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Capital and Money Markets of Muslims: The Emerging Experience in Theory and Practice

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1. Introduction

Capital market – or more precisely the *primary* capital market – is the fulcrum of capital formation whereby liquid funds are effectively mobilised, pooled and channelled through the financial system to finance the production of goods and services in the economy and, hence, effectively contribute to real economic growth. However, the long term commitment of funds in the production of goods and services tend to be thwarted by two major concerns on the supply side of funds (1) parting with liquidity and (2) exposure to various economic risks. An efficiently liquid capital market is, therefore, one which prudently resolves these two major problems through the structuring of appropriate capital market instruments and the placement of supportive financial and regulatory institutions. The worldwide phenomenal growth of *secondary* financial markets have thus flourished to cater the needed liquidity and risk management services through the free sale and purchase of capital and money market instruments. In particular, the trading of short term loans or debt instruments through money markets, with maturity less than one year, proves to be an important efficiency-enhancing arm to capital markets.

Islamic finance is governed by the law of Shari'ah (Muslims' law) which basically prohibits the interest rate as well as a kind of 'structured' uncertainty within financial contracts called *gharar*[1]. Depending on the maturity of financial assets, it will be shown that Islamic securities can be structured to act as either 'capital market' or 'money market' instruments. It is particularly interesting to see how Islamic capital and money market instruments have been structured with a view to issues of liquidity and risk management. Yet, currencies in whatever denomination are not legitimate objects of money market trade from Shari'ah perspective. For example, foreign exchange has to satisfy the hand-to-hand condition, which means that any deliberate delay or deference in the exchange of currency falls in the special category of prohibited usury called *riba al-nasaa'* or the usury of deference[2].

This paper is about the experience of the newly emerging Islamic capital and money markets, and how they have been set out to integrate with global capital markets in accordance with Shari'ah-compliant solutions. At the outset, a brief background on the importance of money markets is given, followed by a comparative demonstration of conventional and Islamic financial markets. The structural properties of Islamic capital and money market instruments are then explained with reference to the emerging financial market experience in the Muslim world. In anticipation

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1) Unlike the strict prohibition of interest rate financing, removal of *gharar* in Islamic jurisprudence is taken as a best effort practice since it might be impossible to guard against all possible sources of uncertainty in a sale contract or a financial contract.

2) *Riba al-nasaa'* is defined in the barter exchange of some specific foods and monetary items (gold and silver) as any time deference in the exchange of such items; e.g. exchanging spot units silver against deferred units of gold.

of possible ideological concerns about the present upsurge of Islamic capital markets in the global world economy, a short historical background about the role capital markets in the early Muslim civilisation is provided, followed by conclusive remarks.

2. Why Money Markets?

Money markets play an important role in helping governments and corporations synchronize cash outflows and inflows, and help regulators control the supply of money. Governments can get quick cash from the sale of Treasury Bills to finance immediate obligations in anticipation of tax proceeds. Similarly, large corporations can have close access to quick cash from money markets to meet their immediate obligations (e.g salary payments, public utility bills, etc.) in anticipation of sales' proceeds. Central banks, on the other hand, are able to regulate money supply through 'open market operations' within the money market. Acting as agents for distributing government securities, central banks sell government securities in large amounts if the desired policy is to reduce money supply, or alternatively buy government bonds from the public if the policy is to increase money supply.

In addition to having 'less than a year maturity' money market instruments have three common characteristics: (1) that they are usually sold in very large denominations hardly accessible to households and small businesses; (2) that they usually have low default risk and (3) that they have a highly active and liquid secondary market. Being *wholesale* markets with large transactions, usually in excess of $ 1 million, modern money markets are more suited to brokers and dealers within the trading rooms of large banks and brokerage houses or through complex electronic networks, than to small scale investors and individuals. The low risk associated with money markets is largely attributable to relatively low investment rates of return compared to capital market rates. Buyers of money market securities (borrowers) are not primarily attracted by prospects of high returns. Rather, it is the appeal of finding a good substitute to holding idle cash for short periods of time which makes money markets' securities particularly attractive to buyers. When a productive use for a cash surplus is still in the process of being worked out, it pays investors to warehouse their surplus cash temporarily in money market instruments until the productive use commences.

Money markets are therefore equally vital for Islamic economies, not in the least for controlling and regulating money supply in the economy. The main jurist problem with conventional money instruments relates to their pre-dominant debt-based structure. Nonetheless, the recent upsurge in short term Islamic bonds (*sukuk* or certificates), seems to have filled a significant gap in the growing Islamic financial markets. Islamic central banks – as in Sudan, Pakistan and Malaysia – have also developed legitimate money market instruments on the basis of *musharakah* to help regulating money supply in the economy. While particularly relevant for short term money market dealings, *sukuk* can still perform the function of capital market instruments, depending on the maturity of the sakk or the certificate. According to AAOIFI's (the Accounting and Auditing Organization of Islamic Financial Institutions) Shari'ah standards, investment *sukuk* include *sukuk* of ownership of leased assets, ownership of services, *murabahah*, *salam*, *istisnaa*, *mudarabah*,

musharakah, investment agency, and sharecropping, irrigation and agricultural partnership.

