Fundamentals of Islamic Money and Capital Markets

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To my mother, my wife, and my children.
—Azmi

To my mother, my wife, and my children.
—Abduh

To my parents, my wife, and my kids (Hanifah, Fakhruddin, and Azmi).
—Raditya

Contents

Preface

Despite many universities in this world currently offering an Islamic finance program (bachelor's and master's degrees), there has been no book on Islamic financial markets that is arranged and structured based on the university's course outline. This book is arranged following the syllabus/course outline used by many universities offering a bachelor in Islamic banking and finance program, particularly in Malaysia. Thus, lecturers, students, and independent readers will find that the topics discussed in this book are very easy to read and understand. Moreover, the book provides readers with not only basic concepts in Islamic financial markets but also discussion of current practices of Islamic financial markets and case studies from real examples in the markets.

Audience

This book is structured and developed based on the course syllabus taught at the International Islamic University Malaysia for several years, and thus it is intended to support the teaching-learning activities in the classroom between lecturers and students.

However, we also believe that those who have curiosity and want to know about the fundamentals of Islamic financial markets, including the Islamic contracts used and how the market works, can benefit from this book.

Overview of the Contents

Chapter 1 provides an introduction to the Islamic financial system and Islamic financial markets. In this chapter, readers will be provided with the list of the functions and roles of financial markets, as well as the difference between debt instruments and equity instruments in financial markets. Most importantly, this chapter identifies characteristics of the Islamic financial system and the conventional financial system that can be used to differentiate between those two systems. Meanwhile, the history of Islamic finance development, particularly the Islamic money and capital markets and their regulatory bodies in Malaysia and other countries, is provided in Chapters 2 and 3.

Chapter 4 discusses the Islamic money market concepts and practices in Malaysia. We believe this chapter will make readers understand many aspects and functions performed by the money market, such as identifying the key participants in the money market, understanding how banks invest surplus funds and obtain funding for deficits, understanding the characteristics of Malaysian Islamic money market instruments, and calculating the price or proceeds of Islamic money market instruments.

Chapter 5 provides the introduction to the Islamic alternative to conventional bonds called ***sukuk***. It explains about sukuk and how it differs from conventional bonds and shares. Starting with identifying basic contracts in sukuk structures and distinguishing between the various sukuk structures, readers are brought to a basic understanding of sukuk so that they are ready to undertake the upper level of the sukuk discussion. This chapter also provides the discussion on factors that differentiate between asset-based and asset-backed sukuk.

Types of Islamic investment are discussed in the last five chapters, which are Chapters 6 through 10. Chapter 6 provides discussion on Shariah-compliant equity that distinguishes between conventional and Shariah-compliant equity securities and explains the screening process of Shariah-compliant equity securities. The next chapter, Chapter 7, explains the concept of mutual funds and their features. In this chapter, we describe Shariah stock screening, purification of income, and the role of Shariah advisors in mutual funds. In addition, this chapter provides a formula and example on how to calculate the net asset value (NAV) in Islamic mutual funds as well as on how to start investing in Islamic mutual funds.

The A-to-Z aspects of Islamic real estate investment trusts (I-REITs) are discussed in Chapter 8, while the structure, practices, risks, and benefits of Islamic exchange-traded funds are discussed in Chapter 9. Last, the concepts and current practices of Islamic derivatives markets and instruments are provided in Chapter 10.

These chapters are also accompanied by real case examples from the Islamic financial markets and "Chapter Questions" sections where you can test your own understanding of the issues discussed. Solutions to selected questions are provided for instructors on the Wiley Global Education website.

Acknowledgments

This book would not have come to fruition without the encouragement and support of many individuals. Among them my family, including my mother, wife, and children who understand and appreciate the life and work of an academic the co-authors of this book who were my former PhD students and are now my colleagues, and my students who gave valuable input when a draft of this book was used in class.

Also many thanks to Nick Wallwork and the team from John Wiley & Sons for getting this book published.

—Mohd Azmi Omar

I would like to thank my mother, my wife, and my children for their patience during all this time, for their faith that I could do this difficult task, and for their spirit in always telling me that willpower will destroy all the obstacles in front of us. Thanks also to my guru, Professor Dato' Dr. Mohd Azmi Omar, who has taught me how to be a better person in this university of life.

—Muhamad Abduh

I would like to express my sincere thanks to my family—my parents; my wife (a pediatrician); my three children, Hanifah, Fakhruddin, and Azmi—for their love and support and for inspiring me. My special thanks go to Professor Azmi, from whom I learned a great deal about the supervision approach, the teaching approach, and the motivation approach. His methods were precious lessons to me when I served as a lecturer at Airlangga University, Surabaya, Indonesia.

—Raditya Sukmana

CHAPTER

1

An Introduction to Conventional and Islamic Financial Systems

Learning outcomes

At the end of this chapter, you should be able to:

1. Define a financial system.
2. List the functions and roles of the financial market.
3. Distinguish between debt instruments and equity instruments.
4. Classify financial markets.
5. Distinguish between financial instruments in financial markets.
6. Distinguish between financial intermediaries in the financial system.
7. Identify characteristics of the Islamic financial system and the conventional financial system.
8. List the salient features of the Islamic financial system.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

Hasan, a researcher in a Halal food technology unit at an Islamic university in Malaysia, has invented a machine to detect whether a chicken has been properly slaughtered or beaten to death. He and his team are interested in selling their machine. Unfortunately, they do not have sufficient funds to produce the machine. Tuan Bakri, on the other hand, has plenty of savings, which he and his wife have accumulated over the years. If they could meet, do you think something could happen? If Tuan Bakri could provide funds to Hasan, the future of Hasan's halal detector machine would be brighter and the ***ummah***, the Islamic society, would benefit from this machine.

However, before we conclude Hasan's story, one might have to ask the following questions:

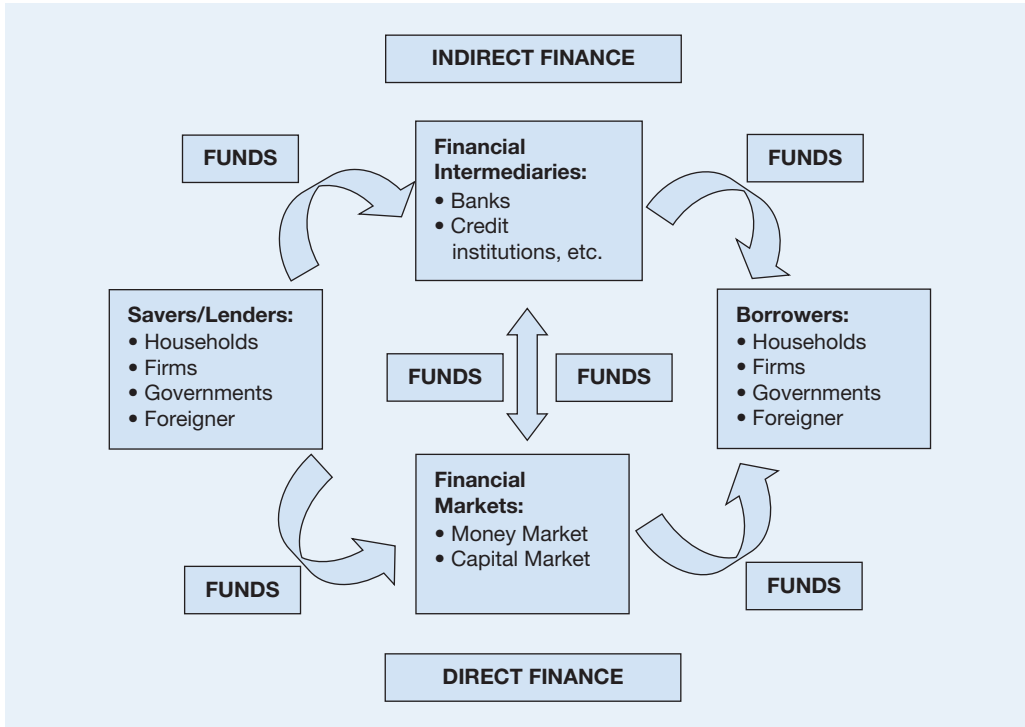
- Do they know each other before they engage in the contract?
- How do Hasan and Tuan Bakri meet?
- Who will control the transfer of funds from Tuan Bakri to Hasan?
- Who will control the repayment process from Hasan to Tuan Bakri?
- And so forth . . .

To answer these questions, we need to first understand the financial system and what is included within it. A **financial system** is the collection of markets, institutions, laws, regulations, and techniques that operate to enable the transfer of money from the surplus side, or savers, to the deficit side, or borrowers. It seeks the efficient allocation of resources between savers and borrowers. A healthy financial system requires, among other things, efficient and solvent financial intermediaries, efficient and deep markets, and a legal framework that defines clearly the rights and obligations of all agents involved. In order to foster the sound development of the financial system and protect the public interest, the central bank permanently monitors the institutions that comprise this system, proposes reforms to the legislation in force, and issues regulations in the areas under its authority.

