

Developing the Islamic Capital Market and Creating Liquidity*

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I. Introduction

It is a privilege to have been asked to join you at this Seminar. I am grateful to the Markfield Institute and the Islamic Foundation for inviting me to attend.

During this session I have been asked to focus on the development of the Islamic Capital Market and to review the progress that has been made in developing its infrastructure. Mine is the viewpoint of a practitioner. I intend specifically to take a look at what the market has to offer and consider how the direction of Islamic asset origination has been shaped by the environment within which we work.

II. Liquidity Management and Mainstream Financial Services

Whatever the financial requirement, a multitude of short-term investment and funding products are available within the mainstream financial sector.

Accessing the services of banks, financial institutions and fund managers are a ready solution for the retail and corporate marketplace. Larger corporations, banks and financial institutions have recourse to the international money markets and to the capital markets. They can place deposits and raise finance on either rolling or fixed terms that range in duration from over night to many years.

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* Presented at a day seminar, *Islamic Finance and Banking: The British Niche Market*, organized by the Markfield Institute of Higher Education and Islamic Foundation, Leicestershire, UK on 28th April 2004.

Nowadays, the ability both to access liquidity and invest flexibly through the conventional financial marketplace can be taken for granted. Within the Islamic financial sector the situation is somewhat different.

III. Islamic Economics

Islamic financial sector products are asset-based. One of the fundamental principles has been that money must be productively deployed for economic benefit. Investment should therefore be effected through physical ownership of tangible assets (or part thereof) with an income stream that may be attributed to the economic use of the asset.

IV. Challenges of Islamic Financial Operations

Religious jurisprudence has excluded the Islamic banks from the natural benefits of mainstream financial practice such as recourse to the institutional money-markets, certain international capital market products and, according to general perception, to a lender of last resort. Despite this, for the past three decades, Islamic banks have had to conform to regulatory stipulations more commonly applied to an interest-based banking environment. They have been required to comply with mainstream capital adequacy and liquidity ratios and have had to find alternative, *Sharī'ah* compliant solutions to the regular, interest-based deposit reserve requirements that satisfy their regulators.

V. Creating a *Sharī'ah* Compliant Asset Base

From the mid 1970s onwards, Islamic banks have enjoyed increasing success in their domestic markets, mobilizing significant retail deposits on the way. Historically, much of the product innovation within the Islamic financial sector has been engineered to meet the specific investment risk and return criteria of Islamic commercial banks. In addition to offering *Sharī'ah* compliant financial services, the banks have also had to convince clients that their assets are secure and their funds available on demand. But the lack of recourse to market liquidity has rendered it virtually impossible for those

institutions to mismatch their own balance sheets. This goes much of the way to explaining why the Islamic commercial banks became pre-occupied with the origination of secure, short-term investment assets that assured obligations to retail customers.

VI. Simplified Morabaha Trade Financing

The Morabaha contract has been dominant. It has enabled Islamic banks to extend trade finance facilities to a range of international counter-parties on deferred payment terms. Commonly, wholesale Morabaha transactions are credit enhanced, with the beneficiary asked to support its payment obligations by arranging for a third party bank to issue a Letter of Credit, or other appropriate security, in favour of the financing institution. In simple terms the profile of the investment becomes broadly comparable to that of an interbank deposit, namely short-term, bank risk with fixed maturity. As a result, it has enabled Islamic institutions to assure their own regulators of their recourse to sufficient wholesale liquidity on demand.

VII. Morabaha: Asset or Liability?

There has been much criticism of the Morabaha contract in recent years, particularly by commentators who fairly point out that it is limited in application. Critics have also harboured very real concern that dependence on the contract has actually impeded research and development of other *Sharī'ah* compliant instruments that might be securitized, and would therefore be better placed to support the development of the Islamic capital market.

On the other hand if we just stop for a moment to consider the various customer and regulatory demands placed upon the Islamic banks, perhaps it helps us to balance the argument. Just imagine what would happen in the mainstream financial environment if the international money markets became inaccessible for a week, or even a day? The market would probably collapse. For three decades the Islamic banks have managed to exist, grow their client base, make profit distributions and satisfy their local central banks, but to do so they have been obliged to maintain an exceptionally high level of liquidity at all times.