It is beyond the scope of this paper to review the special properties or Shari'ah standards of different Islamic financing modes – *mudarabah*, *musharakah*, *murabahah*, *ijarah*, *salam*, *istisnaa*, etc. – as they underlie the complex structure of *sukuk* in the emerging Islamic money and capital markets. The appended list of references can help the reader to acquire the needed background. A more formal statement of how *sukuk* may originate from different Islamic modes is given in Adam and Thomas [2004]. Nonetheless, it is important to offer a brief background on *mudarabah* and *musharakah* in the comparative demonstration of conventional as against Islamic corporate concepts.

3. Corporate Finance: the Conventional versus the Islamic Version.

Liquid capital is channelled to productive enterprises through the creation of corporate equity or the borrowing of funds whenever new enterprises are being established or existing ones being expanded[3]. In the conventional practice there are different ways of raising equity capital or borrowing funds, depending on the different legal structures of companies. Generally, providers of equity capital are considered the legal owners of any given enterprise no matter whether equity is issued to the general public through modern corporations; or privately placed through limited liability companies; or maintained within the legal charter of unlimited partnerships.

However, emphasis is placed in this paper on the modern public corporation since it is the pivotal form of business organisation that sparks the bulk of capital market activity. The modern corporate entity is identifiable by three fundamental characteristics: (1) being an independent legal personality from its equity owners (i.e. the shareholders), (2) having a provision of limited liability of shareholders towards the debts of the company, (3) admitting negotiability of shares in the stock exchange. Obviously, liquidity in the capital market depends crucially on whether corporate equity is negotiable or not in terms of the free sale and purchase of corporate equity within organised secondary markets. This facility, however, is often restricted to listed public corporations, thus partly explaining why public corporations tend to grow at considerably higher rates than other legal forms of business organisation. For example, although public corporations represent around 15% of businesses in the USA, they make about 85% of all sales [Kolb and Rodriguez 1992: 12].

Funds can also be borrowed at an interest rate either directly from the banking system; or through publicly issued bonds that can also be traded in secondary markets; or through the private placement of loans or bonds to lenders subject to agreed terms and conditions. Yet, lending of funds in whatever form does not confer a status of ownership on lenders as it creates a fixed liability upon the equity holders. Companies are thus under the legal obligation to pay lender dues out of the company's profit before paying out any dividends to equity holders. It partly explains why borrowed funds in the conventional practice are not grouped with equity in one class to make

3) Incidentally, the English term 'equity' – which means '*qist*' in Arabic - has similar shades of meaning in both languages. While it means 'fairness' in both English and Arabic, it also means 'stake' or 'share' in both languages, thus giving the logical implication that fairness is rooted in the idea of sharing. Among other things in this paper, it is interesting to see how the Islamic principle fairness in capital markets compares with that of conventional capital market.

up for the accounting definition of capital. Rather, borrowed funds offer a special service of *leverage* to the existing equity capital whenever borrowing money appears to be more rewarding to the owner of the firm than selling new equity. If the business succeeds, the owner should be able to meet the loan repayments as promised, and reap all future profits without the need to share them. In general, if the entrepreneur is confident about the prospects of his/her business, and has the opportunity to borrow money, a loan is a more attractive source of money than getting it from an equity investor, who will own a piece of your business and receive a share of the profits. It is interesting to see how the Islamic corporate structure may accommodate an acceptable form of leverage given that interest rate borrowing is not allowed.

The conventional and Islamic corporate concepts agree on the treatment of corporate equity as evidence of ownership whereas money lending is not. Furthermore, money lending is defined from the Islamic jurist perspective as means of ownership transference thus giving an additional logical reason why the interest rate, in the first place, is an illegitimate source of income[4]. The capital structures of modern Islamic corporations are typically pure equity-based apart from the widespread use of specifically structured Shari'ah compliant bonds, i.e. *sukuk*, for medium to short-term financing and investment objectives. It is shortly shown that the basic structure of *sukuk* reflects fixed earning features similar to those bonds even though they still fall short of furnishing the needed leverage in the capital structure of modern Islamic companies. This is partly due to the prevalence of sovereign *sukuk* in the Muslim world though there is a looming horizon for corporate *sukuk*[5].

As regards the Islamic version of corporate equity, it relates to the concept of *Sharikah*, the Arabic word for 'company', as it originates in the jurisprudence of *mudarabah* and *musharakah* contracts. *Mudarabah* arises where a provider of capital called the *rabb al-mal* (or a group of such capital providers) enters into a contract with a manager (called the *mudarib*) to engage in any specific trade activity with the objective of sharing the potential profit. At the core of any *mudarabah* contract there are four basic conditions between the *mudarib* and the capital provider(s) as follows:

- Profit, when realised, has to be shared between the two parties in accordance with a profit-sharing ratio pre-stipulated at the time of the contract. Loss, in case it arses, would have to be born entirely by *rabb al-mal* as the mudarib only loses his or her effort.

- The *rabb al-mal* cannot interfere in the day-to-day management of the *mudarabah*, apart from his or her right to restrict possible fields of economic activity for the *mudarabah*. This provision, however, has to be made clear within the mudarib contract.