Financial markets (sukuk, bond, and stock markets) and financial intermediary institutions (banks, insurance companies, pension funds) have the basic function of bringing together people like Hasan and Tuan Bakri by moving funds from those who have a surplus (Tuan Bakri) to those who have a shortage (Hasan). Another example is that when the Malaysian government needs to build a road connecting Peninsular and Penang Islands, it may need more funds than local property taxes can provide. Therefore, the government must go to financial markets and ask for some funds by agreeing with the rules implemented in that particular market.

So, basically what could fulfil the needs of people like Hasan and Tuan Bakri is a financial system that provides them facilities to lend and borrow money. Many scholars of finance and economics say that financial development is very important to boost the economic

FIGURE 1.1 Flows of Funds through the Financial System



growth of a country. Therefore, well-functioning financial markets and financial intermediary institutions are crucial to economic wealth.

The flow of funds in a financial system is shown schematically in Figure 1.1. Those who have surplus funds and become lenders are shown on the left-hand side and those who need funds and become borrowers are on the right-hand side. The households are basically the principal lenders through financial intermediary institutions, but sometimes business enterprises, local as well as federal government, foreigners, and foreign governments experience excess funds and therefore lend them out through financial markets. The borrowers also come from households, for example, homeowners; from governments, to build a road or a bridge, or to finance the annual budget; and from business enterprises, to finance their production activities.

Funds flow from lenders to borrowers via two routes. In direct or market-based finance, debtors borrow funds directly from lenders in financial markets by selling them financial instruments, also called securities (such as debt securities and shares), which are claims on the borrower's future income or assets. If financial intermediaries play an additional role in the channeling of funds, one refers to indirect finance. Financial intermediaries can be classified into credit institutions, other monetary financial institutions, and other financial intermediaries.

Financial markets and financial intermediaries are not separate entities but are strongly interlinked. We will discuss this relationship between financial markets and financial intermediaries further in the next section.

One might ask again, why is this channeling of funds so crucial to the economy? The answer is that people who save their money are frequently not the same people who have profitable investment opportunities, the entrepreneurs. Therefore, through this system, people can help each other through the ***mu'amalah*** (transactions). There is nothing wrong about this from an Islamic point of view, as long as they do not cheat others or follow other practices or management methods that do not comply with Shariah principles.

The Roles and Functions of Financial Markets

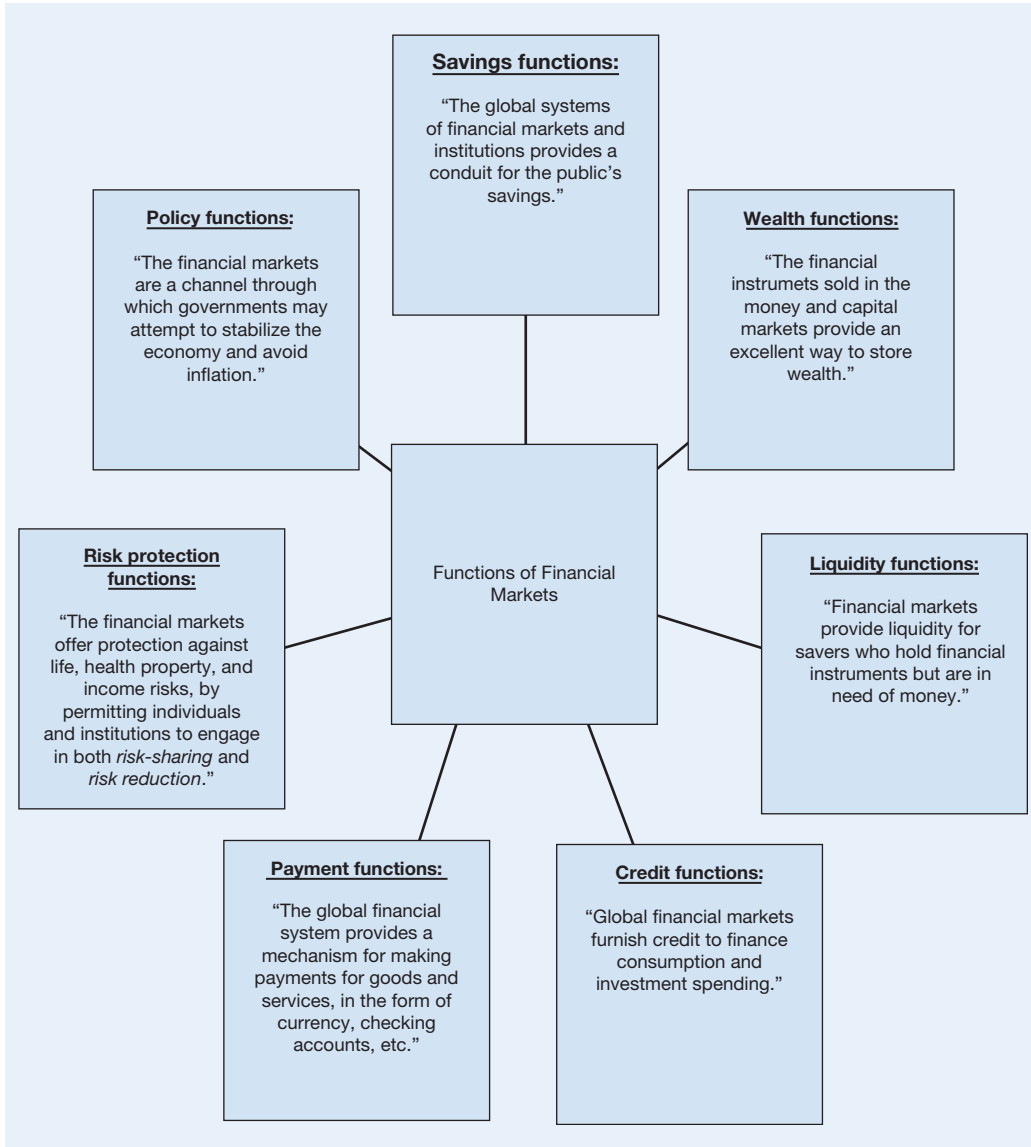
After we discuss the meanings and importance of financial markets to the country's economy, we first discuss the roles and functions of financial markets toward the economy. There are at least two views regarding the links and importance of financial markets' development and growth to a country's economy. The former view says that the development of financial markets and financial intermediaries will stimulate a country's economy and therefore increase production and growth. This strategy seeks to allocate capital more efficiently and to provide incentives for growth through the financial system, and this is recognized more as Schumpeter's supply-leading view. A demand-following relationship, on the other hand, is a consequence of the development of the real sector. This implies a continuous widening of markets and a growing product differentiation, which makes necessary more efficient risk diversification, as well as better control of transaction costs. The latter is known as Robinson's demand-following view. However, we will not discuss the pros and cons regarding which view is right. The most important information that could be derived from these is that the financial market development is significantly higher than the economic growth of a country, and therefore has an important role in a country's economic performance.[1]

From a micro-perspective, examples of the roles of financial markets are enabling university students to obtain loans, families to obtain mortgages for their homes, businesses to finance their growth, and governments to finance their expenditures. Without financial markets, some young men and women cannot go to school, some families are homeless, some businesses are facing bankruptcy, and governments cannot provide sufficient public services. So, the general function of financial markets is to provide a system that will allow people who have surplus capital to finance people who experience deficits in capital.

However, other than that general function of financial markets and institutions, there are some specific functions of financial markets and institutions (as shown in Figure 1.2):[2]

- **Savings**. Financial markets provide an avenue for the public's savings. Bonds, stocks, and other financial claims sold in the money and capital markets provide accessible liquid investments,

FIGURE 1.2 Specific Functions of Financial Markets



a relatively low-risk outlet for public savings, which flow through the financial markets into investments, so that more goods and services can be produced (productivity increases).

- **Wealth**. The capital market provides an excellent avenue to store wealth (preserve the value of assets we hold) until funds are needed for spending. This use of funds is more productive than storing wealth in the form of tangible assets, such as automobiles or items that are subject to depreciation and often carry a great risk of loss. Moreover, bonds, stocks, and other financial instruments do not wear out over time and usually generate income.

- **Liquidity**. The capital market provides a means of converting financial instruments into cash, with little risk of loss. The capital market provides liquidity (immediately spendable cash) for savers who hold financial instruments, but are in need of cash.
- **Credit**. In addition to providing liquidity and facilitating the flow of savings into investments to build wealth, the financial market furnishes credit to finance consumption and investment spending. In this regard, individuals can borrow money to buy properties or a company can get financing to expand their businesses.
- **Payments**. The financial markets also provide a mechanism for making payments for the purchase of goods and services. Certain financial assets, including currency, non-interest-bearing checking accounts (demand deposits), and interest-bearing checking accounts serve as a popular medium of exchange in making payments all over the globe.
- **Risk protection**. Financial markets offer businesses, consumers, and government protection against life, health, property, and income risks. This is accomplished by allowing participants to engage in both risk-sharing and risk-reduction approaches. Risk sharing occurs when an individual or an institution transfers their risk exposure to someone willing to accept that risk (such as an insurance company), while risk reduction usually takes place when we diversify our wealth across a wide variety of different assets, so that our overall losses are likely to be limited.
- **Policy**. Governments, particularly the central bank, use financial markets as one of the tools to manage monetary stability of the country. Through financial markets, governments could manage some economic parameters, such as money supply, inflation, exchange rate, and other relevant factors of the economy.