VIII. Islamic 'Debt' Securities

A review of the audited financial statements of many Islamic commercial banks reveals that regularly, more than 70% of the balance sheet is still invested in Morabaha structures. In both Morabaha and the similarly constructed Al Bai Bithaman Ajil contract, favoured in Malaysia, the underlying asset is purchased and sold at inception with deferred payment consideration. The Malaysian market has developed a procedure for securitization of the Al Bai Bithaman Ajil contract but the resultant Bai Al Dayn securities (sometimes referred to as Islamic Debt Securities) have proven contentious in the Arab World. Outside of Malaysia, the majority of *Shari'ah* scholars concur that any further trading in the income stream will be trading in debt because the receivables are no longer directly attributable to an asset to which the investor retains beneficial title. Similarly the Morabaha contract may not be securitized, as it would amount to securitization of debt rather than assets.

IX. *Ijārah*: Lease Finance

During the past fifteen years the Islamic financial sector has made progress in extending its investment horizons. Investor demand for a combination of enhanced performance plus risk and asset diversification has resulted in the financing of a greater percentage of non-trade assets. *Ijārah*, or leasing, has become a preferred contract for offering medium to long-term asset based finance. An *Ijārah* contract incorporates a fixed-term, or periodically re-fixed, income stream, or rental, from the economic use of a physical underlying asset. Lease income can be readily securitized without the infringement of *Shari'ah*, because the investor retains title to the leased asset throughout the investment period.

X. *Ijārah* Funds

Ijārah funds have been incorporated to capitalize on the availability of a broad spectrum of international investment opportunities. Lease funds tend to invest in pools of suitable leased assets, which may be sold to a special purpose vehicle, owned by the Fund. The Fund manager may choose to evidence holdings to investors by issuing certificates that represent their ownership of, or title to, a percentage

of the asset pool and, thereby, a *pro rata* share of the income stream. Subsequent sale of certificates releases liquidity.

XI. *Ijārah* Funds: Creating Liquidity

Most Islamic lease funds now incorporate periodical redemption facilities as a feature. Whilst invaluable, historically the investment exit strategy has been underwritten by the product sponsor, who will acquire asset holdings from the investor or arrange asset sales on a 'best effort' or matched basis. Amongst the first to implement the concept were the Islamic Development Bank and the Al Tawfeek/Al Amin companies of the Dallah Albaraka Group. As investors had the right to redeem their funds by selling back holdings to the sponsor, these funds became the first to address the issue of in-built liquidity.

Undoubtedly the long-held aim of some of the larger Islamic lease funds has been the securitization and subsequent trading of the asset portfolio within a regulated market environment. Product sponsors have grappled with the challenges of obtaining regulatory approval and the prospects of achieving international ratings, but it has been impossible to move speedily without an established market infrastructure. Nevertheless, there has certainly been progression and more recent initiatives have included liquidity provision by third party facilitators with their own investment grade ratings.

XII. Product Review: *Ijārah* Liquidity Programme

The structure of First Islamic Investment Bank's 'Islamic *Ijārah* Liquidity Programme' is one such example. The programme objectives are to preserve investment capital, to provide consistent income and to offer investors returns comparable to those available through the traditional money markets.

Investor funds acquire a percentage of ownership of a leased asset pool, acquired by the subsidiary of FIIB. Uncertified securities, or *shukūks*, are issued to investors, confirming their fractional ownership interests in the underlying assets. The investor is granted a put option enabling the *shukūks* to be put back to a third party liquidity provider, such as Société Générale. *Sharī'ah* stipulates that the put must be effected at the *shukūk* face value, but operationally it can take place on any redemption date after a minimum one month

holding. A profit return is attached to the *şukūks* and is re-fixed on a monthly basis. Although launched a couple of years ago, FIIB's product is interesting, for a number of reasons. Firstly, as we have heard the *şukūks* was a Malaysian innovation and this was its first implementation by a Gulf based Islamic bank. Secondly, as the put option is underwritten by a third party bank with an investment grade rating, the securities obtain a profile more suited to securitization.

