPV, and the assets identified under this vehicle consist of approximately 66 real properties used for government purposes, including buildings, improvements and fixtures thereon, located in Bandung and Jakarta. These properties may be replaced by a substitution under the "Substitution Agreement". The government's concern in seeking these funds was to assist the economy and, in particular, support its budget deficit. The *Sukūk* is US-dollar denominated with a size of US$650 million; its tenure is five years that will mature in April 2014 with semi-annual payments at a rate of 8.8%. The lead managers and book runners for this *Sukūk* are Barclays Bank, HSBC and Standard Chartered, whereas the principal paying agent is Bank of New York Mellon. The *Sukūk* is listed on the Singapore Exchange.

**Conclusion**

At the moment, Indonesia covers roughly 3% of the total global *Sukūk* market. Its domestic issuances, as of the first half of 2010, are on the rise and this trend is expected to continue given Indonesia's anticipated strong economic growth. The sovereign issuances dominate the *Sukūk* market, accounting for roughly 79% in terms of value. Since the adoption of the law supporting sovereign *Sukūk* in 2008, the market has witnessed a total of 15 sovereign issues, as of 30 June 2010. Although all the issuances in 2010 have been domestic, it indicates a growing demand and interest from investors, who expect and need more issuances for a viable and sustainable market to continue. It remains to be seen if this trend continues.

## *H. Prudential Supervision*

### i. Prudential standards

The survey that we conducted indicates that in all the jurisdictions canvassed there is awareness of the importance of a prudential approach to ensuring the sound and efficient development of both Islamic financial markets and the institutions that operate wholly or partially within such.[191] Indeed, the desire to operate so that supervision, justified by adequate regulation, is sufficiently prudential in character to provide affirmative protection to the markets, in terms of solvency, fitness and integrity, extends, at least as a matter of law, to all those who could have a significant impact on the market and financial system.[192] Consequently, the issues that need to be faced, other than perhaps the appropriateness of drafting in regard to certain and specific laws, relate to whether the institutional resources exist to enable this approach to be a reality that can been relied upon by those in the market and by those who depend upon it.

We have noted in our discussion that in recent years, and in particular post the most immediate financial crisis,[193] governments have been far more concerned with expanding the prudential approach to supervision over economically sensitive activities than has traditionally been the case. Historically, this approach has tended to focus on deposit-taking institutions and those where there is a high level of public involvement and exposure. Considerable criticism has been made at various levels of what some see as the failure of major and well-resourced regulatory authorities in the leading economies to perceive that the level of prudential monitoring and intervention was inadequate in regard to matters which are understood to have contributed to, or at least been associated with, the near collapse of the Western banking and financial system. These concerns, and the measures that have been recommended to address them, are well documented and need not be rehearsed here. Already, significant changes, albeit mostly of emphasis, are taking place in the regulatory landscape in many developed jurisdictions.[194] The emphasis is common, better and more focused prudential

[191] See also A.K. Aldohni, "The UK Prudential Banking Regulation and Islamic Banks: Has the Financial Services Authority Achieved its Regulatory Objectives", 23 *Journal of International Banking Law and Regulation* (2008) 382. See, in particular, *Islamic Finance and Global Stability*, (2010), IFSB, Islamic Development Bank, and Islamic Research and Training Institute.

[192] For example, all governmental agencies canvassed considered that they were fully compliant with IOSCO's various standards. See also IFSB, *Compilation Guide on Prudential and Structural Islamic Finance Indicators: Guidance on Compilation and Dissemination of Prudential and Structural Islamic Finance Indicators for Banking and New-Banking Institutions offering Islamic Financial Services*, (2007) IFSB.

[193] There is a considerable amount of published material of varying degrees of reference. However, in the context of this report, see *The Turner Review: A Regulatory Response to the Global Banking Crisis*, (March 2009) FSA UK and FSA Discussion Paper DP09/2; and *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, (2009) US Department of the Treasury.

[194] Note, in particular, 'An Act to promote the financial stability of the US by improving accountability and transparency in the financial system … and to protect consumers from abusive financial services practices…' (Dodd-Frank: Wall Street Reform and Consumer Protection Act, 11 July 2010). This important statute establishes, *inter alia*, the US Financial Stability Oversight Council. Reference should

management with real commitment to early intervention and resolution.[195] While the perception is that many of the jurisdictions seeking to establish and develop Islamic markets showed resilience in the face of the financial crisis, it is a given that all serious financial centres and markets will be brought under the aegis of these new programmes and supervisory standards. The issue as to whether such constitute a disproportionate cost given their historic profile is in political terms irrelevant.[196] Compliance is a prerequisite for international access.

### ii. Prudential monitoring and surveillance

The recent financial crisis exposed the inability of supervisory organisations to know and appreciate what was occurring in certain parts of the financial services industry. This default was exacerbated by their failure, even when there were known indications, to assess the level of risk and take effective action to limit harm and correct conduct. The failure to actually know and perceive what was taking place was not a simple but complex default. It occurred and operated at different levels within organisations and across regulatory networks. Consequently, in the aftermath few individuals and fewer institutions have actually attracted referable blame and criticism. In many ways the system was just not up to dealing with the issues. Less generously, it might also be said that the failures were so serious in their consequences that there is little point in attributing responsibility.

The relevant laws and regulations justifying prudential monitoring in the main were not seriously deficient. The failure was far more in their administration and the calibre and level of resources that were set to ensure safety and soundness in the system. Of course, in part the availability of resources is itself a result of the adoption of certain policies and arguably, in some cases, mistakes in the initial assessments to re-set a risk-based approach to monitoring. In other cases, there appear to be institutional issues associated with industry capture, lethargy, incompetence and lack of effective communication.[197] Perhaps there was also a greater degree of duplicity and even fraud than has been identified. In the result, as many political leaders have acknowledged, the resources charged with prudential monitoring were not fit for their purpose.

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also be made here to the revisions to IOSCO's Objectives and Principles of Securities Regulation in June 2010 to address issues of systemic risk.

[195] See, generally, Speech, Lord Turner, Chairman of the FSA, UK, 28 September 2010, FSA in which emphasis was given to the full implementation of Basel III; ability to address on a timely basis problems in systemically important financial institutions and the development of macro-prudential analytical tools to identify and limit excessive credit growth. Similar priorities were emphasised by Jean-Claude Trichet, President of the European Central Bank, in a speech setting out the priorities of the New European Systemic Risk Board on 27 September 2010, ECB.

[196] See B. Rider "Finance in the Firing Line", 2 *Quantum* (Qatar Financial Centre Authority) (January 2008) and B. Rider, "The Crusade Against Money Laundering – Time to Think", *European Journal of Law Reform* (1999) 50.

[197] See B. Rider, "The Way Ahead", in *Attaining Corporate Resilience*, (2010) Companies Commission of Malaysia; and A. Young, G. Li and J. Chu, "The Aftermath of the Lehman Brothers Collapse in Hong Kong: The Saga of Regulatory Deficiencies and Government Responses", 31 *Company Lawyer* (2010) 343. See also, for a historical perspective, B. Rider, "Policing the International Financial Markets", 14 *Brooklyn Journal of International Law* (1990) 179.

The failure of law was perhaps most significant in three areas. Of course, this is not to say that there were not in different jurisdictions a host of legal provisions that were found to be inappropriate or in need of refinement. However, considering the broad picture, it is generally agreed that in most jurisdictions the law did not enable the regulators or public authorities to intervene on an efficient and timely basis to conserve assets and avoid a full insolvency. Indeed, there remains still considerable debate as to the appropriateness of the manner and form of intervention in management even where the state directly or indirectly owns a significant interest in what remains in form a private sector institution. It is impossible to separate here the legal from the political issues. Second, it is also generally thought that the law did not demand sufficiently high standards from those in positions of authority within financial institutions and, to some extent, the market. The problem here is where to draw a line between criminal and other forms of accountability. This is not simply an issue as to proportionate culpability or form of punishment, but has serious institutional implications in terms of enforcement and accountability for intervention. We have seen similar issues arise in regard to liability for violations of Islamic law. Indeed, in some respects the *Sharī`ah* is more able to deal with such issues and at least has no problem in recognising an obligation, albeit perhaps not enforceable in the conventional sense, to attain higher standards of behaviour. While there are examples of enforcement failures during the lead-up to the crisis, it remains to be seen whether these were mere symptoms rather than in any direct manner further causes of the collapse. Of course, enforcement failures can have complex implications in terms of confidence, and a lack of integrity may prove to be contagious. Third, the law was felt to be weak in the setting of standards of probity and stewardship. This issue is somewhat related to the issue of enforcement, but is rather more fundamental and pervading in its significance and implications. That there were failures to audit integrity-related issues is manifest and is an issue that has yet to be properly addressed.

### iii. Prudential intervention

Most legal systems provide in various ways mechanisms for sanctioned intervention in the affairs of a business as and when insolvency approaches. The vital significance of certain and efficient legal procedures for those who have a legitimate interest in the solvency or otherwise of a business to interfere and secure assets or even seek the replacement or accountability of management is well recognised. It is obviously necessary that any jurisdiction seeking to hold itself out as a viable commercial and financial centre has such laws and procedures, properly administered by competent courts and supported by sufficient and competent professionals, whether acting as lawyers, accountants or insolvency practitioners. The ability to take sanctioned action short of placing the business into bankruptcy or liquidation is also of the utmost importance. How this might be achieved will vary from one jurisdiction to another, but the basic procedures and objectives are relatively standard. What is perhaps far less developed in most legal systems is the law and procedures which allow interested parties and, in particular, in the context of regulated activity, such as in the financial sector, to intervene even before the stage that an insolvency or bankruptcy is on the cards. Obviously, there has to be some justification in disrupting the authority of management and seeking to conserve or protect all or perhaps certain assets. Different legal systems will have and operate different standards and justifications for such intervention, and in practice it cannot be assumed that such powers will inevitably exist or be capable of effective and efficient use. Indeed, the cost and length of proceedings required before such an intervention is sanctioned by a court can render it in practical terms worthless as a protection. Indeed, from the point of view of a creditor, it might even be counterproductive.

What is important in the context of the financial markets is that where there are circumstances justifying some form of intervention the agency charged with oversight has the ability either to intervene itself or to procure the intervention of a satisfactory other person. It will always be necessary to consider the constitutional position of the relevant agency and the general legal situation. The extent to which it is desirable always to require the sanction of a court is debatable. However, what is clear is that there must be not only accountability in regards to the act of intervention, but also proportionality and competence in the form and conduct of intervention. Where an institution operates in or through the markets, this is of critical significance. Whatever is done should not jeopardise stability in the market or must at least be justified in the desire to promote greater stability. The form that intervention can take will vary and must be realistic in terms of the objectives that have been set and the availability of resources.

