

Equity Market & Islamic Finance: Innovation and Product Development

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The growth of the Islamic finance industry has been encouraging and it is becoming more advanced. In its early development, product offerings of Islamic finance tended to be in more traditional area such as (murabahah) financing and funding. However, as the industry matures, the trend is towards a more sophisticated and complex products and financial instruments. This paper attempts to provide a brief overview of this development, with a strong emphasis on shariah perspectives. The paper begins with reviewing the philosophy of an Islamic economy, especially its moral aspects and main objectives. Then it will show some recent global developments in the Islamic finance industry and Islamic capital markets. From this overview, it also becomes necessary to highlight a conceptual overview of the nature and process in designing Islamic finance products, followed by a close look at the progress of the Islamic equity market, especially sukuk. The paper also observes the strategic position of values and ethics in product development, specifically through a shariah governing body such as National Shariah Board in Indonesia and Shariah Advisory Council in Malaysia. At the end the paper identifies some critical issues on the development of Islamic equity and finance products.

Keywords: Equity market, Islamic finance, Product development

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INTRODUCTION

An Islamic economy, as the umbrella of a financial system and all institutions underneath it, rests on specific foundations prescribed by shariah; namely aqidah, shariah and akhlaq. In Indonesia, for instance, an Islamic economy, or Islamic Finance, is better known as Shariah Finance. On top of that, an Islamic economy is also built using three fundamental pillars of justice, balance and maslaha to support the attainment of one broad and key objective falah.

Islam and its life system are built upon four foundations; aqidah, shariah, akhlaq and ukhuwah. Aqidah denotes the principle faith and belief of human beings in the One and Only God, where Muslims are obliged to worship Allah in the way prescribed in the Quran and Hadith. A strong aqidah in the marketplace leads to adherence to laws and regulations, and encourages good governance and compliance to best practices.

Shariah is the way to express one’s obedience and devotion to God. This way is prescribed very explicitly in the Quran and Sunnah; certain aspects which are not clear or explicit in these divine sources of shariah are then to be sought in the form of ijma, qiyas or few other methods prescribed by Islamic scholars.

Another foundation for an Islamic economy is the observance of decent behavior and good conduct. Akhlaq stipulates the definition of good behavior and good conduct in all aspects of life, social, business or otherwise.

Three pillars distinguish an Islamic system from other systems; justice, balance and maslaha. Justice in an Islamic economy implies avoiding riba, maysir, gharar, dzalim and haram. These ‘vices’ are the very reason for a religious existence of Islam; to propagate virtue and prohibit vice (amar ma’ruf nahi munkar). The second pillar requires that the economy be organized in cognizance of a need for a balance between two opposing sides of a spectrum; real and financial sectors, risk and return, business and social aspects, material and

spirituality, and also between manfaat vs. longevity. The last pillar, maslaha is basically a fulfillment of faith or iman/taqwa, the equity of the next generation, nafs, wealth, and mind or aql.

Falah (prosperity and paradise) is the primary objective of an Islamic economy. If a conventional economy aims for stable growth, price stability and income prosperity then an Islamic economy adds one divine element, which is success in the hereafter. It entails that all economic activities must be in strict adherence to the Will of God, to ensure that success in the worldly life does not take away success in the afterlife. This distinguishes the economic system in Islam and puts it in total contrast with that of other systems. This difference will become clearer as the discussion progresses.

Development of the Islamic Finance Industry & Islamic Capital Markets

Islamic finance is a global movement with actors coming from different backgrounds, operations on a global scale, and customers of different faiths and religions. Islamic financial institutions have also evolved from traditional lenders into sophisticated providers of wide-ranging financial products.

The growth and development of Islamic finance can be described as a natural progression instead of a revolutionary and sudden occurrence. This is evident from one feature of the industry which gives competitive retail product offerings; it has sophisticated corporate banking products, and also innovative project finance solutions.

The table below shows the progression of product innovation and expansion in an Islamic financial system; from mere commercial banking operations in the 1970s to a full array of products that includes equity financing, structured finance and other sophisticated products and services.