XIII. Islamic Investment Asset Base

Although there have been successful initiatives, it has proven difficult to originate sufficient volume of assets that are both eligible for securitization and *Sharī'ah*-compliant. The global market has offered asset supply, but also presented structural and taxation issues that have proven challenging. Nonetheless, ongoing demand has supported the growth of the Islamic fund management sector, where activity has increased dramatically and the international capital markets have served to deliver allocation opportunity. Construction of a balanced investment portfolio requires access to a range of asset categories and investment horizons (and a professional, portfolio manager will seek performance through prudent and diversified allocation). In response to client demand, new initiatives have recently encompassed several new asset classes, as indicated on the slide.

In recent years it is actually the international equity markets that have been a focus of Islamic asset management with equity funds representing more than 65% of the total Islamic fund universe. Although encountering initial reservations from Islamic scholars, sponsors persevered with initiatives to launch equity products. Of course the investment universe of each fund and the resultant dividends or income must always be screened or purified in accordance with prevailing *Sharī'ah* stipulation. Every Islamic investor prioritises *Sharī'ah* compliance, but its delivery in combination with investment exposure to established, regulated and liquid capital markets has provided a compelling story for fund managers to offer to their clients. Certain Islamic equity funds have been listed on both international and regional stock exchanges. Again, that listing may give added respectability and demonstrate a product regulatory endorsement, but does not mean that liquidity is automatically available unless there is a genuine secondary market.

XIV. Disclosure, Regulation and Rating

Investors are increasingly sophisticated. Those unwilling or unable to assess the merits of Islamic financial products will look to accredited rating endorsements. Until now, there has been little to assist Islamic investors in determining whether their risk is ‘investment grade’ or otherwise. Islamic investment products have not, until recently, been rated by the international agencies, who have previously suggested that both levels of disclosure and reporting standards within the Islamic financial sector might be better. Achieving authorization in international jurisdictions has necessitated the implementation of improved management and reporting systems, as both regulators and prospective investors demand more accurate information about structure and performance.

XV. Rising to the Challenge

Accelerating the origination of instruments to support the Islamic capital market infrastructure and inject liquidity is always central to our industry debate. Perhaps occasionally, when frustrated by seemingly insurmountable barriers, we forget that our sector is young and we are endeavouring to develop expertise that has taken centuries to evolve in conventional financial practice.

Mainstream capital market development in the Middle East is, itself, at a relatively early stage. Even large projects have typically been funded through informally raised private equity combined with local bank debt. The pace of change has been dependent upon government perspectives, improvement of the legal infrastructure and the gradual opening of markets to inward investment. Progression in these areas enhances prospects for external assessment and rating of individual investment opportunities.

XVI. Formation of Islamic Capital Market Infrastructure

Unresolved operational and procedural issues have impacted the emergence of the Islamic capital market. Progress in standardizing products and systems has been gradual. It has proven difficult to advance without consensus and consistency of opinion amongst the esteemed *Shari'ah* authorities; at times, there has been insufficient co-operation between the Islamic banks themselves. Although there is no

doubt that the Islamic financial sector needs, and its participants want, the market to evolve, establishing sufficient numbers of founder participants willing to invest in it, and support it, on comparable terms was not easy. Strong and, ideally, centralized regulation has always been a pre-requisite and, for many years, there were unanswered questions as to who might provide it.

During the mid 1990s, with considerable encouragement and support from its government, Malaysia made rapid progress in implementing a dual banking system in which the Islamic banking sector operates in parallel to the conventional sector. As a result, the Islamic interbank money market is already in place and the Islamic capital market has evolved. In the summer of 2002, Malaysia issued a US\$ 600mn Islamic sovereign *Ijārah sukūk*, lead managed by HSBC, with a five year maturity profile. Heavily oversubscribed, the *sukūk* was awarded a BAA2 rating by Moody's and a BBB rating by Standard and Poor's. 51% of investors were Middle Eastern.