- The *mudarib* has a 'hand of trust' (*yad amana*) in the management of *mudarabah* capital,

4) *Al-Mawsu'ah al-Fiqhiyyah*, Volume 33, Ministry of Awqaf, Kuwait, 1992, p.122. All scholars believe that lending is a means of ownership transference, they only differ about the time when ownership is transferred; whether it is transferred immediately by the contract of qard like the Malikites, or transferred after delivery like the Hanafites, Hanbalites and the shafiites, with some internal differences within the same school.

5) [Adam and Thomas 2004] , Chapters 4 and 5.

which means he would work to his best effort and, therefore, cannot guarantee capital or profit to *rabb al-mal*.

- Loss of capital can be guaranteed by the *mudarib* only when such loss proves to be the result of mismanagement or delinquency of the *mudarib*; or where such loss results from a breach of the contract, like violating restricted fields of economic activity.

Alternatively, if all the parties contribute to capital, the contract becomes one of *musharakah* which gives the parties the right to engage in the management of the company but embodies similar features as those of *mudarabah*, notably the uncertainty of profit. The fact that part of the capital is contributed by the client leads to special provisions in the *musharakah* contract which can be summed up in the following:

- Partners of *musharakah* all have the right to engage in the day-to-day management of the *musharakah* capital, except where one party deliberately gives up (wavers) this right to other parties. Many Islamic banks prefer to wave rights of *musharakah* management to clients on the grounds that clients are more qualified to run their own businesses.

- Profit, when realised, has to be shared by partners in proportion to their capital contributions (i.e. on pro-rata basis) unless otherwise agreed on reasonable ground. In the context of Islamic banking, it is possible for the client to get a proportionately bigger share of profit if the bank has already waved its right in management to the client. Loss, however, has to be strictly shared on pro-rata basis.

- No one party can be held liable to guarantee capital or profit to other parties. Only where mismanagement and delinquency are proved or where a breach of the *musharakah* contract is committed, the party so charged may be held liable to guarantee capital contributions of other parties.

- Profit (or loss) cannot be prioritised within the *musharakah* contract. No party (or group of parties) can be preferred to others in terms of profit distribution or loss allocation, and no pre-fixed return can be promised to any. The fact that all parties have to be treated on an equal footing (*paris passu*) underscores profit & loss sharing (PLS) as the core concept of *musharakah*.

As it stands, the received jurist contracts of *mudarabah* and *musharakah* do not embody the limited liability provision, but the majority of the contemporary Muslim scholars have approved of imited liability in the legal charter of the modern Islamic company[6]. Also, the trading of company

6) See [AAOIFI 2004-5: 210], “It is permissible to restrict the liability of a company to its paid up capital if this is

shares was not an accepted practice in the received jurisprudence. The *sharikah* would have to be automatically liquidated in the event of a partner's exit or entry, even though partners may agree to form a new *sharikah* contract afterwards. Again, the contemporary scholars have rightly acknowledged the right of partners to agree on different terms and conditions as regards the trading or otherwise of company shares. In the statement of the generally accepted AAOIFI's Shari'ah standards it is stated that: "*It is permitted to buy and sell shares of corporations, on spot or deferred basis in which delay is permitted, if the activity of the corporation is permissible irrespective of its being an investment (that is the acquisition of the share with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in prices)*" [AAOIFI 2004-5].

The above standard rests upon the common consensus about 'equity' across all the different corporate forms that it represents a partner's 'right of ownership' in the company. Hence, to the extent that the company largely consists of real assets and that the legal charter of the company permits the entry and exit of partners, there can be no Shari'ah objection for the trading of such company shares. In this sense, the modern Islamic company combines important features of *musharakah* and *mudarabah* in addition to the limited liability provision of the modern corporation. On one hand, the *musharakah* element relates to the existence of shareholders who collectively contribute the company's capital and share profit/loss on pro rata basis. On the other hand, the *mudarabah* element relates to the contractual relationship between shareholders, on one hand, as *rabb al-mal*, and the management, on the other hand, as *mudarib* so long as the company's management share in the company's profits. Yet, if the company's management are paid fixed salaries, it will still be an acceptable form of human *ijara* rather *mudarabah*.

To sum up, there are two factors which distinguish an Islamic company from a conventional one: (A) the financing of capital or business operations of the company, and (B) the legitimacy of its economic activity. In a nutshell, the Islamic corporate concept is one which satisfies two basic conditions: (1) that shareholders capital is raised through the Profit & Loss Sharing principle as defined above, and (2) that the economic activity is a *halal* one. In other words, any company will deviate from the above definition of the Islamic corporate concept whenever capital or business operations are partly financed through borrowing at the interest rate, or whenever economic activities include the utilisation or production of illegitimate goods or services (e.g. wine, pig meat, pornographic material, etc.).

4. *Shariah* Issues in Capital Market Instruments.