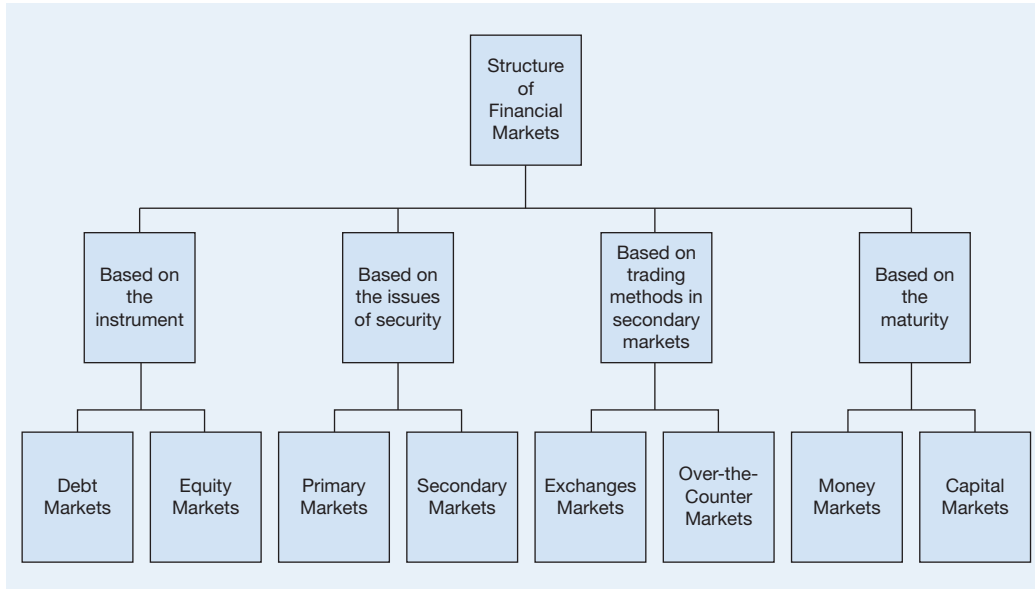
Structures of Financial Markets

After understanding the definiton, functions, and roles of the financial market, the next discussion concerns the structure of financial markets. Financial markets are essentially divided into four types based on the instrument, the issues of the security, the trading methods in secondary markets, and the maturity (see Figure 1.3).

Based on the Instrument

We can divide financial market structures based on their instruments into **debt markets** and **equity markets**. Debt instruments, which are sold in debt markets, such as bonds, sukuk, and mortgages, are the most common method by which firms or governments obtain funds. It is a contractual agreement by the borrower to pay the holder of the instruments a fixed amount of money at regular intervals, including principal and interest or profit margin, until a specified date as the final payment. The specified date for the final payment is the maturity date. A debt instrument is called short-term if its maturity is less than a year, while it is called long-term if its maturity is 10 years or longer. In between are the intermediate-term instruments.

FIGURE 1.3 Structure of Financial Markets



The other instruments that can be used for raising funds are equity instruments. While bonds, sukuk, or other debt instruments have maturity dates, equities do not and so therefore are considered long-term securities. People or firms who are holding common stock, as an example of equity instruments, obtain their shares from the net income and the assets of a business. Therefore, shareholders are sometimes called residual claimants, which means that they can only get their shares after the stock-issuer company pays all its debts and taxes. Table 1.1 depicts the main advantage(s) of debt and equity instruments from the investor's point of view.

From the perspective of a company that wants to acquire funds, debt and equity instruments are the two ways of getting those funds. It is said that the company acquires debt funds when it takes a loan or sells bonds, while equity funds are raised when the company issues shares to the public, who are keen on the company's progress and growth rather than on earning interest on debt.

Table 1.1 shows the different advantages of debt and equity instruments from the surplus side or lender's side. However, there are also some differences between debt and equity instruments from the deficit side, or the borrower's side:

1. Issuing equity instruments means buying capital, while taking debt instruments means borrowing capital.
2. The company shares its profits and gains with the holders of equity instruments, while it must pay back the principal loan plus its interest to the holders of debt instruments.
3. The company should go to credit markets in order to obtain the loan, while it should go to capital markets to issue its shares as equity instruments.

TABLE 1.1 Instruments in Financial Markets

Type of Instruments	Advantage(s)
Debt instruments	1. Fixed returns. 2. Can choose short-term, intermediate-term, or long-term investments. 3. If the company faces bankruptcy, lenders can still have their principal money back plus interest or profit-sharing, where relevant.
Equity instruments	1. Equity holders benefit directly from any increases in the corporation's profitability and asset value. 2. Owning stocks means also owning a portion of the firm and thus having the right to vote on issues important to the firm and to elect its directors.

Based on the Issuance of Securities

People or firms in financial markets can sell new securities and resell old securities issued by them or others. A **primary market** is a market where new issues of securities such as bonds and stocks are sold by the initial issuer, such as firms or the government selling to the first buyer or creditor who wishes to buy. However, primary markets are not as well-known as secondary markets, and in fact most trades are not done in primary markets. Why? Because most of the trades in primary markets are done behind closed doors. Investment banks are the main players in primary markets through underwriting securities, by which the bank guarantees a price for a firm's securities and then sells the securities to the public.

After those securities are traded in a primary market, the current owner may want to sell it again due to liquidity problems or to take profit. He or she can now sell those securities in a secondary market. So, a **secondary market** is a market where securities are traded after they are initially offered in the primary market. Although the person who has sold the security in a secondary market receives money in exchange for the security, the company that issued the security acquires no new funds. The company receives funds only when the security is first sold in the primary market.

Brokers and dealers are very important to the funcioning of the secondary market. Brokers are agents of investors who match buyers with sellers of securities, while dealers link buyers and sellers by buying and selling securities at a stated price. Kuala Lumpur Stock Exchange (KLSE) of Bursa Malaysia is the best-known example of a secondary market. It also includes futures markets and options markets.

Methods Used in Secondary Markets

There are two methods by which secondary markets are conducted: **exchange markets** and **over-the-counter (OTC) markets**. An **OTC** is a decentralized market of securities not listed

on an exchange where market participants trade over the telephone, facsimile machines, or electronic networks instead of on a physical trading floor. There is no central exchange or meeting place for this market. In the OTC market, trading occurs via a network of middlemen, called dealers, who carry inventories of securities to facilitate the buy and sell orders of investors, rather than providing the order matchmaking service seen in specialist exchanges such as the KLSE.

An **exchanges market**, on the other hand, is where buyers and sellers of securities or their agents meet in one central location to conduct trades either physically or through an electronic trading platform. The quoted prices of the various securities listed on the exchange represent the only prices that are available to investors seeking to buy or sell the specific assets. A good example of this is the New York Stock Exchange, and Bursa Malaysia is an example for exchanges market where trades are conducted via an electronic trading platform. The New York Stock Exchange is considered a centralized market because orders are routed to the exchange and are then matched with an offsetting order. However, the foreign exchange market is not deemed to be centralized because there is no one location where currencies are traded and it is possible for traders to find competing rates from various dealers from around the world.

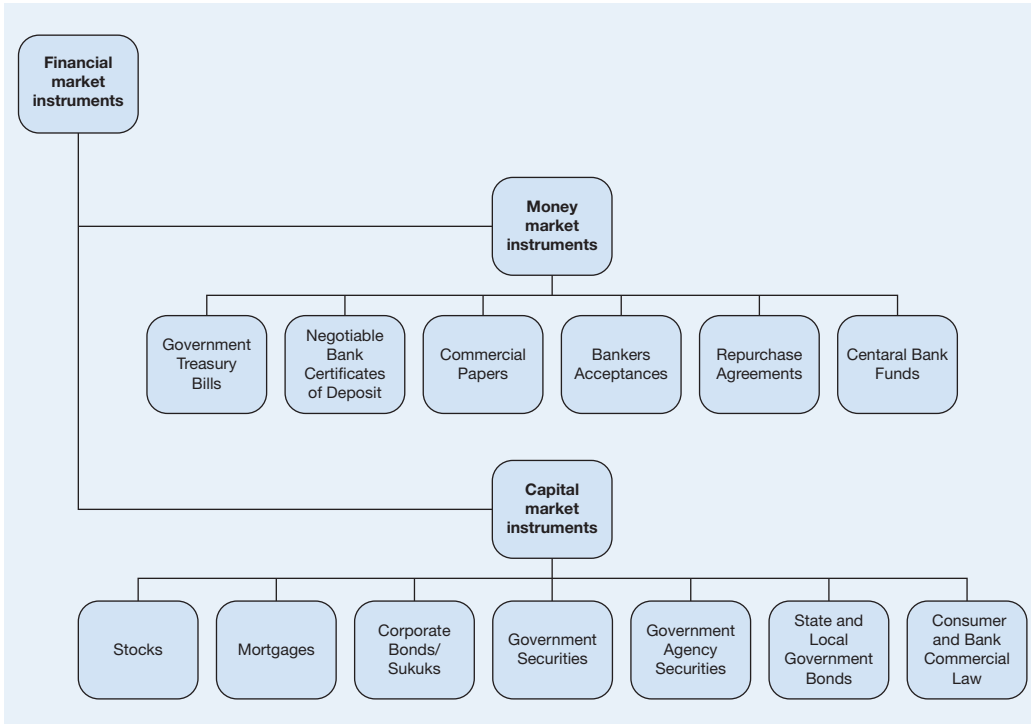
Based on the Maturity

The last method in structuring the financial market is based on the basis of maturity of the securities traded in each market. The **money market** is a segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money-market securities consist of negotiable certificates of deposit (CDs) or Islamic negotiable instruments of deposits[3] (INIDs), bank acceptances, Treasury bills, or Islamic accepted bills, commercial papers, municipal notes, repurchase agreements (repos) and short-term sukuk. The money market is used by a wide array of participants, from a company raising money by selling commercial paper into the market to an investor purchasing CDs as a safe place to park money in the short term. The money market is typically seen as a safe place to put money due to the highly liquid nature of the securities and short maturities, but there are risks in the market that any investor needs to be aware of, including the risk of default on securities such as commercial paper. The **capital market**, on the other hand, is the market in which longer-term debt (one year or greater) and equity instruments are traded. More details about money and capital markets are discussed in the following section.