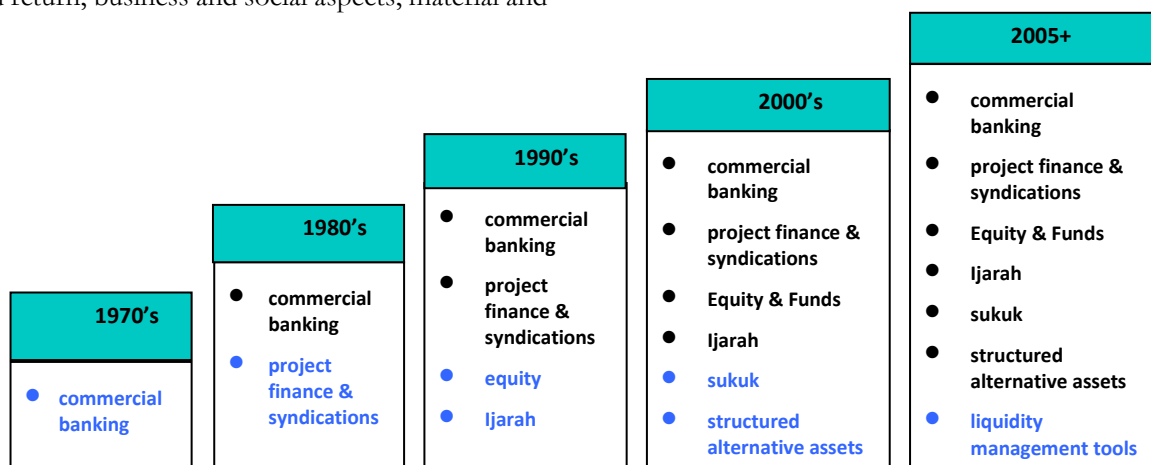


Figure 1: Product Innovation in Islamic Finance

Source: Ijlal (2007)

Designing Islamic Finance Products: Nature and Process

Since their establishment in the early 1970s, Islamic finance products have evolved from just buy and sell, mainly murabahah, to a more equity based instruments like musharaka. In addition, they also include equity financing like mudarabah and musharakah, leasing or ijarah, and sukuk.

Financial innovation & development can be defined as ‘the inter-connected process of accessing the needs of industry, product design, feature development, and the formulation of creative solutions to problems in finance’. Until now, the Islamic financial tools have essentially been limited to classical modes developed centuries ago; they were developed to meet the needs of

those societies. However, financial markets are now becoming more and more sophisticated and competitive. In order to exploit the fast-changing market environment and face increasing competition, financial engineering and innovation is imperative.

In Islamic theory of contracts, parties are free to agree on any terms as long as known Islamic rules and principles are not violated. However, there are special conditions to be observed, which includes the prohibition of riba, gharar and maysir (gambling).

It reemphasizes the earlier premise that Islamic finance is the outcome of religion in banking/commerce. This has been correctly depicted by Iqbal Khan (2007).

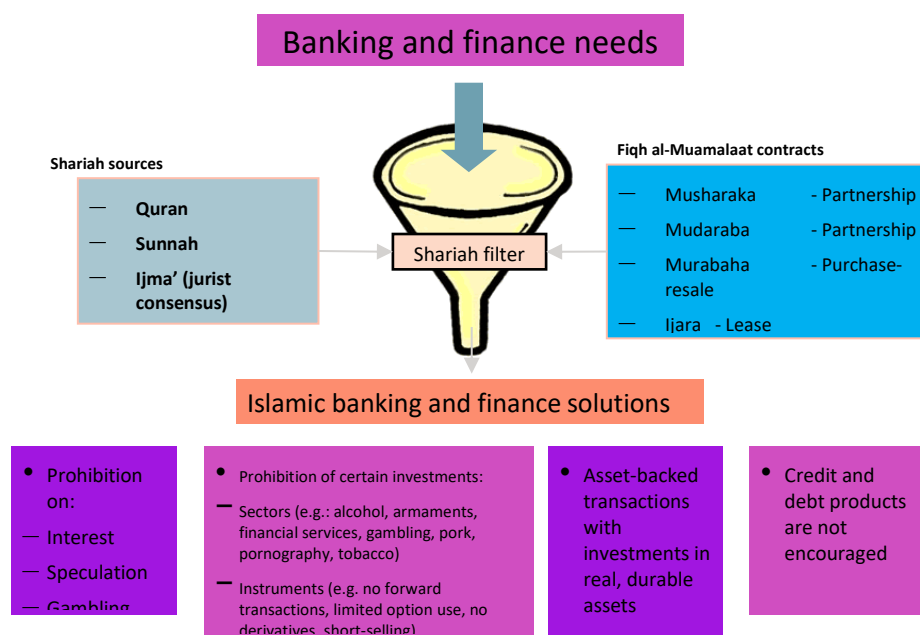


Figure 2 :Banking and Finance Needs

Source: Iqbal Khan (2007)