The essence of modern financial markets is to successfully channel small savings towards productive uses either directly through the issuance of corporate securities (equities and bonds) or indirectly through the financing of banks and other financial intermediaries. This paper, however, is focused on directly issued capital market instruments, hence shedding light on conceptual bases of *security* and *negotiability* as key words from the Islamic perspective. To perceive these key concepts from an Islamic perspective, analogy with physical capital assets proves particularly

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useful. Just as physical productive assets (e.g plants, equipments, and real estate properties) are permissible objects of exchange in the real asset markets , financial assets - or *securities* - are analogous objects of exchange in financial markets. To one thing common between the two kinds of assets is that both are investment assets in the sense of generating future cash flows for the holder, and both are bought and both are sold at a price. Yet while the buying and selling of physical assets is freely allowed under Shari'ah, there are important constraints governing the buying and selling of financial assets. This emerges from the fact that unlike physical assets that are directly visible to potential buyers, a security is an information-loaded document that is purely reducible to a set of terms and conditions between parties.

Shari'ah issues, therefore, crop up from the recognition of a security as a vehicle of contractual information between two parties, the seller of security who demands funding and the buyer who offers the required funding. The conventional bond is an obvious case of a non-Shari'ah compliant security as it guarantees both principal and interest to the lender. Nonetheless, Shari'ah issues encompass a wider range of questions, not only with a view to the prohibited interest but also with regard to the prohibited *gharar* as defined above. It is the main responsibility of Shari'ah Boards to carefully and conscientiously scrutinize the underlying contracts of financial securities even if they seem to represent legitimate transactions. Corporate equity is the best example of a permissible security involving two parties - *investor* (provider of capital) and *investee* (manager of investment) - yet *gharar* might still creep into the equity contract if it contains any structured uncertainties (e.g. an ambiguous statement about the profit-sharing ratio).

Gharar in the context of financial securities stands for incomplete contractual information as it may arise from two possible sources (1) the underlying contract of a financial security or (2) the external marketing information. The first source makes up for uncertainties within the basic structure of the contract, thus evoking outright Shari'ah-rejection. This may arise from contractual ambiguity or uncertainty within an otherwise legitimate security; e.g. failure to make precise statements of price or quantity in an underlying sale contract of a security, or statement of profit-sharing ratio in an underlying *mudarabah* contract. It may also arise from built-in uncertainties in the terms and conditions of a financial security that do not conform to Shari'ah. This is particularly the case of futures, options, and swaps, or more generally financial derivatives that are extensively utilized in the conventional financial markets.

The second source of gharar does not evoke outright Shari'ah rejection but directly relates to the issue of information efficiency. External market information (e.g. movements in stock prices, interest rates, tax policy, corporate profit rate, risk rates, etc.) is often the initial trigger for investors to decide which security to buy and for investees to decide which security to issue. Information flow is indeed the blood circulation of a financial market that makes up for its overall economic health. In the early works of Islamic economists attention was brought to the possible rise of prohibited *gharar* in the trading of company shares when the necessary information is not adequately disclosed to the parties[7]. An efficient financial market is one where the relevant economic

7) See for example, [Tag el-Din 1996].

information is made easily accessible to all potential participants. In particular, information about cost and income is vital for the flow of funds since investors will always look for better investment returns while investees look for lower financial costs. Security prices are the needed indicators of cost for investees and return for investors and, therefore, they must therefore be decided within an information-efficient market. An Islamic financial market has to be information efficient, not only in terms of the relevant financial indicators but also in terms of prudent advice against *gharar* and ghaban-prone malpractices. It is little surprise that failures and occasional crises in financial markets are often attributable to failures in the circular flow of economic information.

4.1. Investment in Global Equity Markets.

Corporate equity – in the sense of ordinary shares – tends to be the most dominant vehicle of investment in Islamic investment funds, given the Shari'ah approval of trading in equity investments. It has further been permitted, subject to a carefully detailed set of criteria, to trade in the shares of corporations whose primary activities are lawful but they make deposits or borrow on the basis of interest, thus opening the door for Islamic investments in global equity markets and the construction of global Islamic Indices (e.g. Islamic Dow Jones, Islamic FTSE, etc.) under strict Shari'ah supervision. It is not our intention to offer a comprehensive statement of the relevant Shari'ah criteria for trading in global equity funds, though it is worth while highlighting two important rules as follows:

- That the total amount of debt raised in the corporation through borrowing at the interest-rate, both long term or short term, should not exceed 30% of the market capitalisation of the corporation (that is the market value of outstanding shares in the secondary market at a given point of time).

- That the total amount of income generated from prohibited activity or prohibited asset does not exceed 5% of the total income of the corporation. This condition invokes special efforts on part of Shari'ah to explore sources of income that are not sufficiently disclosed in the corporate statements.

It should be born in mind, however, that returns realised from global equity funds which abide by the above given percentages are not totally *halal* since they embody an illegitimate component no matter how small it could be. Thus, it is held obligatory on the investor (or the fund manager on the investor's behalf) to eliminate the prohibited component specific to the share. In the actual practice, managers of global Islamic equity funds advice Muslim clients of the amount of prohibited income that needs to be purified out of the distributed returns. It is a usual practice to dispose of such component in charitable activities.