Classification of Financial Markets

In today's financial world, one of the renowned classifications of financial markets is the money market and capital market (see Figure 1.4). As we have discussed in the previous sections, this

FIGURE 1.4 Classification of Financial Markets and Its Instruments



classification is based on the maturity of the securities traded in a financial market. Now, we shall discuss the money market and the capital market.

The Money Market

In spite of its name, money markets are not used for trading currencies but rather for liquidity purposes, such as to obtain or place out short-term funds. Currencies or M1 definition of money (currency in the hands of the public, checkable deposits, and traveler's checks) are traded on the foreign exchange market. However, money in forms other than M1 are traded here (we call them as instruments), such as money market mutual fund shares, negotiable certificates of deposit, repurchase agreements (repos), and government Treasury bills.

Although there are as many different types of money markets as there are instruments, people normally refer to these markets in the singular, as a money market. This is due to the fact that money market instruments share many characteristics.[4] First, they are issued in large denominations, usually of RM100,000 or more. This feature, along with the absence of reserve requirements and lower regulatory burdens when compared to depository institutions, make money markets an efficient means of raising and storing short-term funds. Second, money market instruments have short maturities, ranging from one day to one year. Third, due to short

maturities and active resale markets for most instruments, money market instruments are characterized by low liquidity risk as well as low default risk. Finally, the fourth characteristic of money market instruments is that unlike commodities or stocks, which often trade on specific exchanges, the money market does not occupy any one particular geographic location or trading floor. Hence, although the market tends to be centered in Kuala Lumpur, for example, it consists of borrowers and lenders as well as brokers and dealers linked by online computers throughout the states and the world.

As all players in the economy, such as financial and nonfinancial businesses as well as governmental entities, generally experience flows of receipts and expenditures at different times and sometime experience mismatch between them, they need to balance them. They need to borrow in a period when they experience a shortage of funds and to lend their surplus funds in other periods. One way they can get fresh funds to promote their businesses is borrowing from the money market.

Money Market Participants

There are at least seven categories of participants in money markets, such as commercial banks, governmental entities, central banks, corporations and finance companies, pension funds and insurance companies, brokers and dealers, and money market mutual funds and individuals. Commercial banks participate in the money market by borrowing the central bank funds and repurchase agreement market when they need to meet their reserve requirement and issue certificates of deposits (CDs) to raise funds. The government issues Treasury bills (T-bills) to finance its expenditures. Central banks use these securities to manage the banking system's reserve level and interest rates. Government-linked companies (GLCs) issue commercial paper to fund expenses related to housing, agriculture, and other loans. Corporations and finance companies assist consumers in buying automobiles and real estate investments by issuing commercial paper and lending these funds to their customers. Pension funds, insurance companies, other businesses, and individuals use the money market and money market mutual funds for cash management purposes.

Money Market Instruments

Commercial papers, central bank funds,[5] and repurchase agreements (repos) are the three most frequently used types of money market instruments. Commercial paper refers to short-term, large denomination, unsecured promissory notes issued by the most creditworthy corporations as an alternative to bank borrowing. Central bank funds and repurchase agreements are used primarily by depository institutions to meet their reserve requirements. Unlike the central bank funds, repos are also used by securities dealers, money market mutual funds, pension funds, nonfinancial corporations, and state and local governments. Central bank funds consist primarily of overnight loans of reserves between banks. Repos are short-term agreements in which a seller simultaneously agrees to sell government securities now and also to buy them back in the future at a higher price. In effect, repos look like collateralized loans secured with government securities.

Negotiable CDs and INIDs are debt instruments issued by commercial banks. They typically have fixed interest or profit rates, maturities of 1 to 3 months, and denominations of $1 million. Government Treasury bills (T-bills) are regularly auctioned by the government to finance the national debt and to manage the mismatch between government revenue and expenditures. They are characterized by typical maturities of 4, 13, or 26 weeks, denominations as low as $1,000 an absence of default risk, high liquidity, and preferential tax treatment. Bankers' acceptances facilitate international trade by allowing a bank to guarantee the payments of its customers engaged in importing goods from abroad. Money-market mutual funds pool the funds of their shareholders and use them to purchase a variety of money market instruments. This has brought the safety and high yields of the money market to individual investors.

The Capital Market

As explained in the previous section, the capital market is extremely important because it raises the funds needed by the deficit spending units to carry out their spending and investment plans. It facilitates the transfer of funds from economic agents in financial surplus units to those requiring funds through selling-buying activities of securities, such as shares and bonds. The deficit spending units will issue securities and sell them to the surplus spending units. The major difference between capital market and money market is the maturity of the securities. Capital market instruments are debt and equity instruments with maturities of greater than one year.

The major capital market instruments are stocks, mortgages, corporate bonds, government securities, sukuk, and municipals. Stocks represent partial ownership in the corporations that issued them. They are classified as capital market securities because they have no maturity and therefore serve as a long-term source of funds. The income received by the stockholders due to their ownership is called dividends, which are distributed to the stockholders periodically; and the other earnings for the investors are capital gains, which are obtained when they sell their shares in secondary markets.

Mortgages are long-term debt obligations created to finance the purchase of real estate. In the event the borrower fails to make the scheduled payments, the lender can repossess the property. Lenders try to assess the likelihood of loan repayment using various criteria such as the borrower's income level relative to the value of the home. They offer prime mortgages to borrowers who qualify based on these criteria. Mortgages are usually made for up to 30 years. Savings and loan associations and mutual savings banks are the primary lenders in the residential mortgage market, although commercial banks are now also active lenders in this market.

Sukuk[6] and bonds are long-term debt securities issued by corporations and government agencies to support their operations. They are usually issued by corporations that have excellent credit ratings and the maturity is from 2 to 30 years. Similar to stockholders, sukuk holders and bond holders receive two types of earnings, which are fixed-interest income or

coupon payments twice a year and the principal at maturity. The principal buyers of corporate or government agencies' bonds are insurance companies, pension funds, banks, and foreign investors.

Types of Financial Intermediaries

Financial intermediaries possess many common traits. In general, they are regulated, profit-seeking firms that provide the public with a wide range of financial services. These services help to reduce the risks associated with channeling funds from surplus spending units to deficit spending units. The services provided include the appraisal and diversification of risk, the pooling of funds, and the provision of a menu of claims, including contingent claims, tailored to the needs of customers.

Now how do we classify the financial intermediaries? The most common method is by looking at their balance sheet. A balance sheet is an accounting statement showing the monetary value of an economic unit's assets, liabilities, and net worth at a specific point in time. By examining the balance sheets of the major financial intermediaries, it will be helpful to group them according to the nature of their liabilities or the major financial service they provide. In general, types of financial intermediaries (see Figure 1.5) consist of depository institutions, contractual institutions, and investment-intermediaries institutions.

With regard to the flow of funds in financial intermediaries (see Figure 1.6), a banking institution mostly receives deposits from depositors as its sources of funds and uses them as a