We have been discussing these issues primarily from the perspective of financial soundness. While this is perhaps the most important issue, there are others that may well justify similar forms of prudential intervention. For example, in the United States it has become not uncommon practice for the authorities to insist on the restructuring of compliance systems and resources, which are overseen by an appointed independent monitor. In some cases the monitor will report to the court and in others to the relevant regulatory agencies. It is relatively unusual to find specific statutory authority for the appointment of monitors in this manner, although this is changing. Quite often, they will be appointed by court order, perhaps as part of a settlement of complaints, or as essentially a matter of contract between the relevant institution and the regulator. Of course, the ability to adopt such a device does presuppose the availability of persons of the right calibre and competence.

#### iv. Prudential responsibility

Prudential supervision and, in particular, intervention from the standpoint of the regulator carries certain legal and political risks.[198] Consequently, it is desirable and reasonable for those required to conduct such activity to have a clear legal mandate with an assurance of political support in the proper discharge of their statutory duties. There have been cases where it has been alleged that regulators, including individual

[198] It has also been argued that a significant increase in required capital would drive business out of the regulated environment and into shadow activities: Jacques de Larosiere (co-chairman of Eurofi), “Basel Rules Risk Punishing the Wrong Banks”, *Financial Times*, 25 October 2010.

members of staff, have failed in their duties, both under the relevant statute and at general law, in not conducting adequate and competent prudential examinations of banks, insurance companies and other financial institutions. In practice, relatively few such complaints have ended in a determination of legal liability with consequential financial compensation. Apart from the practical issues in mounting a viable and sustainable legal action in many jurisdictions, bearing in mind that often those seeking to complain will have been seriously financially damaged by what has taken place, there may well be legal problems in establishing a cause of action. Even if there is a statutory or common law duty of care, it will be necessary to show that the standard of care has been broken, resulting in foreseeable loss to the particular claimants. In many countries there are also specific legal provisions protecting financial regulators from the consequences of mere negligence. Provided their acts of negligence or other defaults were done without bad faith, they will be protected from civil claims. In the United States and the United Kingdom, this has led to use against financial regulators of a claim in tort based on allegations of misfeasance in public office. In essence, this liability is based on more than simple negligence and requires proof that the official appreciated that the failure to act properly would result in loss. It is also the case that, in similar circumstances, compensation for failure to discharge duties of prudential supervision have resulted from inquiries by financial ombudsmen and analogous authorities.

It may also be possible to challenge the conduct of the regulator, or agents of the regulator, where the failure is not one of effective prudential surveillance but the complaint is based on its intervention. Indeed, it may be that the act of intervention is itself the basis of a complaint, or the manner in which intervention has been conducted or overseen. It may well be that the terms of appointment, under court order or otherwise, will seek to delimit the scope of potential liability in addition to any specific statutory provisions that might be applicable. It is, however, the case that the more a regulator intervenes in the management and/or operations of a business, the greater potential there is for challenges and complaints. On the other hand, if such powers exist and they are not used, this may also be challenged. The days when regulators could simply sit back and respond to issues as they arise has gone. Today, they must be prepared to adopt an active stance involving looking for problems and then being prepared to act appropriately. Of course, it remains to be seen whether many regulatory authorities have in practice the will, resources and competence to do so.

### v. Investor protection

The development of a comprehensive system, involving primary legislation, regulations and appropriate risk and compliance systems, designed to promote investor and depositor protection is extremely important. We have already emphasised the need to ensure adequate protection for those who come to the market, and we examined the desirability of fashioning laws that achieve this. This is not only a legitimate expectation of investors and depositors, but an international standard that needs to be met.[199] We

[199] See, for example, B. Rider, *The Contract of Insider Dealing – Model Policies and Laws*, (2000) Legal Division, IMF.

have also referred to the relatively underdeveloped state of Islamic law on certain aspects of investor protection.[200] It is certainly the case that a jurisdiction that attempted to rely solely on the *Sharī`ah* to afford investors and depositors protection would not meet the expectations of the international financial community. Having said this, the *Sharī`ah* can play a very significant role, particularly in the emphasis that it places on good faith and fair dealing. Alone, however, it does not give certainty of protection from abuses such as insider dealing.

There is, as we have seen, considerable debate in theory as to the level of investor and depositor protection that it is appropriate to offer by law. To simply seek to prevent fraud is generally regarded as insufficient. Where investments are recommended or managed, there is an expectation of competence and that investment advice will be impartial and suitable to the circumstances of investors. There is a reasonable expectation that conflicts of interest and conflicts of duties to different clients will be avoided, or at least be properly managed. There are expectations of fair and proper disclosure, and so on. Investors and depositors have a legitimate expectation of being treated fairly. Any difference in treatment needs to be justified and rendered acceptable. Of course, in many Islamic financial products and services it is not always feasible to treat all investors or depositors in exactly the same way, as so much will depend upon the structuring of the underlying contracts. There are also practices in Islamic finance that would not sit well in other legal systems, such as commingling of funds, particularly where the Islamic bank or financial institution does not segregate customers' and its own account funds. Smoothing of investment returns in collective and structured investment services is yet another difficult issue. Of course, these and other issues can be properly dealt with provided there is adequate disclosure, agreement and integrity in the implementation of what has been agreed. The traditional dichotomy between investor and depositor protection is also, as we have seen, largely irrelevant in the context of many of the Islamic products that are in fact offered to investors.

In the result, each jurisdiction will need to consider carefully how best within its own markets and industry to offer the degree of protection that investors and depositors have a legitimate expectation of receiving. How this is delivered will depend to a significant degree upon the legal environment within which the relevant market and industry operates. It will also be necessary for specific attention to be given, in terms of justification and monitoring, to those practices which while to a greater or lesser degree are common in Islamic finance, but which do not easily comport with internationally accepted standards of fiduciary accountability. Insofar as such practices may constitute breaches of general law, or even specific laws, in other jurisdictions there is a legal and regulatory risk for those concerned. As we have seen, compliance with applicable laws may have results even within a domestic jurisdiction that permits or condones such conduct. The possible exposure of an institution to proceedings elsewhere is a real issue in its risk profile, which should have implications for assessment and ratings.

[200] Particular reference should be made in this regard to Siti Faridah Abdul Jabbar, "Investor Protection in the Islamic Financial Services Industry", (2010) unpublished PhD Thesis, IALS, University of London.

Consequently, it is desirable that, as much as possible, such potentially risk-related activity should be minimised or forbidden.

It is also desirable to ensure an adequate degree of investor and depositor protection in terms of institutional support and, if necessary, intervention. This obviously has implications for the discussion that we have had on prudential supervision, but it goes somewhat further. There is an obligation on those who wish to see that the mechanisms that have been put in place to deliver investor and depositor protection actually work and are reasonably accessible to those who have need of them. This has implications in regard to the availability and depth of professional advice and assistance, and the accessibility of the legal system through the courts and other forms of determination such as arbitration and mediation. There are also issues relating to the accountability of individual and corporate wrongdoers and their ability to be held effectively and meaningfully to account. This raises issues of indemnity insurance, and in a wider context of depositor and investor protection schemes. If investors and depositors are to have confidence in the markets, these are very real issues that need to be addressed within the context of the relevant environment.

It is finally appropriate to point out in the context of this discussion that differing categories of investor may reasonably and properly have differing expectations as to the level of protection that they require. Professional investors may understandably not require or wish to pay, directly or indirectly, for the level of protection available to a small retail investor. Having said this, there are issues that need to be addressed across the board. Even a speculator should be protected from market manipulators and insider dealers. It is also pertinent to distinguish the nature of protection. There is obviously a difference between protecting individuals or businesses that are making decisions from being misled by fraud or manipulative conduct and the protection of investors' and depositors' funds that are, for example, placed in jeopardy as a result of mismanagement or even circumstances that are the attributable fault of no one. Given the interrelationship between markets, it is difficult to not contemplate affording the same level of protection that is given, perhaps at a disproportionate cost, to investors and depositors in the most secure markets.

### vi. Institutional issues

Throughout our discussion, we have emphasised the practical importance of considering legal and regulatory issues within the broader legal environment, both domestically and internationally, and the institutional aspects in regard to supervision. We have noted that many worthy initiatives have been criticised and, indeed, faltered due to inadequate institutional resources. The pursuit of regulatory objectives and the provision of adequate supervision have clear cost implications. It may not be in every jurisdiction that the resources or the experience and competence to discharge these functions exist or are accessible to the government. Consequently, foreign expertise will need to be imported. This has a number of implications, both positive and negative. In the context of the development of Islamic markets, it is desirable that all such expertise at least has an appreciation of the *Sharī`ah* and its impact. This is not always the case.

It is important that the authority charged with comprehensive or sector responsibility for providing supervision and administering the relevant law not only has adequate resources in terms of competence and knowledge, but also has a clear and settled legal remit. Uncertainty as to authority is a recipe for disaster and possibly unfair criticism. Even where a “one stop” regulatory authority has been established, the reality is almost certain to be that it will need to work closely with other agencies and bodies. We have mentioned this in the context of enforcement, but there are many other issues ranging from law reform to recruitment. It will also need to have the authority and ability to deal effectively with foreign agencies and regulators.

The authority’s role in developing Islamic markets, services and products will inevitably involve action at different levels. It will need to ensure that there is proper and adequate interface between the *Sharī`ah* and other relevant laws, including the general legal environment. It is also desirable that it should have a sensible and sensitive understanding as to its role on issues pertinent to *Sharī`ah*. Of course, it would be exceptional for such an agency to be involved directly in the enforcement or application of *Sharī`ah*. However, it will need to ensure that its own conduct and measures are compatible and possibly compliant. It would also be desirable if, through appropriate initiatives, it is able to promote understanding of the role of the *Sharī`ah* and dialogue between scholars. As we have seen, one of the most significant issues facing the development of at least certain products and services is uncertainty in the law. Fostering scholarship and knowledge within the local professions and industry is obviously extremely important. Of course, some authorities have, with the support of their governments, gone further and established, under legislation, *Sharī`ah* advisory bodies. Anything that promotes relevant understanding and the ability to address, in an authoritative manner, differences of interpretation and to resolve uncertainty is to be welcomed. However, it is also desirable that such initiatives have support on a broad basis internationally.