Shariah Compliance in Product Development

An important issue in development of Islamic finance products is shariah compliance. It is the key distinguishing feature of the Islamic capital market. In order to be deemed as shariah-compliant, Islamic finance products need to be approved by shariah scholars. In a survey (OICV-IOSCO, 2004), it was found that most “respondents recognized the importance of having an appropriate shariah approval process. Survey respondents also indicated the need to have formal regulatory requirements for the establishment of shariah advisory bodies to act as central reference points in assessing shariah compliance of Islamic capital market products and services”.

Many countries have an established regulatory system for the appointment of shariah advisory bodies; however, there are no standardized requirements in place with regard to the eligibility and qualifications of

the shariah advisors. The survey above also revealed that the shariah approval process or certification process is carried out through two different methods in these countries.

There are at least three approaches to this appointment. First is a market approach whereby financial institutions have their own in-house independent shariah advisory bodies. This is largely private sector driven. The second is more government driven whereby the regulatory authority establishes a national body that assesses shariah compliance and issues in the Islamic finance industry. Malaysia, Indonesia, Sudan and Pakistan use this approach. Finally, there is also another approach where no formal shariah body or certification process exists, either in the private sector or at the regulatory level. This shows an inconsistent approach in addressing regulatory issues in the development of Islamic banking and finance products.

The table below summarizes the results of the survey done by IOSCO as described in its report of July 2004.

Table 1: Shariah Certification vis-à-vis Islamic Finance Products

| Shariah certification done at regulatory level | Shariah certification done at industry level | No Shariah certification |
|--|---|--------------------------|
| Indonesia, Malaysia, Sudan, Pakistan | Australia, Bahrain, Bangladesh, Bosnia, Canada (Ontario), UAE (Dubai, Abu Dhabi), Jordan, Malaysia (Labuan), Qatar, South Africa, Singapore, Sri Lanka, Thailand, United Kingdom, United States | Korea, Nigeria, Turkey |

This finding also indicates that there is lack of similarity and convergence of shariah interpretations (OICV-IOSCO, 2004). The survey showed that different jurisdictions have adopted different practices in relation to various Islamic capital market products and services. This is a result of the varying interpretations on various shariah issues, which is rooted in the different mazhab adopted by respective scholars. This may have implications for cross border transactions of Islamic instruments. This may suggest a need for harmonization of shariah opinions, if not convergence.

Arguably, the convergence and harmonization of shariah interpretations could lead to the creation of more homogeneous Islamic capital market products and services that in turn will increase investors' demand and enhance the overall growth of the Islamic capital market.

Another survey as summarized by Ijlal Alvi reiterated and re-emphasized this need. The level of acceptability of various Islamic finance products across Muslim countries varies greatly, or it can also be considered widely dispersed and inconsistent. The table below shows such inconsistencies.

Table 2: Current state of Islamic Capital Market products

| Conventional instrument | Characteristics | Shariah compliant alternative |
|-------------------------|--|-------------------------------|
| Equity | Equity holders are owners of the firm and responsible for conducting its affairs | Accepted |
| Preferred stock | A hybrid security that combines features of debt and equity | - (none) |
| Commercial papers | A short-term debt security that can be easily traded | Developed, but not negotiable |
| Bonds | A term obligation to make a series of fixed payments. | Emerging |
| Floating rate bonds | The interest rate on the debt is based on LIBOR or Treasury Bills rate | |

Strategic position of values and ethics in product development values and good governance are central to Islam. Islamic finance is no different in this adherence to religious and ethical values as it is derived directly from basic tenets of Islam. As described in the earlier part of this paper, Islamic foundations strictly

shape the Islamic financial system and all its actors and activities.