FIGURE 1.5 Types of Financial Intermediaries

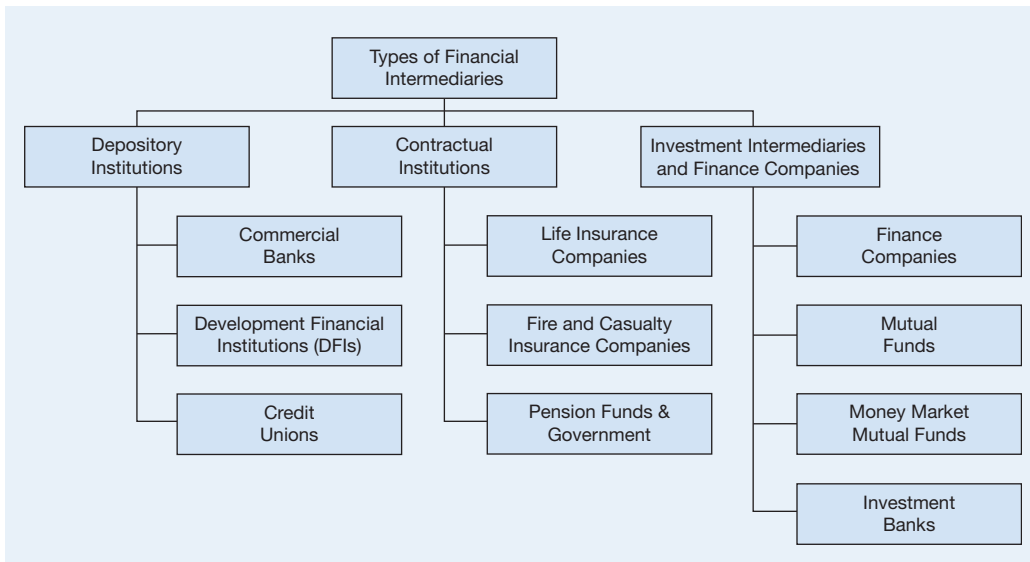
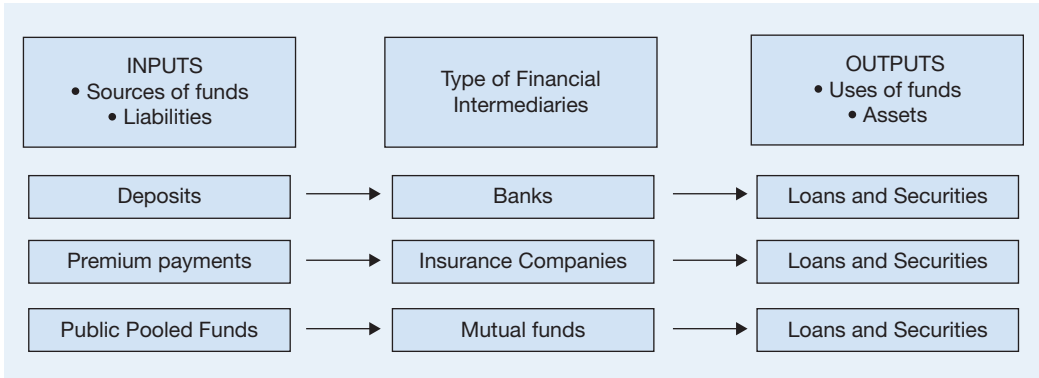


FIGURE 1.6 Input-Output Flow of Funds in Financial Intermediaries



source of financing to businesses. Meanwhile, insurance institutions obtain their funds from premiums paid by policyholders and invest the funds in shares and securities. Last, the mutual funds companies collect the funds from the public pooled funds before they invest them in shares and securities.

Depository Institutions

A large portion of the liabilities of depository institutions are deposits and these institutions include commercial banks, developmental financial institutions, savings banks, and credit unions. The major sources of funds for commercial banks are checking savings, and time deposits plus nondeposit liabilities. Bank's major uses of funds are financing or loans, government securities, and reserves. Banks have also been authorized to underwrite and deal in municipal revenue bonds. Depository institutions are more popular compared to other financial institutions due to the following reasons:[7]

- They offer deposit accounts that accommodate the amount and liquidity characteristics desired by most of the surplus units.
- They repackage funds received from deposits to provide financing or loans of the size and maturity desired by deficit units.
- They have more expertise than individual surplus units in evaluating the creditworthiness of deficit units.

Now, in this modern era, imagine what surplus units will do to meet and evaluate the credithworthiness of deficit units and how deficit units can meet their desired funds in order to expand their business if depository institutions such as banks do not exist. It is not impossible, but it is very difficult.

In Malaysia, they have Development Financial Institutions (DFIs), which are specialized financial institutions established by the government with a specific mandate to develop and promote key sectors that are considered of strategic importance to the overall socioeconomic development objectives of the country. These strategic sectors include agriculture, small and medium-size enterprises (SMEs), infrastructure, maritime, export-oriented sectors as well as capital-intensive and high-technology industries.

As defined by Bank Negara Malaysia, DFIs provide a range of specialized financial products and services to suit the specific needs of the targeted strategic sectors. Ancillary services in the form of consultation and advisory services are provided by DFIs to nurture and develop the identified sectors. DFIs therefore complement the banking institutions and act as a strategic conduit to bridge the gaps in the supply of financial products and services to the identified strategic areas for the purpose of long-term economic development. The DFIs, to a great extent, have contributed to the development and growth of the targeted sectors.

Currently, the members of the Development Financial Institutions are:

Malaysian Industrial Development Finance Berhad
Bank Pembangunan Malaysia Berhad
SME Bank
Bank Pertanian Malaysia Berhad
Sabah Credit Corporation
Sabah Development Bank Berhad
Bank Kerjasama Rakyat Malaysia Berhad
Borneo Development Corporation (Sarawak) Sdn Bhd
Borneo Development Corporation (Sabah) Sdn Bhd
Perbadanan Usahawan Nasional Berhad
Perbadanan Nasional Berhad
Johor Corporation
Bank Simpanan Nasional
Credit Guarantee Corporation Malaysia Berhad
Majlis Amanah Rakyat
Export-Import Bank of Malaysia Berhad
Tekun Nasional
Amanah Ikhtiar Malaysia
Cradle Fund Sdn Bhd

Contractual Institutions

Contractual intermediary institutions offer contingency claims in return for regular payments. They include insurance companies takafuls, and pension funds. Based on its name, a contractual institution has liabilities defined by contract. These contracts generally call for regular payments under specified conditions. Takafuls and insurance companies, for example, offer the public

protection against the financial costs, losses, and reduction in income associated with death, disability, old age, and other health problems, or even automobile accidents. The public makes payments (premium) in exchange for the protection. The funds collected afterward, are lent out to other households, business units, and governments. A part of the incomes and interest received are used to pay benefits to policyholders as they come due. These institutions use fairly large portions of funds to invest in longer-term assets of financial investment. These are because (a) the payment of premiums is relatively steady and predictable, and (b) the probability of policyholders to become disabled, die, or injured in a given year is also predictable.

However, there are some differences between takaful[8] and conventional insurance, in both philosophical and technical aspects. Table 1.2 highlights those differences.

TABLE 1.2 Differences between Takaful and Conventional Insurance

No.	Takaful	Conventional Insurance
1	Takaful is based on mutual cooperation.	Conventional insurance is based solely on commercial factors.
2	Takaful is free from interest (riba), gambling (*al-Maisir*), and uncertainty (*al-Gharar)*.	Conventional insurance is not free from interest, gambling, and uncertainty.
3	The contribution paid by the participant is under *tabarru'* contract (donation) to the Takaful Fund, which helps other participants by providing protection against potential risks.	The premium paid by the participant to the conventional insurance companies is owned by the companies in exchange for bearing all expected risks of the participant.
4	Every takaful company has a *Sharia* Supervisory Board; however, it is still subject to the governing law as well.	Conventional companies are only subject to the governing laws without any requirement to have a *Sharia* Supervisory Board.
5	As a consequence from characteristic number 3 above, the participants Takaful Fund account is fully segregated from the shareholders' accounts.	Premium paid by the policyholder is considered as income to the company, belonging to the shareholders.
6	Any surplus in the Takaful Fund is shared among participants only, and the investment profits are distributed among participants and shareholders on the basis of mudarabah or wakala models.	All surpluses and profits belong to the shareholders only.
7	All funds are invested in Sharia-compliant investment funds	All funds are invested in any type of investment funds, regardless of Shariah-compliant issues
8	Takaful companies have re-insurance with re-takaful companies.	Conventional insurance companies may have re-insurance with any re-insurance companies.

Source: Adapted from Tazur Company B.S.C. (c). (www.tazur.com/takaful-vs-conventional.html).

Pension funds, as another contractual agreement, also provide an alternative and efficient way for individuals to save for their retirement. The money received from individual retirement accounts is invested in stocks or bonds of companies or governments by the pension funds. The pension funds will manage the money until the individuals retire or withdraw their money.

Investments and Finance Institutions

Collective investment-type intermediaries pool funds from the public, invest the funds, and return the income received—after deducting management fees—to the investors. Some funds invest in particular types of securities, such as corporate stocks and bonds, while others have broader asset portfolios that include stocks, bonds, mortgages, gold, and so on. A number of depositors who seek higher returns than the rates offered by depository institutions prefer investment institutions or mutual funds to banks.

Finance companies, on the other hand, lend money to households to purchase consumer durables such as automobiles, appliances, and furniture, and to businesses to finance inventories and the purchase or leasing of equipment.

A Brief Overview of the Islamic Financial System

The term ***Islamic financial system*** was not introduced until the mid-1980s. The proponents of Islamic economics and finance say that the philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behavior. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islamic teachings on the work ethics, wealth distribution, social and economic justice, and the role of the state. It is obviously a challenge for the Islamic system to be implemented in the current economic environment.

The Islamic financial system is a system in a country's economy consisting of financial markets, financial institutions, financial instruments, and market participants that operate along with Islamic principles and are aimed at meeting the ***Maqasid*** (objectives) of Shariah. In general, all Islamic financial instruments and institutions must comply with Shariah principles, namely:

- Prohibition of ***riba***
- Application of ***al-bay'*** (trade and commerce)
- Avoidence of ***gharar*** (ambiguity) in contractual agreement

- Prohibition of ***maisir*** (gambling)
- Disengagement from production of prohibited commodities, such as pork, liquor, tobacco, and so forth.