## *I. Recommendations*

The legal and regulatory issues that are pertinent in the further development and enhancement of Islamic capital markets are obviously numerous, multi-faceted and complex. The specific issues and concerns, particularly in terms of reform and the refinement of the relevant laws relating to *Sukūk* and other financial instruments, to some degree vary from one jurisdiction to another. As we have seen, the manner in which the *Sharī`ah* interacts with the ordinary law in particular jurisdictions varies as a result of a number of institutional and constitutional factors. We have also been at pains to emphasise that before effective, sound and efficient capital markets can be developed and sustained, regard must be had to the much wider legal and regulatory framework. Laws and regulations relating to the creation, issuance and trading of financial instruments and the provision of financial services do not and cannot operate in a vacuum. Consequently, for the development of viable markets and products, detailed analysis is required as to the sufficiency, suitability and efficacy of a host of legal rules and procedures which will inevitably be required to support Islamic institutions, services and instruments. Without addressing these vitally important issues, uncertainty and unpredictability will serve to undermine whatever initiatives take place to foster better Islamic capital markets. In our review we touch upon a great number of issues, and it is difficult and perhaps misleading to attempt to identify and certainly isolate a set of specific recommendations that can properly and usefully apply to all or at least most jurisdictions. Therefore, the following should be looked at in this light.

1. Comprehensive and adequate laws need to be in place to provide for:
    a. The creation and issuance of securities that are compatible with the *Sharī`ah*.
    b. The trading and settlement of such securities that are compatible with the *Sharī`ah.*
    c. The proper reporting of financial and other relevant information relating to the issuers of such securities and their value, that are compatible with the *Sharī`ah.*
    d. Effective and efficient investor protection (including the prohibition of misrepresentation, fraud, manipulative practices, market abuse and insider dealing) that are compatible with the *Sharī`ah.*
2. There must be laws recognising and giving proper effect to the separation of legal and beneficial ownership that are compatible with the *Sharī`ah*.
3. There must be laws ensuring the proper and efficient administration of insolvent companies and business entities, including liquidation and dispute resolution procedures, that are compatible with the *Sharī`ah.*
4. There must be laws which recognise the fiduciary obligations of persons who engage in activities where there would be a reasonable expectation that the parties are in what in common law legal systems would be considered to be fiduciary relationships, that are compatible with the *Sharī`ah.*
5. The relevant legal and other obligations of *Sharī`ah* boards and *Sharī`ah* advisers need to be clarified and reinforced.
6. The obligation to provide and monitor *Sharī`ah* compliance needs to be clarified, emphasised and reinforced.
7. The law relating to the enforceability of agreements where there is an issue under the *Sharī`ah* needs to be clarified, along with the issue of purification of tainted property and profits.
8. Investors and others should have access to viable remedies – including arbitration and mediation – that can result in the payment of adequate compensation or the restitution of relevant property, such being compatible with the *Sharī`ah.*
9. There should be clarity in regard to the relevance and enforceability of orders from courts in other jurisdictions, and appropriate arrangements (e.g. treaties, mutual recognition arrangements, MOUs) to facilitate enforcement.
10. Laws regarding the creation and transfer (including ownership) of rights in property, particularly real property, should be reformed to facilitate the creation of viable financial instruments that are compatible with the *Sharī`ah*.

11. Issues relating to the legal reliability of electronic documentation should be clarified and, where possible, effect given to modern means of communication and execution.
12. Legal documentation, particularly that giving rise to tradable interests in property, should be standardised as far as possible.
13. The law should, as far as is compatible with the *Sharī`ah*, implement international standards in dealing with issues of market and transactional integrity such as in regard to the control of money laundering and the proceeds of corruption.
14. There should be clarity in regard to the institutional responsibilities of regulatory and supervisory authorities and greater willingness and ability to ensure on a proactive basis that those operating in the markets are fit and proper with sound financial bases.
15. Regulatory and other relevant agencies should focus more on issues pertinent to the development of viable Islamic markets and products, and have the ability to pursue agreed objectives in a coordinated manner.
16. Where possible, agreement between scholars should be facilitated and promoted to provide greater certainty on the application of the *Sharī`ah* to current areas of controversy.
17. Legal expertise, along with relevant financial expertise, should be encouraged not merely for practitioners but also for those involved in developing and administering Islamic markets and products, including those responsible for making judgments.
18. Those involved in the management of *Sharī`ah*-compliant businesses in the financial sector should be made aware of the importance of managing and, in particular, controlling legal risk, including risks that arise by virtue of the interface between different systems of law.
19. The relevant law should be made as accessible and as understandable as possible to those in the financial services industry and those who seek to use its services.
20. The legal framework needs to be complemented by appropriate regulations, guidelines, practice notes and other elements that facilitate implementation.

# Chapter Four

## Summary of Recommendations

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# Summary of Recommendations

## *A. Development of Islamic Capital Markets*

**Taxation**. Tax issues connected with Islamic financial products have generally been recognised in all jurisdictions and have been addressed in many of them. Countries should examine whether there are remaining tax impediments to the development of Islamic finance. For those countries that may still have tax reforms to enact, there are now ample precedents for the changes required: all that remains is to have the political will to implement them.

**Liquidity**. The lack of liquidity in the Islamic capital markets remains one of the main concerns. Governments and regulators should encourage more issues by corporations.

The problem of benchmarks can best be addressed by an increase in the number of government issues, either in local or foreign currencies. Government bonds form the basis of a capital market by providing the necessary benchmarks, whether conventional or Islamic. Often governments regard the government bond market as something that is only useful if the government wishes to borrow money. A number of Islamic countries are in fiscal surplus and so there is no financing need to develop the government bond market. However, this misses the key role of the government bond market, which is being (as the risk-free standard) the benchmark for the rest of the capital markets.

The introduction of the International Islamic Liquidity Management Corporation (IILM) in October 2010 can assist the development of both primary and secondary Islamic capital markets, but it will only achieve the desired result if it is strongly supported by the global Islamic financial industry.

**Market makers**. As noted in Chapter One, market makers can play a vital role in facilitating the issuance and liquidity of Islamic securities, as they do for conventional bonds. Encouraging their development, through a careful design of incentives and obligations, would be an important way to foster the growth of the market for both Islamic and conventional securities.

**Encouraging the development of institutional investors**. In developed markets, institutional investors – mutual funds, pension funds and insurance funds – are dominant in the capital markets. The funds they manage are quite large and have been a key factor in the development of liquidity. While there has been some development in Islamic mutual funds, there is a major gap in defining the concept of an Islamic pension fund.

**Market integrity**. Institutional investors will tend to be deterred by markets that are perceived as inadequately regulated – that is, where market abuse is common. Respondents to the questionnaire said that while all markets had laws and regulations against abuse, the level of enforcement was not universally strong irrespective of the type of asset, conventional or Islamic.

Corporate governance standards are critical for institutional investors who are typically substantial but still minority shareholders/bondholders. Standards are a problem throughout all markets, developed and developing, but the problems tend to be worse (or perceived by investors as worse) where there are a large number of firms with a founding family in control or where there is substantial government involvement. These are both features of many markets in Islamic countries.

**Indices and ratings**. All four major global index providers – MSCI, FTSE, Standard and Poor's, and Dow Jones – offer a range of Islamic equity indices covering markets and sectors. Countries should provide the information needed to expand the coverage of these indices.

*Sukūk* issues should routinely be made subject to ratings by the ratings agencies, in order to enhance their attractiveness and competitiveness with conventional bond issues.

**Retail markets**. A number of factors are important for developing retail markets:

- a regulatory infrastructure that encourages competition among collective investments, including the admission of foreign competitors into the market;
- enactment of appropriate investor protection regulations;
- effective and efficient information dissemination (in real time);
- ensuring adequate investor education; and
- making access easy. This implies ease of transacting and ease of payment without unnecessary regulatory barriers or excessive costs of intermediation.

## *B. Improving Liquidity Management for Islamic Banks*

National authorities and international bodies can help further develop the Islamic finance market through a number of actions:

- Increase the supply of sovereign *Sukūk*, denominated both in domestic and in foreign currency.
- Ensure that the tax system does not impose an extra burden on Islamic financial transactions.[1]
- Promote standardisation of documents.

[1] In some jurisdictions this would require eliminating taxes on operations – such as sales of commodities – that are incidental to an Islamic financial transaction, such as *Murābahah*.

- Facilitate international acceptability by setting broad parameters for those needed to access international capital markets.
- Facilitate the convergence of criteria for deeming a transaction *Sharī`ah* compliant.
- Ensure there are appropriate ancillary services and infrastructure to support and enhance liquidity, such as electronic trading platforms.

## *C. Improving the Legal Infrastructure for Islamic Finance*

- Comprehensive and adequate legislation, which is compatible with the *Sharī`ah*, must be in place to recognise and give proper effect to the separation of legal and beneficial ownership.
- Legal obstacles to Islamic asset securitisation must be removed.
- There must be laws ensuring the proper and efficient administration of insolvent companies and business entities, including liquidation and dispute resolution procedures, that are compatible with the *Sharī`ah*.
- There must be laws which recognise the fiduciary obligations of persons who engage in activities where there would be a reasonable expectation that the parties are in what in common law legal systems would be considered to be fiduciary relationships, that are compatible with the *Sharī`ah.*
- The legal framework needs to be complemented by appropriate regulations, guidelines, practice notes and other elements that facilitate implementation.
- The relevant legal and other obligations of *Sharī`ah* boards and *Sharī`ah* advisers need to be clarified and reinforced.
- The obligation to provide and monitor *Sharī`ah* compliance needs to be clarified, emphasised and reinforced.
- The law relating to the enforceability of agreements where there is an issue under the *Sharī`ah* needs to be clarified, along with the issue of purification of tainted property and profits.
- Investors and others should have access to viable remedies – including arbitration and mediation – that can result in the payment of adequate compensation or the restitution of relevant property, such being compatible with the *Sharī`ah.*
- There should be clarity in regard to the relevance and enforceability of orders from courts in other jurisdictions, and appropriate arrangements (e.g. treaties, mutual recognition arrangements, MOUs) to facilitate enforcement.
- Regulatory and compliance personnel specialised in Islamic finance should be recruited and trained.
- Accountants and legal personnel specialised in Islamic finance should be recruited and trained.

# Concluding Remarks

**Professor Datuk Rifaat Ahmed Abdel Karim**

# Concluding Remarks

**Professor Datuk Rifaat Ahmed Abdel Karim**

## Developing Islamic capital markets is a pre-requisite

It is now well established that the development of capital markets plays a key role in building a financial infrastructure. On the one hand, the capital markets contribute to the development of the economy by enhancing the effectiveness of the capital intermediation process. On the other hand, the lack of developed capital markets may be a source of vulnerability to the financial system, since an over-dependence on financing from the banking sector may lead to funding mismatches, with negative implications for financial stability.