In regard to product development in Islamic finance, this observance is best depicted by Khan (2007) in terms of compliance to principles of governance and ethics, as summarizes below.

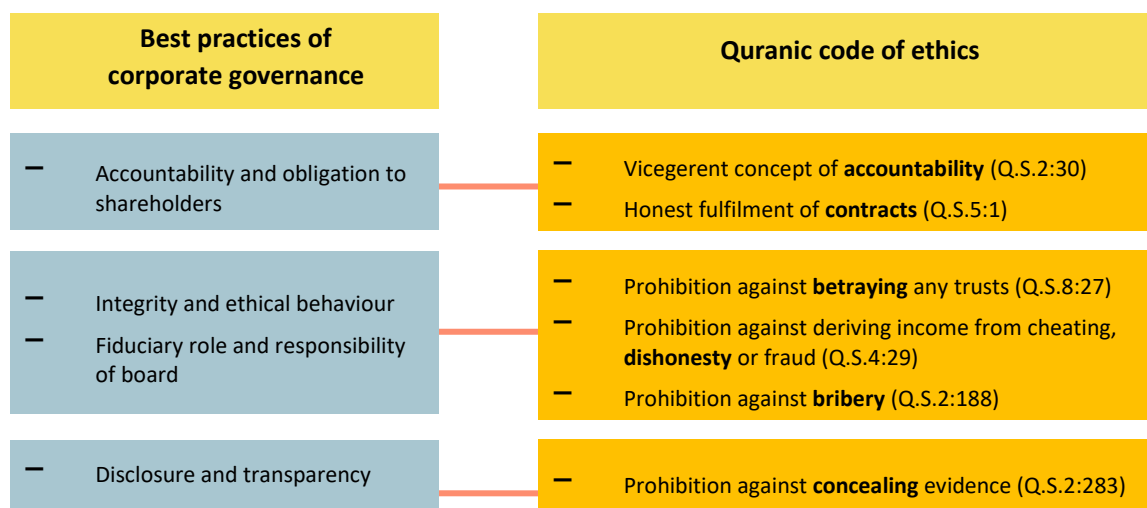


Figure 3: Islamic Corporate Governance

Al-Quran (Surah 4:135), beautifully illustrates this “O you who believe! Stand out firmly for justice, as witnesses to Allâh, even though it be against yourselves, or your parents, or your kin, be he rich or poor, Allâh is a Better Protector to both (than you)...” This adherence to Islamic principles is in fact unique to Islamic finance. Iqbal Khan (2007) also reiterated that Islamic Finance is more than just financial contracts as it is embedded within values.

In practice, there are certain commonly accepted principles of corporate governance to be followed. These principles include:

- Rights and equitable treatment of shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.
- Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.
- Role and responsibilities of the board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person.
- Integrity and ethical behavior: Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important

to understand, though, that systemic reliance on integrity and ethics is bound to eventual failure.

- Disclosure and transparency: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Islamic equity market: progress and challenges of sukuk

Sukuk is a phenomenon. It has been debated within academic circles since its emergence in the Middle East and Malaysia in the early 2000s. Practitioners alike have improvised the sukuk model with different aqad, hence ensured rapid growth and market acceptance. It was also well received by large number of Muslim jurists (fuqaha) from almost every Muslim country.

In the case of Indonesia for instance, Islamic bonds or sukuk have grown from a mere issuance of 6 in 2003 to more than 21 by the first semesters of 2007, or almost quadrupled the number. This is also commensurate with their growth in value or nominal terms. As far as Malaysia is concerned, as pointed out clearly by Zeti Akhtar Azis, the Governor of Malaysian Central Bank (2008), the Malaysian sukuk market is now the largest Islamic bond market in the world with more than 62% (or USD60 billion) of the global outstanding sukuk having been originated from Malaysia. Supported by a comprehensive infrastructure including the settlement and bond information system, Malaysia has an active primary sukuk market with an average annual growth of 17% over the period 2001-2006. It also has

one of the most active secondary markets with a turnover of sukuk trading, which registers more than USD40 billion annually.