XVII. Islamic Securities in Malaysia (IPDS)

Arab scholars, as I mentioned earlier, have been reluctant to endorse or accept certain Islamic capital market instruments developed in Malaysia. In 2002, Morabaha-backed securities had risen to 33% of total Islamic bond issues, representing a 10% increase on 2001. In an endeavour to address this, in 2003 the Federal Budget of the Malaysian government introduced tax concessions against the cost of structuring, documenting and issuing Islamic asset-backed securities based upon the more broadly acceptable contracts of *Ijārah*, *Muḍārabah* and *Mushārah* rather than the debt securities resulting from Morabaha and Al-Bai Bithaman Ajil.

XVIII. Islamic Securities in the Middle East

Encouragingly, the Middle Eastern authorities are becoming increasingly involved. The Islamic financial sector has recently benefited from the launch of a series of Islamic bonds, or *sukūk*, that have been developed with the proactive support of the Bahrain Monetary Agency. These include short-term financial papers, issued as *sukūk* Al-Salam, and the longer-term *sukūk* Al-Ijārah extending to five years. In October last year, the Government of Bahrain

announced the latest US\$250mn *ṣukūk* issue. This offer has taken Bahrain's issuance of *Shari'ah*-compliant short and medium term instruments during the past three years to US\$ 1 billion.

The undoubted strength of the sponsor and the premium on return over comparable risks in the international marketplace have been very positively received by investors. In a new development, the most recent issues have been rated A – by S&P, distributed in the intl marketplace and listed on the Bahrain Stock Exchange. In October of last year, the government of Qatar issued its own *ṣukūk*. Lead managed by HSBC and QIIB, at \$700mn, it is the largest single issue to date. The issue was rated A+ by SSP.

XIX. The International Islamic Financial Market

The Islamic world is extremely diverse and the emergence of the Islamic capital market has always been dependent, not only upon the satisfaction of *Shari'ah* stipulations at a very broad level, but also the ability to accommodate the regulatory and financial accounting standards of jurisdictions stretching from the Middle East, to Africa, Asia and beyond. Recently, new direction appears to be stemming from international co-operation and shared intention to deliver.

Four years ago the Labuan Offshore Financial Services Authority (LOFSA) signed a Memorandum of Understanding with the Bahrain Monetary Agency (BMA) and the Islamic Development Bank, to support the establishment of the Islamic capital market. The resultant, multinational International Islamic Financial Market (IIFM) is now headquartered in Bahrain. Its membership now extends to the Central Bank of Indonesia, the Central Bank of Sudan and Ministry of Finance of Brunei. Its primary purpose is to provide a co-operative framework for the market infrastructure.

XX. Islamic Capital Market: Multinational Institutions

The Liquidity Management Centre (LMC) has been established in parallel. Islamic Development Bank, Kuwait Finance House, Dubai Islamic Bank and Bahrain Islamic Bank were founder shareholders. The LMC has taken a proactive role in the *ṣukūk* issuance programme. Ultimately, the LMC will be well placed to perform as liquidity manager for the Islamic financial sector. This is extremely

important because, whilst there are a number of new initiatives taking place, most of them presently address investment of liquidity rather than the ability to access funding. Bahrain is also the headquarters of the International Islamic Rating Agency, established to bring consistency to the rating of Islamic financial instruments. To gain international credibility the procedures of the rating agency will need to be utterly transparent and there have been suggestions that it will work with the international agencies to achieve comparability. Finally, the Islamic Financial Services Board in Kuala Lumpur has been established to centralize the setting of prudential standards for the regulation and supervision of Islamic banking.

XXI. Ongoing Development: *Ṣukūk*

The role of individual Islamic banks is also crucial – they have all important credibility in their domestic environments plus the size and scope to anchor capital market initiatives. In April 2003, First Islamic launched its debut *ṣukūk* to finance the expansion of its European operations. The US\$75m medium-term issue was lead managed by The Securities House of Kuwait, with asset facilitation by Dawnay Day.