4.2. Structural Properties of *Sukuk* and Certificates.

The literature on Islamic *sukuk* and Islamic investment certificates has grown rapidly since the early 1990's in a sincere effort by Islamic economists, bankers and Shari'ah scholars to reap the fruits of a liquid Islamic financial market through a sufficiently wide range of Islamic instruments. The challenge was not only to structure an Islamic bond/ certificate, but to also make it 'negotiable' in the sense of being freely bought and sought in the secondary market. Take, for example, the case of a legitimate *murabahah* contract as the subject matter of an Islamic bond. The jurist problem would soon arise that the *murabahah* bond cannot be freely bought and sold without violating the Shari'ah ruling about the sale of debt; basically, because the *murabahah* bond underlies a receivable debt from the sale of a commodity. Selling a debt instrument in practice is the same thing as discounting the amount of debt, implying that the seller receives from buyer a smaller amount than the actual debt. In other words, the *murabahah* bond, if traded, will boil down to a conventional 'discount bond' that is issued below par value.

The problem will not have arisen if the *murabahah* bond represents a share, not only in receivable debt, but also in the inventory of goods being traded, such that receivable debt represents a small percentage (usually less than 50%) of the total asset base of the bond. More radically, the problem will not have arisen if the Islamic bond is based on an *ijarah* contract whereby the bond represents, not just a share in the rental payments, but basically a share of ownership in the underlying asset or equipment being rented. This is the essence of an *assed-based* security in Islamic investment banking which should not be confused with the conventional concept of *asset-backed* bond. The latter is often used in the sense of the cash flow being collateralised by a physical asset, rather than a right of the bond holder in the ownership of the underlying asset.

The basic structural property of a legitimately negotiable *sakk* is the assurance that the bond represents a share of ownership in an underlying fixed asset not less than 30% of the total asset base that generates the cash flow. This makes it comparable to a corporate equity, and therefore permits the buying and selling of such Islamic bonds side by side with Islamic company shares in secondary markets. This is the basis rule upon which Islamic investment bankers have recently utilised the various properties of Islamic financing modes (*ijarah*, *istisnaa*, *musharakah*, *mudarabah*, etc.) to structure a wide variety of negotiable *sukuk* with carefully detailed Shari'ah standards. In the AAOIFI Shari'ah standards, investment *sukuk* are characterised as "certificates of equal value issued in the name of the owner or bearer in order to establish the certificate owner over the financial rights and obligations represented by the certificates". ([AAOIFI 2004-5: 300], 4/1 - under Characteristics of Investment *Sukuk*).

To better appreciate the structure of a negotiable Islamic bond (*sakk*), there are five structural features of conventional bonds that need to be assessed from Shari'ah perspective.

- **Par value or face value:** This is the actual amount of money promised by the bond issuer to the bond holder at maturity.
- **Maturity date:** This is the time when the face value of a bond will be paid

off to holder.

- **Coupon payment:** It is the amount of money paid to the bond holder at specified periods (e.g monthly, quarterly) before and/or at maturity.
- **Coupon rate/ or coupon interest rate:** is defined as coupon payment divided by par value.
- **Zero coupon bonds (zeros):** these are discount bonds, carrying no coupon payments apart from payment of par value at the time of maturity.

In brief, a conventional bond is always issued with a face value that is promised to the holder at the time of maturity regardless of whether or not coupon payments are paid during the bond's holding time. The main Shari'ah objection against conventional bonds is the guaranteed payment of face value at the time of maturity plus interest return. The Shari'ah objection is obvious with coupon bonds where interest rate payments are promised in addition to the face value at maturity. But this is also true of zero-coupon bonds as they are issued at discount rates, which means in the sense of bond holders paying less money today for more money tomorrow. This is the prohibited interest rate lending.

Nonetheless, an Islamic *sakk* can be so structured as to yield predictable cash flows, as in the case of *Ijarah*-based bonds, but no legitimate Islamic bond can guarantee payment of pre-determined amounts at the time of maturity in addition to other stream of payments. The only situation where an Islamic bond can guarantee payment of par value to holder is the *qard hasan* bond which ought to be issued at par as well as retired at par value. Fairly broad coverage of potential *sukuk* with appropriately stipulated Shari'ah standards is formally stated in Adam and Thomas [2004].

5. Asset-backed Securitised *Sukuk*

Securitisation is a popular method of structured finance that is gaining increasing grounds in Islamic finance. Conventionally, it is a means of securitising debt, but securitisation is not limited to debt. As a matter of fact it is mostly the securitisation of real capital assets and property leasehold interests that give room to the Islamic and alternative. It all depends on the nature of the cash flow generated by the pool of receivable assets that needs to be securitised. If it is simply debt-servicing in terms of interest and principal repayments, this is obviously non-tenable to Shari'ah. Otherwise, if the cash flow represents lease payments generated from a pool of rented property or equipment, it then becomes tenable to Shari'ah-compliant securitisation.

In taking the decision to securitize an outstanding pool of receivable loans or other assets, the issuer is often motivated by various possible motives. This can be the desire to raise finance at the least possible cost of funds, or simply to remove a specific pool of assets from the firm's balance sheet with a view to improving returns on debt or equity, or to free up working capital for further core business, or to restructure the balance sheet and reduce capital leverage in the way of conforming to regulatory capital adequacy requirements. The securitisation process consists

of transferring the given pool of assets from the original firm to a Special Purpose Vehicle (SPV) which will then break it down into investment units and sell them out to investors. In the current practice there are three possible financial structures of securitisation.