Strategies for developing the Islamic financial services industry (IFSI) need to follow a cross-sectoral approach, because of the close interconnection and interdependence between the various sectors of the financial system. For example, developing a sound, stable and efficient Islamic banking sector cannot be effectively achieved without developing the Islamic capital markets and the Islamic money markets.

Further, Islamic capital markets are a core component of economic development, as they are a source of long-term funding for corporations, governments and other entities. They provide opportunities for investors with surplus funds and facilitate the efficient use of capital.

## Islamic capital markets development: Challenges and opportunities

Developing Islamic capital markets presents opportunities as well as challenges. The IFSI (including Islamic capital markets) has seen sustained, significant growth for the last ten years and this trend is expected to continue. The growing population and high rates of economic growth in many Muslim countries will further increase the demand for infrastructure projects and their funding. In addition, product innovation and diversification will help the IFSI to reach a wider investor base and to tap the excess liquidity in oil-producing countries and some other emerging markets.

While these factors constitute real opportunities for the development of the Islamic capital markets, challenges exist and need to be overcome to ensure a sound and stable development of the IFSI. These challenges include:

i) The Role of Regulatory and Supervisory Authorities

Perhaps the most important role lies in the hands of the regulatory and supervisory authorities. They should take on not only their traditional regulatory and supervisory roles, but also a developmental role. Such a role may include proactively developing regulations and providing supportive rules, clearer guidelines, and statements of best practice for the development of *Sharī`ah*-compliant products and services, together with appropriate incentives for market players.

ii) Building a Liquidity Management Infrastructure

The lack of an effective and efficient liquidity management infrastructure has been an ever-present challenge for the industry, hampering its development and limiting its competitiveness. A number of initiatives have been undertaken, including the establishment of the International Islamic Liquidity Management Corporation, facilitated by the Islamic Financial Services Board (IFSB). This initiative will support the continued efforts by the central banks and monetary authorities to enhance the efficiency of institutions offering Islamic financial services in managing their liquidity.

iii) Product Innovation Aimed at Encouraging the Spirit of Islamic Finance

Developing the Islamic capital markets starts with promoting appropriate product structures that reflect the specificities of Islamic finance. Currently, many *Sukūk* structures have replicated conventional bonds by using mechanisms such as a liquidity facility arrangement, a purchase undertaking at a fixed formula, capping of profit by way of incentive payments, and tranche structures. Such practices have raised *Sharī`ah* issues. In at least some cases, they have diluted the essence of *Sukūk* instruments, leading to a lack of differentiation between *Sukūk* and conventional bonds. This is where product innovation has a role. We need to place an emphasis on product innovation in structuring Islamic capital market products. This will encourage the spirit of Islamic finance and facilitate greater acceptance by global financial markets, whereas merely replicating conventional financial products in ways that do not satisfy *Sharī`ah* criteria will not gain general acceptance. One of the Islamic legal maxims states that the origin of all rules is permissibility. In other words, the original rule for all beneficial things is permissibility, so long as there is no contradiction with *Sharī`ah*. This implies that there is room for product innovation within the context of *Sharī`ah* rules and principles.

iv) *Sharī`ah* Governance in Islamic Capital Markets and Implementation of IFSB-10, "Guiding Principles on *Sharī`ah* Governance Systems for Institutions offering Islamic Financial Services"

*Sharī`ah* is the "*raison d'être"* of Islamic finance (including Islamic capital markets); hence, a sound and effective *Sharī`ah* governance system should be in place in Islamic capital markets. The IFSB published the "Guiding Principles on *Sharī`ah* Governance Systems for Institutions offering Islamic Financial Services" in 2010. This document sets out several recommended best practices aimed at ensuring competence, safeguarding independence, observing confidentiality, and promoting consistency in *Sharī`ah* governance structures and processes. This document is easily accessible on the IFSB website (www.ifsb.org).

v) Ensuring a Level Playing Field, Particularly in Taxation

As indicated in Chapters One, Two and Three, for Islamic capital market products and in developing those markets, taxation plays a pivotal role. This is because it can heavily influence or distort decision-making in structuring particular products as a result of arbitrage between different tax regimes. Even a small difference in transaction costs incurred in structuring Islamic capital market products may lead to disadvantages, resulting in a loss of competitiveness of Islamic capital market products.

vi) Legal Issues and Challenges

Legal systems need to provide clarity and certainty to investors and other stakeholders with regard to transactions and products. Clarity and certainty attract the more sophisticated investors, who are wary of the dangers of legal disputes arising in their absence.

**The way forward**

This book both highlights the major challenges to the development of Islamic capital markets and makes practical recommendations for overcoming them.

We emphasised above that developing Islamic finance requires a cross-sectoral approach. It is clear that the way forward demands the active involvement of all stakeholders: regulatory and supervisory authorities, other government authorities and market players.

It should always be remembered that the development of the conventional capital markets took place over many generations in various countries, in ways that reflected national circumstances. (For example, the UK developed a vibrant equity market before other European countries.) Regulatory and supervisory authorities should set the priorities for the development of Islamic capital markets in their jurisdictions, taking account of the facts and circumstances within their jurisdictions and the stage of development of the capital markets in their countries from both a local and an international perspective. These priorities will define the implementation strategy of the recommendations set forth in this monograph. Implementing all the recommendations at once is neither desirable nor feasible. A continuing and dynamic process of regulatory and legal reforms to support the development of Islamic capital market products is likely to prove to be more effective.

After setting priorities for their jurisdiction, regulatory and supervisory authorities may wish to review whether their existing laws and regulations appropriately cover and support *Sharī`ah*-compliant products and services.

It is a well-known fact, established by many empirical studies, that one of the key factors in developing capital markets is having an appropriate legal and regulatory framework. This is also true for Islamic capital markets.

In today's global markets, an essential building block in financial stability is the close cooperation between regulatory and supervisory authorities themselves. In spite of some existing initiatives, information exchange is scarce and a general lack of awareness of the products and practices of Islamic capital markets remains. Enhanced cooperation and information-sharing between the regulators will be highly desirable and beneficial for the development of Islamic capital markets and the IFSI as a whole.

## Appendix

Case Studies

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The following case studies were prepared to provide additional details on some of the countries visited and are based on information obtained during those visits and other sources as referenced in each case.

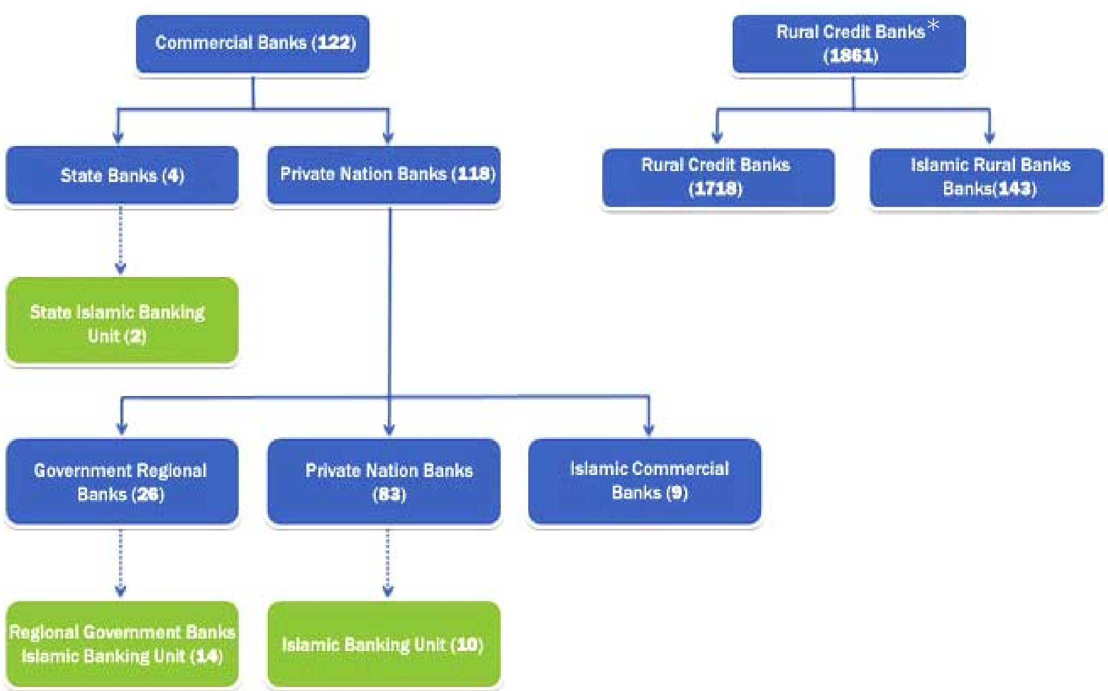
- **Case Study 1: Indonesia**
- **Case Study 2: Malaysia**
- **Case Study 3: Sudan**
- **Case Study 4: United Arab Emirates (UAE)**

# *Case Study 1: Indonesia*

## a. Financial Industry

In terms of Islamic finance, Indonesia differs from Malaysia or the United Arab Emirates (UAE). The latter are characterised by being well-developed financial markets in which Islamic finance and banking (IFB) is actively promoted by the government. In contrast, Indonesia is usually regarded as having a less fully developed financial sector with a relatively small banking sector compared with countries at a similar level of development. Banks are divided into commercial and rural banks. Commercial banks – also known as "public banks" – have a full range of functions, in addition to which they can participate in the payments system. In contrast, rural credit banks – also known as "people's credit banks" – have limited functions in savings and credit, and cannot participate in the country's payments system.[1] Rural credit banks are typically involved in microfinance-type activities and are relatively small in size. Both commercial banks and rural credit banks can be conventional or Islamic.

**Figure 1 Banking Institutions in Indonesia as of May 2010[2]**




** Amount of Rural Credit Banks by March 2010*

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[1] Banking Act 10, 1998.
[2] Source: Bank Indonesia.

As can be seen from Figure 1, the number of commercial banks is relatively small given the size of the country, with only nine Islamic banks. Until the last few years, Indonesia has not actively promoted IFB. With a Muslim population of approximately 86%, Indonesia has a large untapped market for IFB, both retail and wholesale.

Indonesia is a much more geographically spread country than either Malaysia or the UAE. Its population of 243 million is spread over 11,508 islands, although an estimated 55% is based in urban areas,[3] with in excess of 10 million people based in Jakarta. Encouraging banking and saving participation outside urban areas is a major challenge even for conventional finance.