In addition, many Islamic finance scholars assert that although Islamic finance institutions perform mostly the same functions as conventional ones, they do this in distinctly different ways. Some of the salient features of Islamic banking and finance which make it distinct and unique from its conventional counterparts include:[9]

- Islamic finance promotes a just, fair, and balanced society. Therefore, the many prohibitions are to provide social harmony and to protect the interests and benefits of all parties involved in the market. For example, the practice of a conventional financial system in imposing interest causes injustice to the borrowers since the interest has to be paid regardless of the outcomes of their business.
- Islamic finance is structured on the principle of brotherhood and cooperation, which stands for a system of equity-sharing, risk-sharing, and stake-taking between the surplus spending units and deficit spending units.
- As a system grounded on the ethical and moral framework of Shariah, Islamic finance is also characterized by ethical norms and social commitments. Verses from the Qur'an and traditions from As-sunnah are two divine guidances that provide halal (permissible) and haram (prohibited) filters to control these norms in the Islamic financial system.
- The Islamic financial institution is community-oriented and entrepreneur-friendly, emphasizing productivity and physical expansion of economic production and services.
- The Islamic financial institution operates within the limits that ensure stability in the value of money and curtail destabilizing speculation. This is due to the monetary flows through Islamic financial modes that are always tied directly to the flow of goods and services.

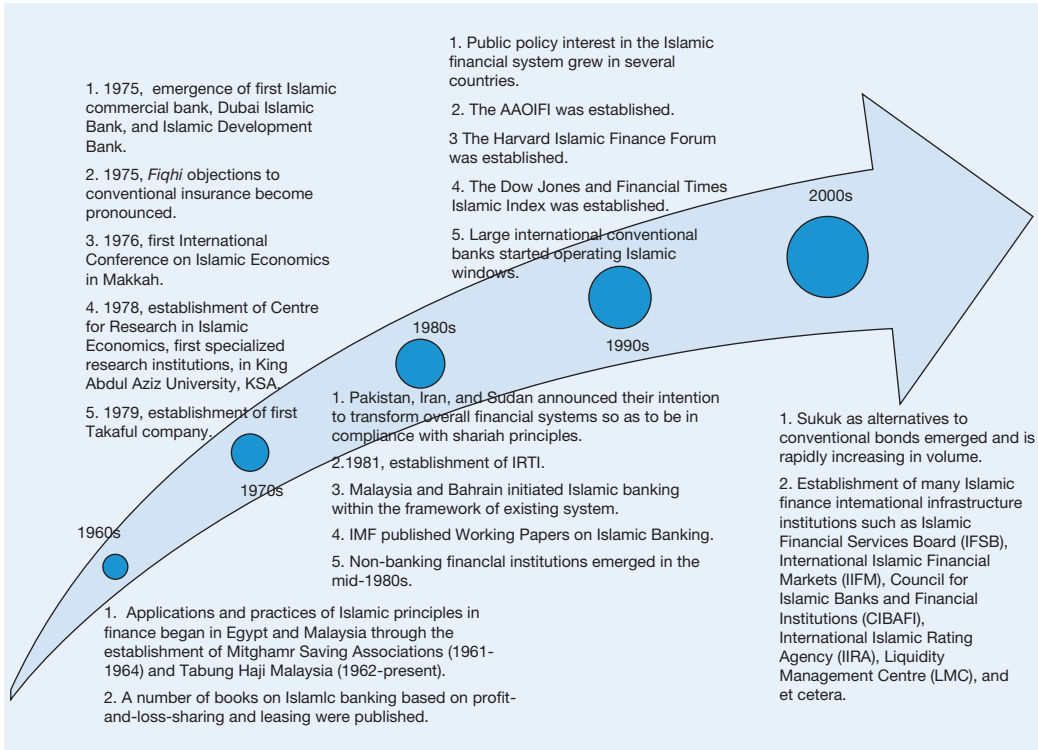
Evolution of Islamic Finance

The creation of modern Islamic finance (see Figure 1.7) began with the establishment of Islamic banks. The landmark events include the rise and fall of Mitghamr Savings Association in Egypt during the 1961 to 1964 periods and the establishment of Tabung Haji in Malaysia in 1962. Although it is not considered an Islamic commercial bank, Tabung Haji has since flourished and become the oldest Islamic financial institution of modern times.

The first Islamic bank emerged in 1975 with the establishment of the Dubai Islamic Bank and the Islamic Development Bank (IDB). These emergences were facilitated by at least two events:

1. Third Islamic Conference of Foreign Ministers in 1972, held in Jeddah, resulted in abolishing interest from Islamic financial institutions. A comprehensive plan to reform the monetary and financial systems of the Islamic communities according to Shariah principles was laid out concurrently.

FIGURE 1.7 Timeline of Evolution of Islamic Finance



2. There was a change in the political climate in many Muslim countries that was induced by the energy price rise in 1973 and 1974 and increased Arab oil wealth. The oil-rich countries enabled a wide range of institutions to participate in the social and economic development of Muslim countries, while facilitating resurgence in self-confidence in the cultures of the Middle East. Most of the major Islamic banks and banking groups formed in the 1970s were funded by oil-linked wealth.

One of the important outcomes from the conference held in Jeddah in 1972 was that many Muslim countries started to show their commitment by initiating various efforts to Islamize their financial system, particularly in the banking industry. In general, the Islamization process of the financial system in the Muslim countries can be divided into two different approaches or settings:

1. Full Islamization. This approach was aimed at economy-wide elimination of interest. The countries that pioneered the full Islamization process were Pakistan, Iran, and Sudan.
2. Promotion and adoption of Islamic banking practices side by side with conventional banking. The majority of Muslim countries adopted this approach whereby Islamic banks coexist with conventional banks. These countries are Malaysia, Indonesia, Turkey, Bahrain, and others.

In 1981, the governors of central banks and monetary authorities of the Organization of Islamic Conference (OIC) member countries were called upon jointly to strengthen regulation and supervision of Islamic financial institutions, followed by the establishment of The Islamic Research and Training Institute of IDB in the same year. In the middle of the 1980s, Islamic mutual funds and other nonbanking financial institutions emerged. The period of the 1990s onward was the era of rapid development in every angle of Islamic finance. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in the early 1990s and the development of Islamic banking products intensified afterward. The interest in Islamic finance increased in western academic and business circles. The Harvard Islamic Finance Forum was established in 1998 and large international conventional banks started operating Islamic windows and the Dow Jones and Financial Times Islamic indexes were launched during that time.

At the end of the 1990s, several countries introduced legislation to facilitate Islamic banking and its regulation and supervision. In other words, systemic concerns and regulation, supervision, and risk management issues gained momentum. Early in the 2000s, sovereign and corporate sukuk as alternatives to conventional bonds emerged and its practice increased rapidly in many countries. In order to have a conducive environment, international infrastructure institutions were established. These institutions include Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), Council for Islamic Banks and Financial Institutions (CIBAFI), International Islamic Rating Agency (IIRA), and Liquidity Management Centre (LMC).

The Islamic capital market, as an integral part of the Islamic financial system, plays an important role in complementing the investment role of the Islamic banking sector. Although its functions are similar with conventional capital markets, the way it is structured may be different from conventional ones

Chapter Summary

- The financial system is the collection of markets, institutions, laws, regulations, and techniques to transfer money from the surplus side, or savers, to the deficit side, or borrowers.
- Specific functions of financial markets and institutions are: savings function, wealth function, liquidity function, credit function, payments function, risk protection function, and policy functions.
- Structure of financial markets can be categorized by (a) instruments, (b) issuance of securities, (c) methods used in secondary markets, and (d) maturity date.
- Debt instrument is a contractual agreement by the borrower to pay the holder of the instruments a fixed amount of money at regular intervals, including principal and interest or profit margin, until a specified date as the final payment.

- A debt instrument is called short-term if its maturity is less than a year, while it is called long-term if its maturity is 10 years or longer.
- Equity instruments do not have a maturity date and so are considered as long-term securities.
- A primary market is a market where new issues of securities are sold by the initial issuer to the first buyer.
- A secondary market is a market where securities are traded after they are initially offered in the primary market.
- There are two methods by which secondary markets are categorized: exchanges market and over-the-counter (OTC) markets.
- An OTC is a decentralized market of securities not listed on an exchange where market participants trade over the telephone, facsimile machines, or electronic networks instead of on a physical trading floor.
- An exchanges market, on the other hand, is where buyers and sellers of securities or their agents meet in one central location to conduct trades either physically or through electronic trading platforms.
- The money market is a segment of the financial market in which financial instruments with high liquidity and very short maturities are traded.
- The capital market is the market in which longer-term debt (one year or greater) and equity instruments are traded. More details about money and capital markets are discussed in the following section.
- The Islamic financial system is a system in a country's economy consisting of financial markets, financial institutions, financial instruments, and market participants that operate with Islamic principles and are aimed at meeting the ***Maqasid*** (objectives) of Shariah.
- There are two layers of Shariah-compliance in Islamic financial principles. The first is in contracts and the second is in practices and management.