The Malaysian bond market has also been liberalized to enable foreign entities to raise ringgit and foreign currency denominated funds from the market. International issuers may thus issue multi-currency Sukuks or alternatively have the flexibility to swap domestic currency funding into other currencies. Most recently a Malaysian corporation issued the largest-ever sukuk issue in the world amounting to equivalent USD4.7 billion which was two times oversubscribed. This hybrid sukuk which has both equity and debt natures is one of the several innovative instruments that has been issued in the sukuk market.

This encouraging trend calls for further scrutiny in terms of shariah compliance and adherence to Islamic principles; and at the same time attracts both wide public and new players' attentions. With such growth, it is imperative for the regulators and issuers alike to ensure full compliance to shariah, as investors are becoming more concerned with shariah permissibility, ethical values, and good governance. Many investors are wary that these types of instruments are just another form of 'back door riba'.

In terms of the issuer, sukuk were first issued by governments since they feature a relatively riskier profile. However, with the success of Malaysian and Qatar Sovereign Global Sukuks, more corporate issuers are entering the markets. However, the value and number of issuances of sukuk worldwide are still way behind conventional bond issuances, or in other words they constitute about 2.5% and 12.5% of total global bond issuances respectively.

Case studies of Indonesia and Malaysia: the role of DSN and SAC

Indonesia and Malaysia have similarities in many respects, mainly due to geographical proximity, as well as historical and cultural bonds. Regarding the shariah aspect as well, both countries adhere mostly to the Shafite School, including the applications of shariah rulings to economic and financial activities. Malaysia embraced Islamic finance a decade earlier than Indonesia, as indicated by the establishment of their first Islamic bank; Bank Islam Malaysia Berhad begun operation in 1983 and Indonesia's Bank Muamalat opened its business in 1992.

The development of Islamic banking and finance in Indonesia was rather low-profile at the beginning, especially from 1992 to 1997, where Bank Muamalat was a 'lone ranger' without any competitor, and consequently received minimal support from central banks. At that time, Bank Indonesia only provided a 'desk' to supervise and regulate the Islamic banking 'industry'. It was not until 1998 that a second bank was established and then conventional banks were allowed to offer Islamic banking products through Shariah Units. This marked the beginning of a dual banking system which, at the same time, opened the door for more products to be offered and paved the way for the creation of Islamic financial markets.

It was also during this period that Bank Indonesia and other key stakeholders produced a strategic document outlining the strategy and objectives of Islamic banking development in the Blue Print of Islamic Banking Development.

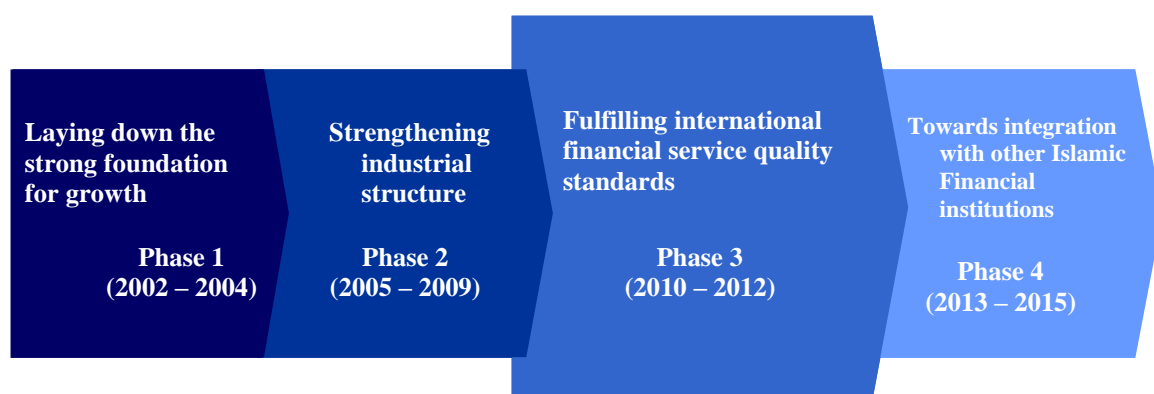


Figure 4: Blue Print of Islamic Banking Development

With this Blue Print, all institutions necessary to support the functioning of an Islamic financial system needed to be established and/or reorganized. This system is rather unique, because Indonesia has one body that issues fatwa and shariah opinions to all Islamic finance players; banks, insurance companies and funds. The National Syariah Board (or Dewan Syariah Nasional – DSN) is a body under the Indonesian Council of

Ulema (Majelis Ulama Indonesia). In addition, every Islamic financial institution must appoint two or three scholars to sit on their Shariah Supervisory Board or Dewan Pengawas Syariah (DPS), whose members are endorsed by DSN. In theory, DPS must ensure that all fatwas of DSN are implemented, and also act as a shariah compliance board at the Islamic financial institutions.