The Indonesia Stock Exchange is similarly less well capitalised than others in the region and faces additional problems of achieving its target of 31% population participation in equity over the next five years.

### b. Regulatory Authorities

The financial sector in Indonesia is regulated by the central bank (Bank Indonesia). Law No. 8 of 1996[4] established BAPEPAM as the capital markets regulator. Consideration is being given to establishing an umbrella financial sector regulator or otherwise combining the regulatory functions of Bank Indonesia and BAPEPAM.

### c. Current Developments in the IFB Sector

Generally, the development of Islamic financial services in Indonesia has lagged behind that of the GCC countries and Malaysia. Recognising the potential, however, the government introduced the Islamic Banking Act in 2008, which is intended to promote and enable the expansion of IFB.[5] Article 3 of the Act states that "the objective of *Sharī`ah* (Islamic) banking is to support the implementation of national development in the framework of improving justice, cooperation, and the people's welfare...." When the Act was introduced, Bank Indonesia announced a target of increasing the proportion of Islamic banking assets to 5% of total system assets. Nevertheless, the sector accounted for less than 3% (75 trillion Indonesian rupiah (IDR) (US$8.4 billion)) of all bank assets in the country at the end of 2009.[6]

Positive recent developments in support of IFB include:

- **Sales tax.** Legislation that came into effect in April 2010 removes double sales tax on *Murābahah* transactions. Where previously tax was charged on both the

[3] Central Intelligence Agency, *The World Fact Book*, August 2010, https://www.cia.gov/library/publications /the-world-factbook/geos/id.html.
[4] A Law of the Republic of Indonesia, No. 8 of 1996, concerning the Capital Markets.
[5] A Law of the Republic of Indonesia, No. 21 of 2008, concerning *Shar'ia* (Islamic) Banking.
[6] Bloomberg (2010), "Indonesia Reviews *Shariah* Loan Restructurings: Islamic Finance", 18 August (http://www.businessweek.com/news/2010-08-18/indonesia-reviews-shariah-loan-restructurings-islamic-finance.html).

purchase and the sale, under the new legislation both sales will be treated as one transaction; hence, sales tax will be charged only once.

- **Regulation.** Bank Indonesia operates under a dual regulation regime in which conventional and Islamic banks are supervised separately, each in accordance with their own rules and regulations. The IFB sector is regulated based on the standards and guidelines defined by the Islamic Financial Services Board (IFSB). The Islamic Finance division within Bank Indonesia is designed to encourage and develop IFB.
- **National *Sharī`ah* Board.** Similar to Malaysia, a national *Sharī`ah* Board has been created which approves instruments on a national level. Instruments for deposits, financing and services have been defined (Codification of Islamic Banking Products, 2008).
- **Government *Sukūk*.** The Indonesian government has issued a series of *Sukūk* denominated in USD and IDR, some of which have been designed for retail participation. The most recent issues in IDR have unfortunately failed to attract sufficient interest, and the USD *Sukūk* originally scheduled for the second half of 2010 has been postponed until the first half of 2011.
- **Legal environment.** As noted above, in 2008 the Islamic Banking Act was introduced to allow banks to offer Islamic financial instruments. This law and its regulations are being reviewed with a view to reducing some of the restrictions on Islamic banks. For example, Islamic banks would be allowed to alter the terms of financing even before a debt becomes non-performing.

The range of products offered by the Indonesian IFB sector is limited compared to the more advanced centres such as Malaysia. Compared with the UAE, however, Bank Indonesia is more advanced in that it offers a number of liquidity management and monetary control instruments in the form of *Sukūk*, deposit facilities on a *Wadī`ah* basis, and the purchase and sale of Islamic securities, including repo and reverse repo transactions. In addition, Bank Indonesia has developed an innovative *Sharī`ah* certificate for monetary control based on *Ju'ala*.

### d. *Ju'ala* for Monetary Control

The *Sharī`ah* guidelines for *Ju'ala* contracts are encapsulated in *Sharī`ah* standard No. 15 as defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The standard specifies that *Ju'ala* can be used for contracts in the IFB sector if the end result can be determined and it is not affected by uncertainty regarding the work to be done. The *Ju'il* (offering party) can issue the contract to the general public or an individual worker, and the end date does not have to be known in advance. The contract can, for example, be applied in the following circumstances:

- exploration for minerals and extraction of water;
- debt collection;
- securing permissible financing facilities;
- brokerage; and
- discoveries, inventions and designs.

Bank Indonesia applies the *Ju'ala* transaction for the Bank Indonesia *Sharī`ah* Certificate (SBIS), which is an instrument within the Open Market Operation framework. The SBIS has the following characteristics:[7]

1. *Unit price*: IDR 1 million
2. *Tenure:* Minimum 1 month, maximum 12 months
3. *Issuance:* Paperless
4. *Collateral:* Permitted to be used as collateral to Bank Indonesia
5. *Secondary market:* Non-tradable
6. *Eligible counterparty:* Institutions offering Islamic financial services (IIFS) in Indonesia to meet the requirements of the Financing to Deposit Ratio (FDR) stipulated by Bank Indonesia

The SBIS are issued through an auction mechanism, and can be used as a repo to Bank Indonesia. SBIS are issued to tighten liquidity on a weekly basis and the compensation is determined based on fair market value.

### e. Securities Market

In Indonesia, the securities market is governed by Law No. 45 of 1995 concerning the Capital Markets, which covers any security listed on the Indonesian securities markets, and is regulated by BAPEPAM. Both conventional and Islamic securities are listed on these markets and fall under the same regulations. The regulations do not specifically make any provisions for Islamic securities. Instead, the laws are generically applicable.[8] In 2009, the Indonesian government asked the Asian Development Bank (ADB) for technical assistance in attaining deeper and more liquid capital markets, enhanced market supervision, and improved regulatory resources and capacity. The ultimate aim is to improve overall governance standards for capital markets and provide better investor protection.[9] As a result of this initiative, a number of rules have been introduced that govern the issuance of *Sharī`ah*-based securities.[10] The dominant securities market is the Indonesia Stock Exchange, on which all bonds and equity instruments are listed, including corporate and government *Sukūk.* The growth of the market in *Sharī`ah*-compliant securities is shown in the table below (in billions of rupiah).[11]

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[7] Bank Indonesia regulation No. 10/11/PBI/2008.
[8] http://www.bapepam.go.id/old/old/E_Legal/Law/index.htm.
[9] http://www.adb.org/documents/tars/ino/32507-ino-tar.pdf.
[10] http://www.bapepam.go.id/pasar_modal/regulasi_pm/peraturan_pm/indexENG.htm. Articles IX.13.A, II.K.1, IX.A.14.
[11] BAPEPAM Annual Report, 2009.

| **Product** | **2006** | **2007** | **2008** | **2009** |
|---|---|---|---|---|
| *Sukūk* | 2,282 | 3,174 | 5,498 | 7,015 |
| *Sukūk* Negara | | | 4,700 | 20,329 |
| *Sharī`ah* Investment Fund | 723 | 2,203 | 1,815 | 4,629 |
| **Total** | **3,005** | **5,377** | **12,013** | **31,974** |
| Growth | | 79% | 123% | 166% |

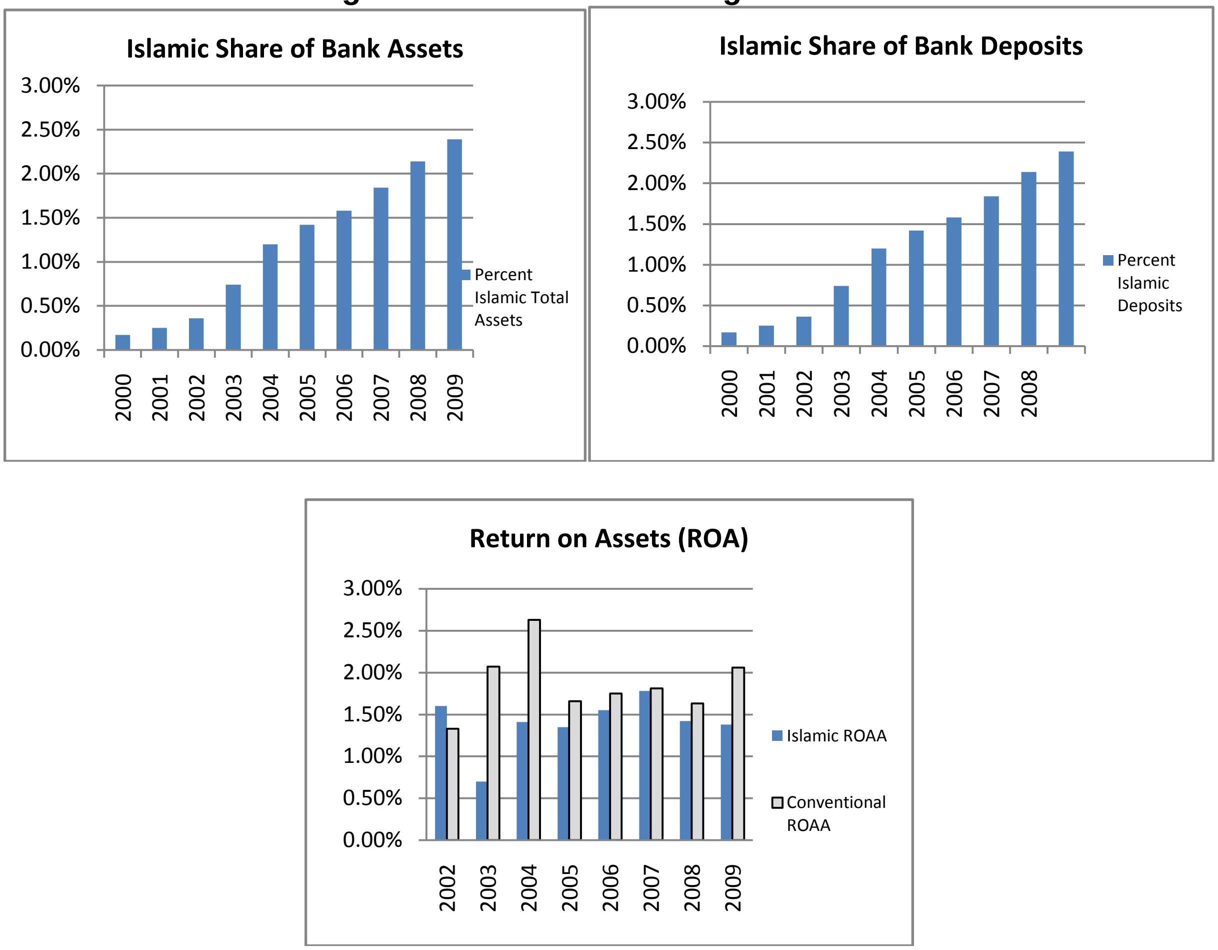
### f. Concluding Remarks

The Indonesian IFB has the potential to catch up with countries further along the road of Islamic finance development, particularly given the size of the country's Muslim population. To this end, a range of initiatives has been adopted, which should encourage the development of the IFB. These include the removal of the taxes on sales and purchases required in some Islamic financial transactions, the introduction of regulatory guidelines, a national *Sharī`ah* Board and the issuance of government *Sukūk.* Although it remains to be seen whether these measures will have sufficient impact, or whether other forms of stimulus may be required, the measures already taken have resulted in a level playing field for the IFBs. However, the Islamic segment – like most of Indonesia's financial sector – is highly fragmented with a significant number of low-capitalised banks, many with only one branch. This may need to change in the future for both the conventional and Islamic segments to develop more fully.