Chapter Questions

1. Discuss briefly the differences between Islamic and conventional financial systems.
2. What are the functions of developmental financial institutions?
3. What are the differences between money and capital markets?
4. What are the salient features of Islamic banking and finance?
5. Islamic financial systems and markets are said to perform similar functions as conventional financial systems and markets. Such functions include savings, wealth, liquidity, credit, payments, risk protection, and policy. Is this statement true, false, or uncertain? Explain your answer.

Notes

1. For further discussion about causal relationships between financial development and economic growth, the following article is very useful: Ross Levine, Norman Loayza, and Thorsten Beck, "Financial Intermediation and Growth: Causality and Causes," ***Journal of Monetary Economics*** 46 (2000): 31–77.
2. Securities Commission Malaysia, 2009, 6–7.
3. It refers to a sum of money deposited with the Islamic banking institutions and repayable to the bearer at a specified future date at the nominal value of INID plus declared dividend.
4. Burton et al., 2003, 179.
5. For example, in Malaysia it is known as Bank Negara Monetary Notes.
6. Sukuk need not be only debt instruments, as they can also be issued on the basis of profit-and-loss sharing contracts. For further information, see Chapter 5.
7. Madura, 2010, 14.
8. Takaful is an Islamic insurance that has started its operation for the first time in Sudan, 1968. Nowadays, takaful is one of the rising industries in the world.
9. Securities Commission Malaysia, 28.

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CHAPTER

2

Development of Islamic Capital and Money Markets in Malaysia

Learning outcomes

At the end of this chapter, you should be able to:

1. Understand the development of Islamic finance in Malaysia.
2. Understand the development of the Islamic capital market in Malaysia.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

Over the past few decades, the Islamic financial industry has rapidly expanded worldwide. While it is difficult to exactly date the establishment of the first formal Islamic financial institution in recent history, references are often made to the Mitghamr Egypt Savings Association, founded in 1963.[1] Though the bank is still active, under the new name Nasser Social Bank, its objectives are more social than commercial.[2] Moreover, Mitghamr is a group-initiated bank, operating without any support from the Egyptian government. Therefore, when we discuss which country has hosted the modern development of Islamic financial institutions, we will come across Malaysia and Pakistan. Malaysia is the pioneer of modern Islamic finance development through the establishment of Tabung Haji in the mid-1960s.

Development of Islamic Financial Institutions in Malaysia

Malaysia is currently known as one of the leading countries in the world for Islamic financial development. According to PricewaterhouseCoopers Malaysia,[3] Islamic banking assets in Malaysia were reaching US$30.9 billion while Takaful assets were around US$1.7 billion at the end of 2010. Moreover, Malaysia also has the largest Islamic private debt securities (IPDS) market, which is reaching 45.5 percent (around US$34 billion) of domestic corporate bonds and active Islamic money market channelling about RM30 to RM40 billion every month.

However, to end up as the leading country, Malaysia has passed through at least four phases in its development:

1. Establishment of Islamic financial institutions.
2. Conventional banks allowed to offer Islamic financial products and services under Islamic banking schemes.
3. Conventional banks allowed to set up Islamic subsidiaries.
4. International integration of the domestic Islamic banking system.

However, the following discussion will be focused on the three decades of Islamic banking development in Malaysia: (1) 1960 to 1990, (2) 1990 to 2000, and (3) 2000 to 2010.

1960 to 1990: Establishment of Islamic Financial Institutions

Tabung Haji

Tabung Haji, established in 1969, is known as the first Islamic financial institution in Malaysia. Its main function is to mobilise the savings of Malaysian Muslims who intend to perform the

Hajj (pilgrimage) and to strengthen the economy of Muslims in Malaysia. Therefore, in order to achieve its vision, Tabung Haji also conducts several activities to channel the funds to Islamically permissible investments. According to the Pilgrimage Management and Fund Board 1969, the objectives of Tabung Haji are:

- To enable Muslims to save gradually to support their expenditure during pilgrimage and for other beneficial purposes.
- To enable Muslims to have active and effective participation in investment activities that are permissible in Islam through their savings.
- To protect and safeguard the interests and welfare of pilgrims during pilgrimage by providing various facilities and services.

Tabung Haji maintains its competitiveness with other investment companies by diversifying its scope and functions. As a result, the Malaysian government introduced a new Act, the Pilgrimage Board Act 1995, which changed the name of the Pilgrimage Management and Fund Board to Pilgrimage Board, or, as it is better known in Malaysia and internationally, as Tabung Haji (TH).

Among the Tabung Haji subsidiaries are Bank Islam Malaysia Berhad, TH Plantations, TH Technologies, TH Travel and Services, TH Properties, TH Global Services, and THETA EDGE.

Bank Islam Malaysia Berhad

Bank Islam is the first Islamic bank in Malaysia and Southeast Asia. It opened on July 1, 1983 after the National Economic Congress of 1980 produced a resolution for the government to allow Tabung Haji to establish an Islamic bank in Malaysia. The main objective during that period was to mobilise the Malay's fund (local Muslim's fund) in the country and invest it on the basis of Shariah principles. Table 2.1 depicts the sources of funds of the Bank Islam during its inception in 1983, showing that the government plays a vital role in the development of Islamic finance in Malaysia.

After more than a decade, Bank Islam experienced rapidly growing assets and networks. At its inception, its capital was only RM80 million, while in June 2009, its paid-up capital

TABLE 2.1 Sources of Funds of the Bank Islam during Its Inception

Source of Funds	RM (million)
1. Government of Malaysia	30
2. Tabung Haji	10
3. PERKIM	5
4. State Religious Councils	20
5. State Religious Agencies	3
6. Federal Agencies	12
Total	**80**

Source: Securities Commission Malaysia (2009), p. 38.

swelled to RM1.73 billion, which made possible the growth of its assets and the implementation of its expansion programs.[4]

Syarikat Takaful Malaysia Berhad

In 1981, there was a "Task Force on the Study for the Establishment of an Islamic Insurance Company in Malaysia" set up by the government. This task force concluded that a takaful company based on the principle of ***al-Mudharabah*** (profit-sharing) would be a viable venture in that its participants would have the opportunity to save, invest, and earn profits based on this principle.[5]

Takaful Malaysia commenced operations on July 22, 1985, although it was established on November 29, 1984, with Bank Islam Malaysia Berhad as its major shareholder. The regulation under which Takaful Malaysia is operated is produced and supervised by Bank Negara Malaysia (BNM). In fact, the Director-General of Takaful is the BNM Governor.

1990 to 2000: Conventional Banks Allowed to Offer Islamic Financial Products and Services

Malaysia and Pakistan had started Islamic banking in the early 1980s, but adopted entirely different approaches. While Pakistan attempted to convert the entire financial system in accordance with Islamic law at the national level, Malaysia implemented a gradual approach. Malaysia allowed Islamic and conventional banking systems to operate side by side and to compete for deposits on a parallel basis.

To strengthen the government support for Islamic finance, in March 1993 the Malaysian government allowed conventional banks to participate in the Islamic banking business and to offer Islamic banking scheme and services by using their existing infrastructure and branch facilities. This policy was introduced by Bank Negara Malaysia under the name "Islamic Banking Scheme" (IBS), and some of the conditions that have to be fulfilled by the banks participating in this scheme are:

1. Banks are required to have firewalls between their conventional and Islamic funds.
2. Banks are required to establish an Islamic banking unit.
3. Banks are required to create an Islamic banking fund.
4. Banks are required to appoint at least one Shariah consultant to advise on its daily operations.

The Islamic interbank money market (IIMM) was introduced by the government of Malaysia on January 1994, to bridge the gap between the Islamic banks and banks participating in IBS and their instruments. This policy helped the industry to solve liquidity problems while

maintaining Islamic principles. In order to satisfy the stakeholders of the Islamic banking industry, the central bank of Malaysia issued a model of a financial statement to be used by the banking institutions participating in IBS to disclose their Islamic banking operations. Within this period, especially in 1999, the second Islamic bank, Bank Muamalat Malaysia Berhad (BMMB), was established.

2000 to 2010: Islamic Subsidiaries and the International Integration of the Islamic Banking System

In November 2002, the Islamic Financial Services Board was established and based in Kuala Lumpur, Malaysia, the host country of the IFSB. Malaysia enacted a law known as the Islamic Financial Services Board Act of 2002, which gives the IFSB the immunities and privileges that are usually granted to international organisations and diplomatic missions.[6]

This is expected to boost the development of Islamic banking and finance in Malaysia and promote Malaysia as a major hub for international Islamic finance. The government, industry, and market responded positively. In 2003, Bank Negara Malaysia set up the Islamic subsidiary concept, to give greater opportunities for Islamic banking to develop with regard to corporate governance, resources, and strategic focus. Another reason for the Islamic subsidiary came from the Shariah point of view: Many scholars commented that running both interest-bearing and Islamic banking businesses under one roof may invite ambiguities. Securities Commission Malaysia (2009) mentioned that among the commercial banks that set up distinct Islamic subsidiaries were:[7]

- Hong Leong Islamic Bank, which had its origins from a division before being incorporated as a separate entity on March 28, 2005.
- Affin Islamic Bank Berhad (AFFIN Islamic) and EONCAP Islamic Bank commenced business operations on April 1, 2006.
- AmIslamic Bank started its operations on May 1, 2006. The official launching ceremony was held on May 18, 2006.
- On January 1, 2008, Maybank's Islamic Banking started its operations under a new subsidiary of Maybank known as Maybank Islamic Bank Berhad (MIB).