International banks have also played their part in the development of Islamic financial services and it is to be hoped that their commitment will extend beyond proprietary investment services. Certainly, there is great competition amongst the global investment banks to lead manage the new Islamic bond issues. Additionally, their substantial balance sheets and long-term market experience can be harnessed to support the market making capability and accelerate volume-building process.

XXII. Ongoing Development: Issuance and Secondary Trading

Other Arab governments, banks and now large corporations are exploring *ṣukūk* issues. Corporate domestic issues in Malaysia aggregated US\$3bn in 2002 and represented 60% of all bonds issued, but are not yet commonplace in the Gulf. However, the signs are encouraging, the Islamic Development Bank's debut international *ṣukūk*, raised US\$400m and was awarded a AAA rating by Standard and Poor's. This was the first time an Arab issuer, either mainstream

or Islamic, had received such a rating of its issue. The Islamic Development Bank planned the *ṣukūk* in an effort to familiarize the international capital markets with the structure. Lead managed by Citigroup and co-led by Abu Dhabi Islamic Bank and Kuwait Finance House, 70% of the issue was placed with conventional investors. 70% of the order book was Middle Eastern, 14% European and 16% Asia Pacific.

In preparation for secondary trading, provision is being made to list and cross-list *ṣukūk* issues. By example, in September of last year, the Malaysian global *ṣukūk* was cross-listed on the Bahrain Stock Exchange. There is still some concern that Sukuks are not actually being traded. This is certainly true, but the market was starved for so long of high quality sovereign paper that investors have, thus far, been purchasing to hold. Aggregate international issues, currently total less than US\$3bn. Market consensus suggests that there will be little evidence of appetite to trade before critical mass builds beyond US\$10bn.

XXIII. Ongoing Development: *Tawarruq*-based Contractual Arrangements

In the meantime, maintaining sufficient liquidity flows is still essential to the market and the development of *Tawarruq*-based products has been a strong initiative of the past year or two. Previously, Islamic institutions have, as I have mentioned, allocated short-term liquidity through deferred settlement *Morabaha* transactions. Reciprocal requirement has often been dependant upon reverse *Morabaha* solutions.

In a new era of co-operation, the major Islamic banks are exerting greater direct control over the management of their own liquidity. Spot value purchases and sales of assets are supporting the facilitation of wholesale, *Sharī'ah*-compliant interbank transactions. The Islamic banks interface as direct counterparties with asset brokers, merchants and each other, thereby avoiding unnecessary and costly intermediation by third party banks. Further structuring developments have enabled *Tawarruq*-based financing products to be offered at retail level by a growing number of Islamic and Arab banks. Such has been the growth and demand for the structure that esteemed

Islamic scholars have been called to review its merits on a number of occasions and the Fiqh Academy in Jeddah has called for a full procedural and structural review. It is likely that the principles of the contract will require further definition but it is to be hoped that we can establish parameters for ongoing development with full *Sharī'ah* endorsement. Although new to the market, we have already seen unprecedented levels of standardization in the operational and administrative procedures that support delivery of this product. It has served to facilitate dependable liquidity.

XXIV. Conclusion

There are still issues to resolve, but quality of asset origination is undoubtedly improved and the structuring innovations of recent years have served to strengthen the asset-based platform upon which we must build. It seems that the foundations of the market are finally in place. The Islamic financial infrastructure should be greatly strengthened by its four new multinational institutions. Improved co-operation, dialogue and direct interaction between the major Islamic institutions is enhancing their own contribution and beginning to create some standardization of newer products and innovations within the market.

Ultimate success has, to an extent, always been dependent upon the proactive involvement of the central regulatory authorities relevant to Islamic financial services. The visible participation and support of Bahrain and Malaysia, in innovating *Sharī'ah*-compliant bonds, has enhanced product credibility and market profile. Subsequent sovereign issues are consolidating the position. Successful capital markets thrive on substance and security. Effective supervision and strong regulation helps to prohibit erratic behaviour by participants as well as serving to comfort investors. Independent rating endorsement allows objective assessment and, again, develops investor confidence. In turn, market confidence injects liquidity and helps build the critical mass that any financial market needs to flourish.