Although there is a division of duties between Bank Indonesia and BAPEPAM, the exact distinction does not always appear to be clear to market participants. It is therefore recommended to provide further clarification and dissemination of such division, to facilitate effective and efficient operation in banking and the capital markets. The offering of SBIS for monetary control is innovative, and it is worthwhile assessing whether a similar structure can be applied to other instruments.

Overall, there appears to be a large untapped market that can be serviced by the IFB sector in both the retail and wholesale segments.

**Figure 2 Indonesia: Banking Indicators**

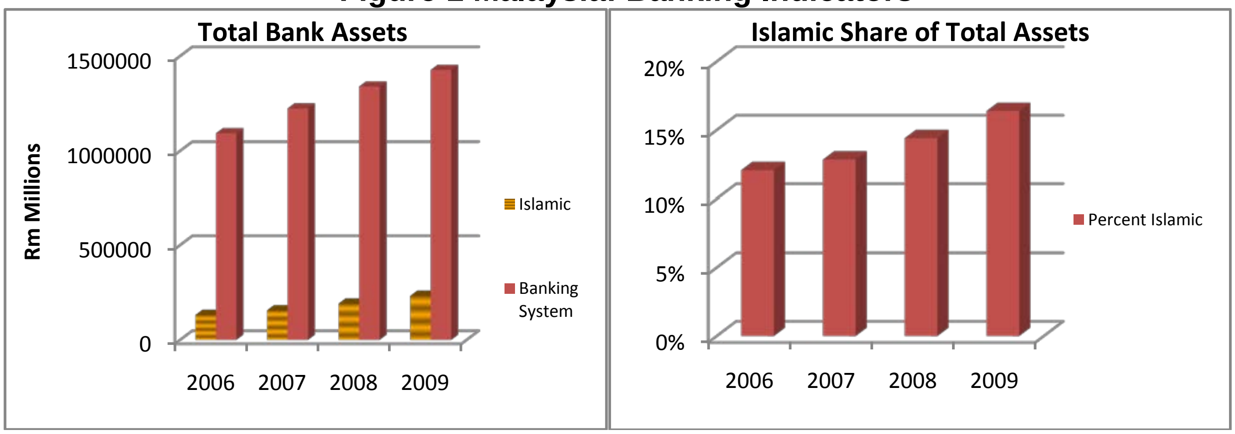



*Source: Indonesia – Indonesian Islamic Banking Outlook 2010.*
*http://www.bi.go.id/NR/rdonlyres/075B56DD-F6FA-4F5F-9292-C805F768266B/20188/ IndonesianIslamicBankingOutlook2010.pdf*

## *Case Study 2: Malaysia*

Malaysia has made great progress in developing Islamic finance over recent years, a process facilitated by a supportive infrastructure. Figure 1 presents the evolution of the banking sector over the last few years, and shows the steady increase in the share of the Islamic segment. Nonetheless, the industry still faces some impediments to its further development.

**Figure 1 Malaysia: Banking Indicators**




*Source: Bank Negara Malaysia, August 2010.*

The Malaysian authorities have been strong supporters of Islamic financial development. Key elements of their support include a legal and regulatory framework that takes into account the special characteristics of Islamic finance, a consistent and stable *Sharī`ah* environment, tax incentives, and central bank liquidity management facilities.

Malaysia included specific provisions on Islamic financing in its legislation on banking in 1983 and on securities in 1993. Specific regulations complemented the legislation, in order to give Islamic finance a clear legal and regulatory framework. Regulations usually follow a two-tier approach: first, a tier that applies to both the conventional and Islamic segments, followed by another tier that states the requirements to meet *Sharī`ah* prescriptions.

In many jurisdictions, different interpretations of the *Sharī`ah* by scholars have added uncertainty to Islamic financial transactions. Malaysia has addressed this problem by setting up two National *Sharī`ah* Advisory Councils. One council is attached to Bank Negara Malaysia (BNM) and covers Islamic banking and insurance, and the other is attached to the Securities Commission (SC) (which acts as its secretariat) and deals with all *Sharī`ah* matters under the Commission's jurisdiction. The initial advisory powers of these bodies were expanded in 2009, to make their rulings of mandatory application by judges and arbitrators.

As a result of the efforts carried out in both the legal and *Sharī`ah* areas, market participants in Malaysia appear satisfied with the clarity of the legal and regulatory environment. Thus, a bank wishing to introduce an Islamic product need consult only its own *Sharī`ah* Board. The Board only needs to consult the BNM's *Sharī`ah* Advisory Council if the proposed product differs from those that the Council has already approved. Also, the Advisory Councils attached to BNM, SC and the Labuan Financial Services Authority have taken steps to harmonise their actions through meeting with each other and having common members. These steps will be formalised in Memorandums of Understanding.

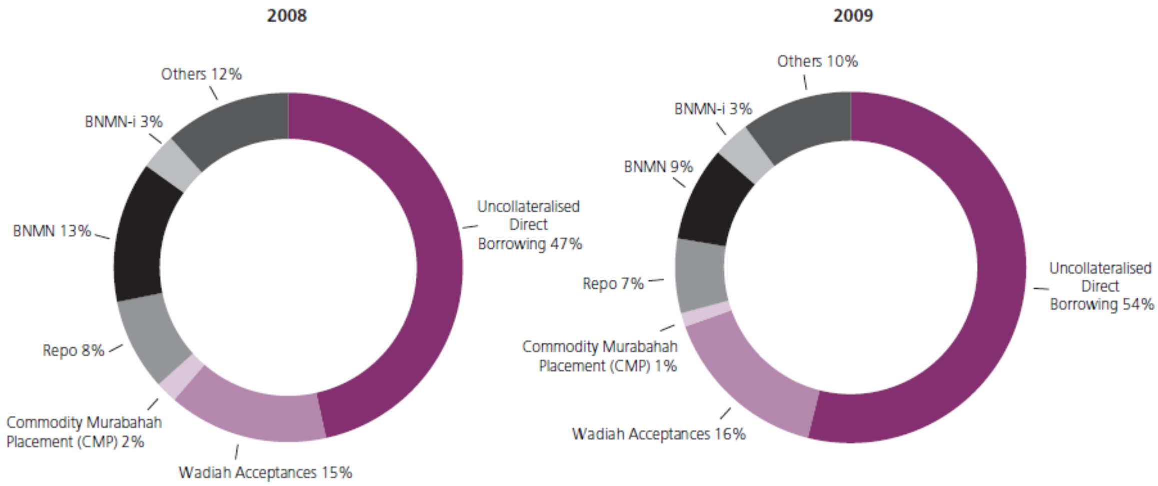
BNM has also supported the development of Islamic banking by introducing specific monetary instruments that facilitate both monetary policy execution and the IIFS's own liquidity management. BNM offers daily to borrow from Islamic institutions for maturities ranging from 7 to 45 days. For maturities up to 21 days, BNM prefers to use the *Wadī`ah* principle, and gives a gift on maturity. The IFI is not told in advance what the gift will be, but BNM relies on the *Hibah* principle, and its gift to the IIFS is in line with the yield of a similar transaction in the Islamic interbank market. For longer maturities, BNM normally uses commodity *Murābahah*.

In addition to the above instrument, BNM also issues Islamic monetary notes, based on *Ijārah* (using the lease on BNM buildings) and commodity *Murābahah*,[1] which are the counterpart of the monetary notes available to commercial banks. It also plans to issue securities using *Istihmār*, which will combine 51% *Ijārah* and 49% commodity *Murābahah*.[2] [3]

Both IIFS and conventional institutions can participate in BNM operations in securities. To minimise competition between conventional and Islamic issues, BNM differentiates in terms of tenure of the issue.[4] Figure 2 below shows the relative importance of the various monetary instruments (conventional and Islamic) that BNM used in 2008 and 2009.

[1] The commodity *Murābahah* was introduced to replace earlier issues under the *Bay` al-`Inah* concept, which had raised some *Sharī`ah* compliance concerns.
[2] The Islamic Development Bank has issued securities using a similar method.
[3] While *Istisnā* could also be used, the BNM will only rely on commodity *Murābahah* in this case.
[4] Issuance takes place regularly, twice a week, albeit BNM can skip an issue if it deems that appropriate in light of market liquidity.

**Figure 2 Malaysia: Breakdown of Outstanding Monetary Instruments**




*Source: Bank Negara Malaysia Annual Report, 2009.*

The Islamic interbank market relies mostly on *Mudārabah* for shorter maturities (overnight to one week) owing to its lower cost compared to commodity *Murābahah*, which is the instrument of choice for longer maturities. Some operations rely on *Wakālah* arrangements.[5] According to BNM, the yield curve for Islamic interbank operations lies below that for conventional operations at shorter maturities (e.g. five points for overnight transactions) but above it for longer ones (beyond three weeks).

The SC has a dual role, as regulator and as promoter of capital markets development. With regards the latter, since 2000 a ten-year Capital Markets Master Plan has provided a blueprint for action, and will be continued with another now presently under preparation. The SC follows the IOSCO principles – which its *Sharī`ah* Advisory Council has found as compatible with the *Sharī`ah*. The Council has been open to innovation: insofar as a proposal is of general benefit and in line with the *Sharī`ah*, the Council has been prepared to approve it. The Council also manages a registry of approved *Sharī`ah* scholars. These scholars must meet certain requirements as regards knowledge of financial matters and also of the *Sharī`ah* principles applicable to finance. In the case of members of banks' *Sharī`ah* advisory councils, it is the BNM that must give its consent.