- **Path-through securitisation:** This is associated with the sale of the pool of assets by the original issuer to the SPV, thus ridding the balance sheet of the originator from the given pool of assets. The SPV will then utilise the acquired pool of assets to issue investment bonds (or Islamic *sukuk*). Investors will have total interest in the cash flow generated by the securities assets such that all cash receivables are passed directly by the SPV to the investors (less servicing charges and third party expenses). The immediate appeal of this arrangement lies in making it possible for the original issuer to raise lump sum money while being isolated from any future repayment claims in relation to this transaction. That is, investors' recourse is only to the trustee who assumes a fiduciary responsibility to protect the interest of investors against a fee payable by the issuer or from the pool of assets. From the investors' perspective, the quality of cash flow generated by the given asset-backed securities is easier to analyse since it emanates from a small well-defined pool of assets rather than a complex business structure. The issuer SPV is usually described as 'bankruptcy-remote' as the liquidation of the originator will not impact the assets and their income stream through the SPV.

- **Asset-backed bond securitisation:** In this case the pool of assets is not sold to the SPV and the investors will only have a fractional interest in the cash flow generated by the pool of assets. The latter will therefore remain in the originator's balance sheet but used as collateral for a further debt obligation by the issuer. All that is being done in this case is the ability of the originator to utilise its pool of debt assets in generating further funds without having to sell the debt assets. The best example is a mortgage company with debt assets which generate a steady stream of income. Asset-backed bond securitisation makes it possible for the mortgage to raise further capital in order to make further loans without having to wait long until the existing receivable debt has been recouped. Hence, by bundling up a large number of individual residential mortgages, it will be possible to partly issue high quality asset-backed bonds to potential investors through an SPV while still keeping the assets within the balance sheet of the originator.

- **Pay-through securitisation:** As against the pass-through structure where the SPV only stands ready to re-direct collected cash flows of the original pool through securitised bonds to the investors, this securitisation structure places an additional obligation on the SPV to guarantee a stream of income to bond holders irrespective of collections dates of the original pool of assets. In order to avoid possible fluctuations in collection dates and hence smooth out payments to bond holders, the SPV falls back on guaranteed investment

contracts or credit enhancements through third parties. Here again the pool of assets remains within the balance sheet of the originator, but the SPV reconfigures the cash flow to suit payment obligations to various classes of investors, hence combining features of path-throughs and asset-backed bonds.

As it appears, the path-through securitisation structure is the one that is more readily compatible to Shari'ah provided that the original pool of assets to be securitised is not of a pure debt nature. Yet, in the current experience of Islamic securitisation it has been possible to adopt various versions of securitisations subject to specific Shari'ah provisions. For example, it was possible to work out an Islamic securitisation on the basis of fractional interest in underlying equipment leases owned by three off-shore USA companies [El-Helw 2000]. More detailed analysis of Islamic *sukuk* can be referred to the edited work of Nathif J. Adam and Abdelkadir Thomas[8].

6. The Islamic Investment Fund

In the terminology of AAOIFI (the Accounting and Auditing Organization of Islamic Financial Institutions), Islamic investment services are divided into two broad categories: unrestricted investment accounts and restricted investment accounts. The first category consists of the Profit and Loss Sharing ("PLS accounts") accounts, being the balance-sheet alternative for conventional interest-based term deposit where Islamic banks are authorized to mix their own resources with the clients' investment deposits. The second (restricted investment accounts) are also governed by the Islamic Profit and Loss Sharing principle, but it is managed by banks as off-balance sheet investments on behalf of clients, and in accordance to different investment preferences of the clients. It is, indeed, the second category which makes up for widely ranging investment services offered by Islamic banks to satisfy ever-changing needs of clients. This booklet is particularly focused on the structural features of 'Islamic investment funds' which is the dominant investment vehicle marketed under different terms and conditions by Islamic banks.

The working principle of an investment fund is to invite subscriptions from multiple investors, combine them into relatively large funds and appropriately manage them against a fee or a pre-agreed ratio of the return through investment banking departments. Each subscribing investor will hold a number of units in the given fund, priced at a specific value on the subscription day. Working in the best interest of the investors, the fund manager's objective is to generate economic growth that reflects an ever rising unit value of the investment fund. Apart from growth prospects, open-end investment funds offer valuable liquidity services to investors through well-timed schedules of entry and exit – or 'subscription' and 'redemption' as they are often known. Risk management is a particularly valuable service offered to investors through professionally managed investment funds. Investors are, therefore, attracted by the prospect of access to a wide range of investments made possible by economies of scale which, otherwise, are unattainable through individual investment efforts.