On the other hand, Malaysia adopted a different approach and path. It has, first of all, a central shariah body which is attached to Bank Negara Malaysia that supervises and looks after shariah issues for all banks and insurers that offer Islamic products; likewise, the Securities Commission of Malaysia has also equipped itself with a national shariah body to supervise its Islamic capital market.

Malaysian Islamic finance naturally follows a different path. It is more outward looking because strong support from the highest levels of government means it has more leverage to boost the industry. Bank Negara Malaysia is a known advocate of Islamic finance, in addition to the Securities Commission. Likewise, this clear path and strategy fueled robust growth since Tabung Haji initiated the establishment of Bank Islam in the 1980s until the creation of Malaysia as an International Islamic Financial Centre.

Contemporary Issues in Product Development

In resolving contemporary issues on muamalat, the Islamic jurists have taken into account very seriously the fundamental aspects of the tradition of *istinbat al ahkam* (derivation of Shariah ruling). However in performing their responsibilities, the Shariah scholars always adopt a balanced approach between theoretical and practical aspects and between complying with Shariah principles and the common practice of economic activities and industrial needs.

There are some contemporary issues in Islamic equity market and finance need further study of Muslim jurists. Among the products are the *bay al inah*, *tawarruq*, *hibah* in *mudharabah* contract, *ibra'* in variable rate of *murabahah* agreement, the application of *wa'd* in repurchase agreement, acceptance of funds from unlawful sources and many others.

One of the most controversial issues in Islamic product perhaps is *bay al inah*. Even though the majority of Shariah scholars disallow this concept the product is used in Malaysian Islamic banking system and capital market to facilitate the need of market players to include bond issuance, debt securitization and credit card facilities.

In term of *tawarruq*, there is a proposal to use *ijarah sukuk* as underlying asset in *tawarruq* or *murabahah* to manage liquidity in Islamic financial system. The proposed characteristic of *ijarah sukuk* include *ijarah sukuk* which is backed by tangible asset, financial asset and a combination of both tangible and financial asset. The issue is whether the use of financial asset like *sukuk* and securities instead of commodity in *tawarruq* is permissible in Shariah.

Another delicate issue is *hibah* in inter-bank *mudharabah* investment contract. Usually when banks are in need of funds offer competitive returns to attract investors. However there are bank can only manage to offer returns lower than the market rate of return. To

attract more investors, there is a proposal to introduce *hibbah* in the link-bank *mudharabah* investment contract. Based on this concept, it is suggested that the receiving banks that have lower rate of returns offer *hibah* as a gesture of consolidation gift to the investing banks that are willing to invest with the former.

Generally under the Shariah principles a contract is different from a promise (*wa'd*). Each of them has its own legal implications. As the transaction of Islamic equity market and finance gained more complexity the use of promissory elements are increased. The concept of *wa'd* is widely used in sale and buy back agreement (*repo*), forward transaction of foreign currency and various hedging activities.

CONCLUSION

Islamic finance has evolved throughout the last three decades and turned into a sophisticated global industry. Although this is an excellent opportunity to grow and expand, this development poses great challenges for all stakeholders, especially its players and regulators. As the industry matures, it leads to a more complex form of transactions and exposes the industry to more risks. In addition, clients have also evolved into a more advanced group of fund owners or beneficiaries. They require a higher quality of products and demand more returns or competitive pricing.

Another issue is shariah compliance. The Islamic financiers will not only be obliged to satisfy a new type of customers, but at the same time must ensure all products and services are in compliance with shariah rulings. Shariah compliance is a must and it is probably the last defense in the now overly uncertain global financial industry where regulators cannot cope with the fast development of the financial world.

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