In broad terms, the authorities wish to provide a level playing field for both Islamic and conventional finance. However, since they consider the Islamic segment to be still at an infant stage, they have given it some incentives (e.g. fiscal) that go beyond the objective of levelling the playing field and are intended to encourage the segment's development. The incentives include, for instance, waiving taxes on *Murābahah* sales and purchases and stamp duties on the many agreements required to complete an Islamic financial operation. (Stamp duty in Malaysia is 0.5% on the amount of the borrowing; Islamic

[5] Risk and cost affect the choice of instruments. For instance, the broker's cost of a commodity *Murābahah* transaction is IDR30–35 (depending on the size of the transaction) per IDR1 million if done through the London Metal Exchange, and IDR25–30 if done through the Palm Oil Exchange in Malaysia.

operations get a 20% discount). First-year expenses for *Sukūk* issuance are tax deductible.

Notwithstanding the overall favourable environment, the secondary market for fixed-income Islamic securities is not well developed yet – although market participants perceive it to be more liquid than in other jurisdictions.[6] The SC estimates that, on average, one *Sukūk* is traded about three times a year. The bulk of these transactions are over the counter, but must be reported to the stock exchange within ten minutes of execution: this applies to both government and private paper.

Both market participants and the authorities have taken steps to facilitate internationalisation of the Malaysian Islamic market and products. The Advisory *Sharī`ah* Councils include foreign scholars (e.g. from Afghanistan, Indonesia and Thailand). Progress is being made also in areas such as mutual recognition of financial products and linkages between exchanges. In the same vein, Cagamas has announced the launching of a new product, *Sukūk* ALIm, which by excluding certain aspects of other *Sukūk* is expected to be compatible with *Sharī`ah* requirements in areas such as the Middle East.[7] The basis of the new *Sukūk* will be more than 50% in the form of tangible assets and the remainder will be receivables commingled under one basket (including commodity *Murābahah*).

Historical data on Malaysian government bond yields suggest that *Sukūk* yields tend to exceed those of conventional bonds because of their lower liquidity.[8] They attract investors with a buy-and-hold objective. Often, like in the case of those issued by PETRONAS and the Malaysian government, the largest share of the issue is bought by conventional investors.

Malaysia has undoubtedly made great headway in developing a vibrant Islamic finance sector. Nonetheless, market participants mentioned several aspects that still affect the potential development of the sector: (1), further progress in document standardisation would reduce costs; (2) the interbank market remains underdeveloped (one problem being the small size and perceived riskiness of some IIFS); (3) too limited possibility of hedging; and (4) lack of sufficient tangible assets to support Islamic instruments.

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[6] Electronic trading platforms, trading companies and rating requirements are some favourable elements of Malaysia's infrastructure for securities trading (including Islamic issues).

[7] In a press release announcing the operation, Cagamas indicated that "*Sukūk* ALIm structure is a type of *Sukūk Istithmar* but precludes the principles of *Inah* (sale and buyback), *Bay` al-Dayn* (trading of debt) and *Wa`d* (undertaking)".

[8] Source: http://bondinfo.bnm.gov.my/portal/server.pt?open=514&objID=27205&parentname=CommunityPage&parentid=18&mode=2&in_hi_userid=22874&cached=true

## *Case Study 3: Sudan*

### a. Primary Market

The *Sukūk* law of 1995 regulates the issuance of both private and public *Sukūk*. The Sudan Financial Services Company (SFS) has been in charge of issuing *Sukūk* on behalf of the government.[1]

The government has issued two types of securities: Government *Mushārakah* Contracts (GMC) and Government Investment Certificates (GIC). The former have a one-year maturity and are issued quarterly. GIC have longer maturities: it used to be three to seven years, but now a two-year security is also available.

GMC and GIC are both issued by the Ministry of Finance to finance the budget and to encourage savings. These securities, as well as the central bank's *Ijārah* certificate (GIC), are considered safe collateral for borrowing from IIFS, which enhances their attractiveness to investors. The ministry plans to replace GMC (too costly) with GIC as they mature, which could take three to five years. It would also like to use GIC to finance ordinary government expenses and not just new projects.

Presently, GIC are earmarked for investment projects and are part of the development budget. The financial arrangement with the supplier can be in the form of supplier credit or a letter of guarantee. In the latter, the government commits to paying certain amounts against certificates of completion as the project is executed, after a grace period.

GICs also help to develop the market and manage liquidity. However, issuing them takes time, as it must be determined whether the contracts will be *Ijārah* or *Istisnā`*, which depends on the progress of the project. The Ministry takes into account market demand to determine whether a quarter is a good time or not to issue GIC.

Both GMC and GIC are placed by subscription, with indicative prices. If oversubscribed, orders are filled on a first-come first-served basis. Issuance takes place in January, April, July and October. The subscription is open for ten days. One month later, subscribers get the physical certificate, which can then be traded in the Khartoum Stock Exchange (KSE). The placement is done through underwriters (e.g. a group of banks), which also serve as market makers. Underwriters have not needed to fill a gap for GMC, but occasionally have had to do so for GIC.

While, in principle, GICs are issued quarterly, the ministry decides whether to carry out a sale depending on its financial needs and market conditions. For instance, on 1 January, the first GMC sale takes place. The ministry reviews results and on that basis

[1] The SFS is owned by the Central Bank of Sudan (99%) and the Ministry of Finance (1%) and chaired by the Minister of Finance.

decides if and when GIC will be issued. In 2009, four issues of GMC took place and only one of GIC.

Both securities are issued in paper form. The SFS keeps the registry, and trade takes place at the KSE, which plans to shift to electronic dealing by the end of April 2011. At that point, investors will have accounts with both the KSE and the SFS, and settlement will be fully electronic, linking the KSE with the real time gross settlement of the central bank. The KSE will be both depository and registry.

The scarcity of assets to back *Sukūk* has prevented developing an issuance strategy. Issuance depends on the needs of the Ministry of Finance. The privatisation of public companies has limited the possibility of issuing GMCs.[2] The GIC are part of the government development budget, and are earmarked for specific investments of government departments.[3] [4] The funds stay with the SFS, which acts as *Mudārabah*. Lack of proper listing of assets has further limited the possibility of issuing GIC. In addition, it takes time to establish whether the underlying contracts will be *Istisnā`* or *Ijārah*, since it depends on the progress of the project. As a result of these constraints, issuance has been irregular and issuance notices are provided only one or two weeks before placement. In 2009, there was only one issue of GIC.

Individuals hold about 30% of GMC. This share falls to 7% in the case of GIC. The yield on both has been similar, in the range of 15–17%.

The Bank of Sudan Investment Fund relies on *Ijārah*; the same concept will be used for the Agricultural Bank of Sudan. Attempts to issue *Salam* certificates (which allow the funds to be used for anything) failed, since investors have to wait for the property to be sold to know the yield on their investment. With *Ijārah*, the issuer can announce a range for the yield.

Backing of Islamic securities is presently 49% *Istisnā`*, the rest other fixed assets. In these arrangements, the investor typically gets 92%, and the rest goes to the company.
The High Advisory Committee for Government *Sukūk* (an internal committee of the Ministry of Finance) makes the recommendation for approval of all *Sukūk* issuance, giving the approval recommendation to the Ministry of Finance. Issuance of *Sukūk* also requires approval from the KSE and the Central Bank.

[2] This does not affect GIC, since the government has plenty of assets.

[3] For instance, to build a school, the SFS signs an *Istisnā`* contract with the government, and another with the builder. SFS gets the funds. The contract with the government is a restricted *Mudārabah* contract, and the contract the SFS signs with the builder is a regular construction contract. As another example, the government allocates funds to a state to buy medical supplies. That state will then sign a *Murābahah* contract with the SFS.

[4] The GIC yield is practically fixed at 16%. The GIC is based on Islamic contracts built on profit-sharing to be invested in certain low-risk activities, such as *Murābahah*, *Muzawama* and *Ijārah*. This makes it easy to price.

### b. Secondary Market

All securities trading takes place on the KSE – which is owned by the Ministry of Finance and chaired by the minister. A Sudan capital markets authority is supposed to regulate the currency and stock markets, but has not yet been established.

The market trades shares of 67 listed companies, of which 30 are actively traded – mainly telecommunications and banks.[5] The only debt securities traded are those issued by the government. *Sukūk* trade much more actively than shares; on average, *Sukūk* for 10 million pounds (about US$3 million) trade daily. GMC is the most active security traded in KSE, and is the closest to what the market wants. This security has existed since 1999 and has built a good reputation. It used to take two days to settle transactions, but that time will be shortened following the KSE's move to electronic trading.

### c. Money Market and Monetary Operations

There is no money market in Sudan. Banks can hold up to 25% of their deposits in *Sukūk*, which are investments attractive to them.

Banks adjust their liquidity by selling securities in the KSE or through transactions with the central bank. The latter uses GMC and GICs in open market operations, to manage liquidity and help market development. The Central Bank of Sudan (CBoS) is obliged to buy government securities upon banks' request. OMOs are outright sales. Banks prefer doing transactions with the CBoS rather than with the KSE, because it is faster (funds are available the same day) and cheaper – the CBoS charges no fees or expenses, while the KSE charges a 0.25% transaction fee.[6]

The CBoS does not regularly go to the market. Its interventions are typically through interbank investment deposits, using *Murābahah* or investment deposit. To determine yield, the CBoS calculates a fair yield of 16% for the *Sukūk*, which it divides by 12 to get the monthly yield.

For OMOs, the CBoS carries out transactions in GMC, GIC and its own *Ijārah* certificate – of which there has been only one issuance. Sudan's *Sharī`ah* does not allow repos.
The CBoS may also buy securities from a bank with liquidity needs – it does so directly, without going through the KSE. The CBoS may also enter as a partner with other banks in a *Mushārakah* contract to finance a project.

The CBoS has been trying to hold regular (weekly) *Sukūk* auctions to buy and sell *Sukūk.* In addition to its OMOs, the CBoS runs a last-resort facility, in the form of an unrestricted deposit with banks, under the same conditions as apply to any bank customer.

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[5] Thirty-six brokers operate, all of which can trade but are classified into four categories, depending on the broker's capital.
[6] Securities can only be transacted through the KSE.

There are no restrictions on holding *Sukūk* in foreign exchange or placing funds abroad. Some banks place overnight foreign exchange deposits abroad, using their own funds abroad or purchasing the foreign exchange from the central bank.

Lack of instruments is a problem for short-term liquidity management; only cash is available as daily liquidity, since securities take time to convert into cash. Market participants have suggested that making more short-term Islamic securities available would help.