Islamic investment funds are structured along similar lines of open-ended *unit investment*

8) [Adam and Thomas 2004], Chapters 2, 3, 4 and 5.

trusts as usually seen in the UK, or *mutual funds* as usually seen in the USA. Where the underlying value of the assets is always directly represented by the total number of units issued multiplied by the unit price, less the transaction or management fee charged and any other associated costs. The fund manager, also known as the portfolio manager, utilises the collected investment subscritions for the purpose of generating investor returns from the underlying investments. The value of a share of the fund, known as the net asset value per share / unit (NAV), is calculated through the division of the total value of the fund by the number of shares / units currently issued and outstanding. The investment proceeds are then passed along to the individual investors in terms of appreciated unit values, or depeciated unit values in the case of loss.

6.1 The Structural Properties :

Shari'ah issues are particularly related to three structural properties commonly shared by investment funds as follows:

1. **The Management contract.** This relates to the contractual relationship between manager of the fund, on one hand, and the community of investors making up the fund on the other hand.
2. **Funds' utilization.** This relates to the operational process of utilizing the funds and generating investment returns.
3. **Distribution of returns:** This relates to how investment returns are distributed to the subscribing investors.

6.2 The Management Contract.

There are two possible options for the manager / investor relationship in Islamic investment funds: (1) an agency contract, as it is most commonly adopted (2) or, more occasionally, the Profit and Loss Sharing principle.

The latter is where the Islamic bank performs management under, for example, the capacity of *mudarib*, with or without mixing of bank's funds, visa-vis the community of investors as the *rabb al-mal* parties. And since the *mudarib* will get nothing in the case of loss, the major attraction of *mudarabah* management lies in the strong profit incentive for more efficient management.

On the other hand, the agency contract has the special appeal of generating fee income to the manager as a pre-assigned percentage of the fund's NAV (Net Asset Value, as defined above). Unlike the case of *mudarabah*, where manager's income is tied up with net profit, the agency fee is relatively more secure since it is tied up with the fund's NAV.

Taking the manager as agent and investors as principal, it should be noted that the agent can only work on best-effort basis, hence cannot guarantee the desired results to the principal. Nonetheless, the agency contract has its own incentive-compatible property since the NAV fluctuates up and down with the market unit value of the fund, thus putting appropriate pressure

on management to perform most efficiently. Furthermore, the agent may be given a "Performance Incentive" being an amount equal to profits generated above a certain rate of return on the *wakala* capital invested for a relevant *wakala* period.

6.3 Utilization of Funds.

The second structural feature of Islamic investment funds relates to how the pooled funds are utilized in the pursuit of investment returns. At the outset it is obviously clear that Islamic funds should operate in accordance with Shari'ah rules; hence excluding illegitimate economic activities (e.g. production of *haram* goods and services) and illegitimate financial transactions (mainly, interest rate transactions and *gharar* dealings).

However, investment funds operate primarily in secondary financial markets where financial securities are bought and sold rather than primary financial markets where productive economic projects are yet to be financed. Secondary financial markets include 'capital markets' and 'money markets' where governmental and corporate securities are traded, together with 'securitized' financial assets (issued through special purpose vehicles), and financial market derivatives (e.g futures, options and swaps). The study of secondary financial markets has therefore become an integral part of investment funds. It is true that 'securitized' assets and financial derivatives are vital for the operation of investment funds but this is beyond the scope of the present booklet. It suffices within the limited scope of this introductory booklet to shed light on capital market and money market securities.

6.4 Distribution of Returns:

The third and final structural feature of Islamic investment funds relates to the distribution of investment returns to the investor community who subscribed to the fund. Whether or not the management contract is one of *mudarabah* or agency, the manager's role is to pass the investment proceeds along to the individual investors in terms of appreciated unit values – or depeciated unit values in the case of loss. In other words, the manager of an Islamic investment fund cannot guarantee any returns to the investors. This is an important difference from conventional investment funds where in certain agent agreements investment returns are guaranteed.

Another important difference relates to the equal treatment (*pari passu*) of investors in Islamic funds, as opposed to the possibility of prioritizing the payment of investment returns in accordance to an agreed preferential order of investment classes. It is a common practice in conventional funds to issue three or more securities on the basis of the fund with different levels of default risk, such as security A is the first to be paid off from the investment proceeds, followed by security B and then the residual goes to security C, if any. This procedure clearly violates the Shari'ah principle of fair treatment to investment partners where the *same level of investment risk* has to be faced by all the partners and all the net profit has to be distributed on pro rata basis, at the same time to the investors.

7. Islamic Banking and Capital Market Legacy

As noted above, a brief historical background from the early Muslim civilisation will help underscore the Islamic legacy of banking and capital markets, and hence drive home the current economic and cultural interaction of Muslim economies with the West as a healthy heritage from the distant past. It is noteworthy that centuries ago the major Italian cities which constituted the birthplaces of modern Western capitalism (i.e. Venice, Genoa, Amalfi and others) borrowed many of Muslims' financial instruments and corporate tools, including the accounting principles of book-keeping and Arabic numbers which gradually replaced Roman numerals. Western economic historians have unequivocally acknowledged the leading role of Muslims' booming merchandise across the Mediterranean with the Italian Cities in lifting Western Europe from its Dark Ages and bringing about the twelfth century economic renaissance to Europe. In *Britannica* this is clearly stated as: "Ironically, the great age of Islam coincided with the low point of culture in Western Europe … Arabic rulers of Baghdad in the ninth Century had the bulk of the corpus Greek Science translated, and soon after, their own scholars advanced further, particularly in mathematics, astronomy, optics, chemistry and medicine… The twelfth century saw a heroic programme of translation of works from Arabic to Latin[9)]".