## *Case Study 4: United Arab Emirates (UAE)*

Islamic banking was launched in the UAE with the establishment of Dubai Islamic Bank in 1975. Since 1998, seven new Islamic banks have been established. Total assets and deposits of Islamic banks have grown rapidly since 2002 and by end-2009 were equivalent to about 18% (19%) of total banking assets and deposits, respectively (see Figure 1). Issuance of *Sukūk* expanded rapidly during 2005–2008, but has since levelled off following the 2008 financial crisis and the default of the Nakheel *Sukūk*.

As an Islamic country, the UAE supports the development of Islamic finance through an enabling legal framework. The Dubai International Financial Center (DIFC)[1] has actively promoted the development of Islamic products and markets and sees the UAE as a potential hub for intermediating petroleum and other revenue in the GCC.

The UAE has provided specific authorisation for Islamic finance beginning with Federal Law No. 6 of 1985 concerning Islamic Banks and Financial Institutions. The Dubai Financial Services Authority (DFSA)[2] established the Law Regulating Islamic Financial Business in 2004. ESCA, the Emirates Securities and Commodities Authority, issued regulations covering *Sukūk* in 2005. Furthermore, the Civil Code defines various Islamic products in the UAE context, such as *Mudārabah* (trust financing), *Mushārakah* (partnership financing) and *Ijārah* (leasing).

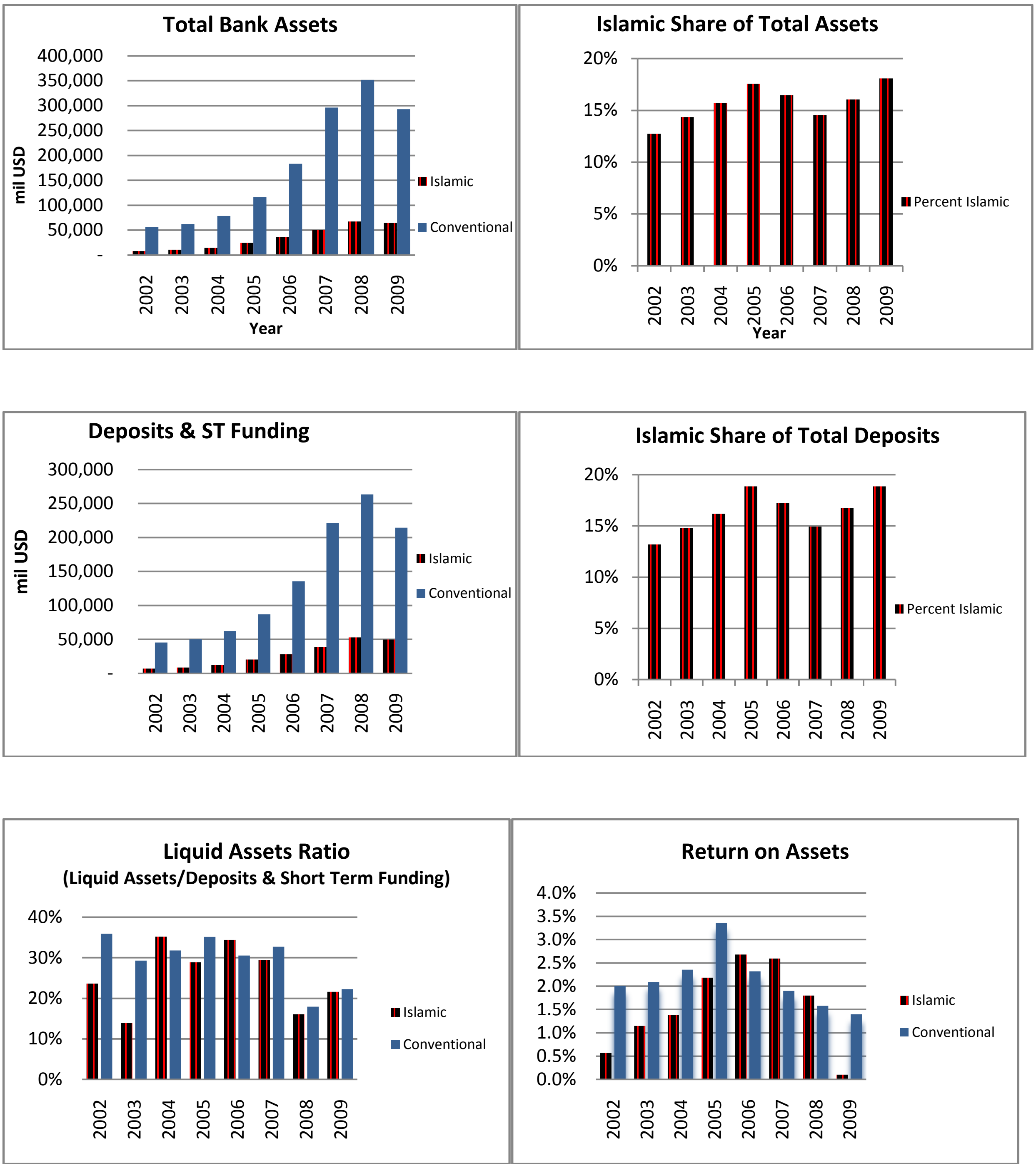
Market participants generally thought there was a level playing field as regards the supervisory and prudential regulations affecting conventional and Islamic finance. Double taxation of Islamic products is not an issue, because there are no transactions, turnover or income taxes in UAE. Banks did not express concern about the treatment of "*displaced commercial risk*". They are more conservative than required by prudential regulations (a guideline of 35% for alpha, the proportion of assets financed by profit sharing investment accounts to be included in the denominator of the capital adequacy ratio) about the degree of displaced commercial risk.

The Central Bank of the UAE (CBU), DFSA and ESCA are *Sharī`ah* systems regulators, not *Sharī`ah* regulators. This means there are no national-level *Sharī`ah* Boards in UAE. Instead, each IIFS is required to put in place its own *Sharī`ah* Board. The Board makes rulings as to the consistency of proposed financial products with Islamic principles.

The lack of standardisation of Islamic products, as approved by individual *Sharī`ah* Boards, is a significant impediment to development of Islamic finance in UAE. Market participants expressed the view that central banks should support groups of *Sharī`ah* scholars to move towards international standards and standardised Islamic products. They suggested that international organisations, such as the Islamic Financial Services Board (IFSB), the Islamic Development Bank and the Asian Development Bank should be taking the lead in standardisation of *Sharī`ah*-compliant contracts.

[1] DIFC is a 110-acre enclave designated as a financial free zone, located in the centre of Dubai and owned by the Emirate of Dubai.
[2] DFSA is the sole and comprehensive financial regulator for the DIFC.

**Figure 1 UAE: Banking Indicators**




*Source: Bankscope.*

### a. Liquidity Management Infrastructure

To mop up excess liquidity at conventional banks, the CBU issues its own certificates of deposit (CDs) on demand, with maturities of one month to 18 months. Until 2008, the CDs were the only available government-backed financial instruments.[3] Following the

[3] Owing to large oil revenues and fiscal surpluses in most years, UAE has never issued sovereign debt.

worldwide financial crisis of 2008, and the collapse of Dubai World, a large government-related enterprise (owned by the Emirate of Dubai), the Emirate of Dubai issued US$10 billion of its debt to the CBU. CBU is presently using these assets as the basis for liquidity support via repos to conventional banks.

Because all of the instruments available to banks are interest-bearing, CBU has no instruments to help Islamic banks with their liquidity management. After some years spent considering modalities for Islamic monetary operations, the Governor of CBU announced in a June 2010 speech in Singapore: “There is now a reasonable proposal to advance solutions for this issue.”

CBU has recruited specialised staff, including from Malaysia, to help develop new Islamic instruments. CBU is considering launching *Sharī`ah*-approved instruments that would allow Islamic banks to invest their large amount of excess liquidity in *Murābahah* instruments. Conversely, to access liquidity, under the new arrangements, Islamic banks could do repos at penalty rates.

Banks that operate through Islamic windows or as Islamic subsidiaries of conventional banks have much less difficulty with their liquidity management than freestanding Islamic banks, because of their relationship with the parent bank. Within the organisation, operations can be characterised as interest transfers, not transactions, and thus do not come under *Sharī`ah* surveillance. Hence, excess liquidity can be transferred from the Islamic side to the conventional side without the need for *Sharī`ah* Board approval.

### b. Islamic Capital Markets Development

Debt markets, both conventional and Islamic, are relatively underdeveloped in UAE, constituting less than 6% of total financing. There has been no sovereign *Sukūk* issued in UAE, although this is under active consideration by the Ministries (of Economy and Finance), CBU and the Departments of Finance of the Emirates of Dubai and Abu Dhabi. Such an issue is seen as key if Islamic finance is to expand in UAE as it has, for example, in Malaysia and Bahrain. Market participants viewed the issue of sovereign debt instruments as a question of will rather than the absence of instruments, since other countries have had very successful Islamic sovereign debt issues. Dubai Department of Finance indicated that its *Sukūk* programme has identified many assets that can potentially be used to back *Sukūk*, such as Dubai Airport Terminal 1, the Rapid Transit Authority and roads.

Another impediment to the further development of Islamic debt markets is the absence of price discovery mechanisms and the lack of emergence of a yield curve. In particular, there is no active secondary market and an unknown volume of trading in the over-the-counter market. Almost all corporate and Emirate *Sukūk* issued have been in the maturity range of one to five years. There was a boom in *Sukūk* issuance in 2007–2008 and then a decline after the default of the Nakheel *Sukūk*.[4] Owing to the lack of any regular issue of *Sukūk*, especially of longer tenor, most buyers intend to “buy and hold” because they don’t know when another *Sukūk* will be issued. The market lacks the breadth, depth and liquidity necessary to the development of a yield curve. Notionally, there is little difference between the yield curve for conventional instruments and that for *Sukūk*. UAE banks are aware of,

[4] Nakheel is the real estate subsidiary of Dubai World, owned by the Emirate of Dubai.

and support, the IFSB's initiative to establish IILM, an International Islamic Liquidity Management Corporation, to enable the regular issue of highly rated *Sukūk*, marketable across countries.

While not specific to Islamic finance, CBU staff responsible for *payments and settlement* oversight noted that UAE is a cash-based economy. The government vision for 2011–2013 is to try to move towards electronic systems of payment – for example, by the use of metro cards, cards for low-price purchases, and credit and debit cards. For settlement in dirham, all banks are members of the UAE funds transfer system. Islamic credit cards are widely available through Visa and MasterCard.