The positive attitude in medieval Islam towards the profit motive was indeed the basic drive of commerce and trade. At the time when the Muslim state encouraged trade and supported the profit motive subject to injunctions of Shari'ah, the teachings of the Christian Church in Western Europe cherished a poverty-oriented culture, hence, frustrated entrepreneurial motives and accentuated the impact of the Dark Ages in socio-economic life. In their analysis of Muslims trade with medieval Europe, economic historians acknowledged the groundbreaking role of *mudarabah*-financed trade in acquainting Western Europe with a powerful instrument of corporate finance, hence opening up immense opportunities of profitable trade across the Mediterranean. *mudarabah* came to be known in the Italian cities as *commendo*, marking thereafter an important historical phase of corporate growth in Western Europe which culminated through time into the modern corporate structure.

The role of a usury-free capital market in early Muslim states was fuelled by rising demand for liquid capital and credit to both governments and private entrepreneurs. The simplest manifestation of financial services within the early Muslim states took the form of money-changers (*sayarifah*) who were also partially engaged in the holding of deposits and the short-term financing of trade. Yet a more sophisticated form of banking finance for trade and government was represented by the *Jahabidhah* who practiced much of the modern financing activities under the supervision of the Muslim state. In the highly developed market economy of the Abbasid State, *Jahabidhah* bankers proliferated throughout the state, even though they were mostly of Jews who enjoyed the status of *Ahl al-Kitab* origin (People of the Book) within the early Muslim state. The *Jahabidhah* were basically trade vendors who concurrently practiced business of financing and commercial transactions to others. Banking operations were therefore ancillary to primary mercantile operations, yet they seemed to have grown to sizeable banking functions particularly

9) *The New Encyclopaedia Britannica*, 15th ed., 1975, Vol. 16, p. 368.

when the *Jahabidhah* accepted deposits in efforts to augment their own businesses.

The high streets of Basra were so much replete with money-changers and *Jahabidhah* that the banking network in Basra was rightly called by a Western historian 'the Wall-Street of the Middle Ages' [Heck 2006: 113]. The famous Persian historian, Nasir-i Khusraw, was reported to have estimated the number of *Jahabidhah* bankers in the state of Isfahan alone at 200 banks [Heck 2006: 113]. It was such a complex network of banking activities that the call for appropriate government supervision and regulation was acknowledged by the Islamic state. To this effect, the Abbasid State established a central banking agency in year 316 H/ 929 A.D called *Diwan al-Jahabidhah* to foresee the performance and growth of banks within the empire. A similar central bank was established in Egypt by the Fatimid State by the name *Dar al-Mal* in the commercial capital of al-Fustat to supervise an equally intense *Jahabidhah* banking activity in Fatimid Egypt. Among the most commonly practiced banking instruments were the *sakk* (the Arabic root of 'cheque') and the *suftajah* (which combined features of traveller cheques and letters of credit), the *hawalah* (which is a means credit transfer), *wadi'ah* (i.e. deposit), *ruq'ah* (which was a sort of promissory note). The use of cheque (*sakk*) was particularly known since the time of the Rightly-Guided Caliphs. A renowned historian, Ibn Abdel-Hakam, reported that Umar ibn al-Khattab paid for the grains delivered to the state warehouses by cheque and that he used to pay government wages by cheques signed by his treasurer Zaid ibn Thabit.

Unfortunately, however, usury came to be approved by the Christian Church around the fifteenth century and the whole process of economic incorporation followed a non-Islamic usury-oriented culture. The contemporary movement of Islamic banking should therefore be viewed as a revival of earlier efforts of usury-free banking which flourished during the bright years of Muslims civilisation. The Crusades are viewed as a significant landmark in the gradual recovery of Europe from its Dark Ages. In the final analysis, it was the encounter with the thriving civilisation of Muslims in commerce and trade which fuelled up the process of economic recovery from the dominant barter system even before the Crusades. The monetisation process in Medieval Europe was believed to have taken off from the widespread adoption of the Fatimid Dinar either in original form or counterfeited forms which still preserved Arabic scripts to convey a sense of monetary genuineness. The Arabs' minted money helped lifting Europe out of its barter system during the middle Ages. *Mudarabah* also broke new grounds in Italian cities as the most effective corporate tool in commercial financing.

8. Conclusions

This paper provides an overview of Islamic capital and money markets and how they compare to their conventional counterparts. It explained the nature of Shari'ah issues that normally arise in the development of legitimate Islamic products, as they basically relate to the elimination of *riba* (the interest rate) and *gharar*. Capital market and money market tools have been analysed, leading to the Islamic concept of *sukuk* as it is currently taken to replace the conventional bond in Islamic financial markets. In this context, asset-backed securitisation and investment fund structuring have

been introduced. And finally, the ideological issue of how the current upsurge of Islamic capital markets conforms to Islamic legacy has been addressed by reference to the pioneering impact of Muslims' early civilisation on Medieval Europe.

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