In August 2006, the Malaysia International Islamic Financial Center (MIFC) initiative was launched to promote Malaysia as a main player for international Islamic finance. The MIFC initiative comprises a community network of financial and market regulatory bodies, government ministries and agencies, financial institutions, human capital development institutions, and professional services companies that are participating in the field of Islamic finance.[8] Table 2.2 depicts the development of Islamic finance in Malaysia.

TABLE 2.2 Development of Islamic Finance in Malaysia

Key Highlights of Islamic Finance in Malaysia	
1962	Establishment of the Pilgrim Fund Board or Tabung Haji.
1983	Islamic Banking Act 1983 comes into effect. Establishment of full-fledged Islamic Bank, Bank Islam Malaysia Berhad.
1984	Establishment of the first takaful operator, Syarikat Takaful Malaysia Berhad.
1993	Interest-free banking scheme is introduced, later known as Islamic Banking Scheme.
1994	Islamic Inter-bank Money Market. Dual banking system is created.
1997	The Shariah Advisory Council for Islamic Banking and Takaful (SAC) is formed.
1997 – 98	Economic crisis.
1999	Establishment of the second Islamic bank, Bank Muamalat Malaysia Berhad (BMMB).
2002	Islamic Financial Services Board (IFSB) is established. International Islamic Financial Market (IIFM) is launched, which aims to hasten the integration of Islamic finance.
2003	Bank Negara Malaysia's Review calls for the setting up of an "Islamic subsidiary." Legal reforms adopted to improve the efficiency of Islamic banking and finance: • High Court judges preside over matters relating to Islamic banking and finance. • At Bank Negara level, Law Review committees are set up. • Shariah Advisory Council is established at the Central Bank. • Hong Leong Islamic Bank, which had its origin as a bank division, is incorporated as a separate entity on March 28, 2005.
2006	Affin Islamic Bank Berhad (AFFINISLAMIC) and EONCAP Islamic Bank commence business operations on April 1, 2006. AmIslamic Bank started its operations on May 1, 2006. Kuwait Finance House (KFH) officially opens on February 17, 2006. Al Rajhi Bank sets up its first overseas branch operations in Malaysia in October 2006. Asian Finance Bank Berhad (AFB) is incorporated on November 28, 2006. First branch opens on January 19, 2007.
2008	Maybank's Islamic Banking begins its operations.
2010	The Islamic banking and finance industry constitute 20 percent of the overall market.

Source: Securities Commission Malaysia (2009), p. 42, with additional information.

The integration of international Islamic banks with local Islamic banks started in 2003 when three foreign banks were granted licenses from Bank Negara Malaysia to conduct Islamic banking business. These three banks were:[9]

1. Kuwait Finance House (KFH) was the first foreign Islamic bank to be licensed by the Ministry of Finance of Malaysia, which commenced operations on February 17, 2006.
2. Al Rajhi Bank, which set up its first overseas operations in Malaysia in October 2006.

3. Asian Finance Bank Berhad (AFB), which was incorporated in November 2008 and backed by a consortium of shareholders such as Qatar Islamic Bank and Associates (70 percent), RUSD Investment Bank Inc. of Saudi Arabia (20 percent), and Global Investment House of Kuwait (10 percent).

Islamic Capital Markets in Malaysia

The capital markets in Malaysia consist of conventional and Islamic markets for medium- and long-term investment. The history of Islamic capital markets development in Malaysia cannot be separated from the contribution of all the stakeholders of capital markets in Malaysia. Apart from Bank Negara Malaysia, there are some statutory bodies established by the Malaysian government to regulate and support capital markets in Malaysia, including Islamic capital markets: the Securities Commission (SC), Kuala Lumpur Stock Exchange, Rating Agency Malaysia, and others.

In February 2001, the SC announced the Malaysia Capital Market Masterplan (CMP), which represents a significant milestone in the history of the Malaysian capital market (see Table 2.3). There are three distinct phases in CMP:

1. Strengthening domestic capacity.
2. Strengthening key sectors and liberalise market access.
3. Expanding and strengthening of market process.

TABLE 2.3 Phases in Malaysian Capital Market Based on Its Masterplan

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Strengthen domestic capacity and develop strategic and nascent sectors.									
			Further strengthen key sectors and gradually liberalise market access.						
					Further expansion and strengthening of market processes and infrastructure toward becoming a fully developed capital market, and enhancing international positioning in areas of comparative and competitive advantage.				
Phase 1			Phase 2		Phase 3				

Source: Malaysian Capital Market Masterplan, Securities Commission, Malaysia.

Six objectives have been identified that form the basis for the CMP's main strategic initiatives and specific recommendations: (1) to be the preferred fund-raising center for Malaysian companies, (2) to promote an effective investment management industry and a more conducive environment for investors, (3) to enhance the competitive position and efficiency of market institutions, (4) to develop a strong and competitive environment for intermediation services, (5) to ensure a stronger and a more facilitative regulatory regime, and (6) to establish Malaysia as an international Islamic capital market center.

With regard to establishing Malaysia as an international Islamic capital market center, nowadays, the Malaysian government has established its market infrastructure and lead over the other relatively nascent Islamic capital markets. Based on the CMP's strategy, the initial focus will be given to the development of a wider range of competitive products and services related to Islamic securities. To do this, efforts will be concentrated to enhance liquidity, comprehensive accounting, rating methods, and tax and regulatory frameworks for the Islamic capital market so that it can create a sustainable market for the effective mobilisation of Islamic funds.

Sukuk

As we can read from the previous discussion, the Government of Malaysia has been very supportive in the development of the Islamic Capital Market (ICM). In February 2001, the SC came out with Malaysia Capital Market Masterplan (CMP), which represents a significant milestone in the history of the Malaysian capital market, including the plan to establish Malaysia as an international center for Islamic capital market activities. The rapid development of Islamic Capital Market (ICM) started in 1990 when Shell MDS Sdn Bhd issued the country's first Islamic bond.

The government support of the development of ICM has encouraged major market players to issue sukuk. Some of the major sukuk issued from 1997 to 2010 are as follows:

1. In 1990, issuance of the first Islamic corporate bond by Shell MDS Sdn Bhd.
2. In 1997, Khazanah Nasional Berhad launched the Khazanah Murabahah Bond, which is a zero coupon bond based on Murabahah and bay' ***al-Dayn*** concepts.
3. In 2002, Kumpulan Guthrie Bhd issued a US$150 million sukuk ijarah: the first global corporate Islamic bond issue ever recorded. The issue was listed on the Labuan International Financial Exchange (LFX) and constituted the first tranche of a US$395 million sukuk ijarah programme.
4. Still in 2002, the Malaysian government launched a landmark sukuk ijarah bond issue (Malaysian Global Sukuk) worth US$600 million, becoming the first country in the world to issue a global sovereign Islamic bond.
5. In 2004, Sarawak Corporate Sukuk Inc., a special-purpose vehicle established by the Sarawak Economic Development Corporation (SEDC), launched a maiden five-year US $350 million global sukuk ijarah. In the same year, International Finance Corporation (IFC), the private arm of the World Bank issued RM500 million Islamic bonds, which was the first issuance of ringgit-denominated Islamic bonds by a supranational body.

6. In 2005, The World Bank issued RM760 million Islamic bonds that will mature in 2010. This ringgit-denominated issue is the largest supranational deal in the ringgit bond market.
7. In 2009 the Malaysian Government issued RM5 billion-worth of Sukuk Simpanan Rakyat.
8. Bank Negara Malaysia on May 10, 2010, released a press statement that the Malaysian Government would issue RM3 billion-worth of Sukuk 1Malaysia 2010 on June 21, 2010.

Islamic Collective Investments

Islamic collective investments or Islamic mutual funds is a type of investment scheme that involves collecting money from different investors and then combining all the money collected to fund the investment, which is in compliance with Shariah principles. A collective investment scheme provides almost absolute control of the investment to the company pooling and investing the money. This chapter includes only a brief discussion of the development of the Islamic unit trust in general and the Islamic Real Estate Investment Trust (*i*REIT).

The Islamic unit trust industry has evolved and experienced significant growth in the past decade, as shown in Table 2.4. The inception was launched by the Arab-Malaysian Bank when it established the Tabung al-Ittikal in 1991, followed by Tabung Amanah Bakti by Asia Unit Trust Berhad in 1993. BIMB and the states of Sarawak, Selangor, and Kedah established a unit trust fund in the following year, 1994. The total number of Islamic unit trust funds increased from 144 in September 2009 to 160 in June 2011, out of 580 unit trust funds in the industry. The net asset value (NAV) of approved funds for Islamic unit trusts also increased from RM21.18 billion in September 2009 to RM26.18 billion in June 2011, equivalent to 10 percent of the total NAV in the industry.

If we go to the performance of Malaysian Islamic capital market by category, currently there are 83 equity funds with total NAV equal to RM18.8 billion and 20 sukuk funds with total NAV that was approaching RM2.1 billion in June 2011. In addition, the number of balanced funds is 21 with NAV equal to RM1.6 billion and others amounting to 36 funds with NAV of RM3.7 billion (see Figure 2.1).

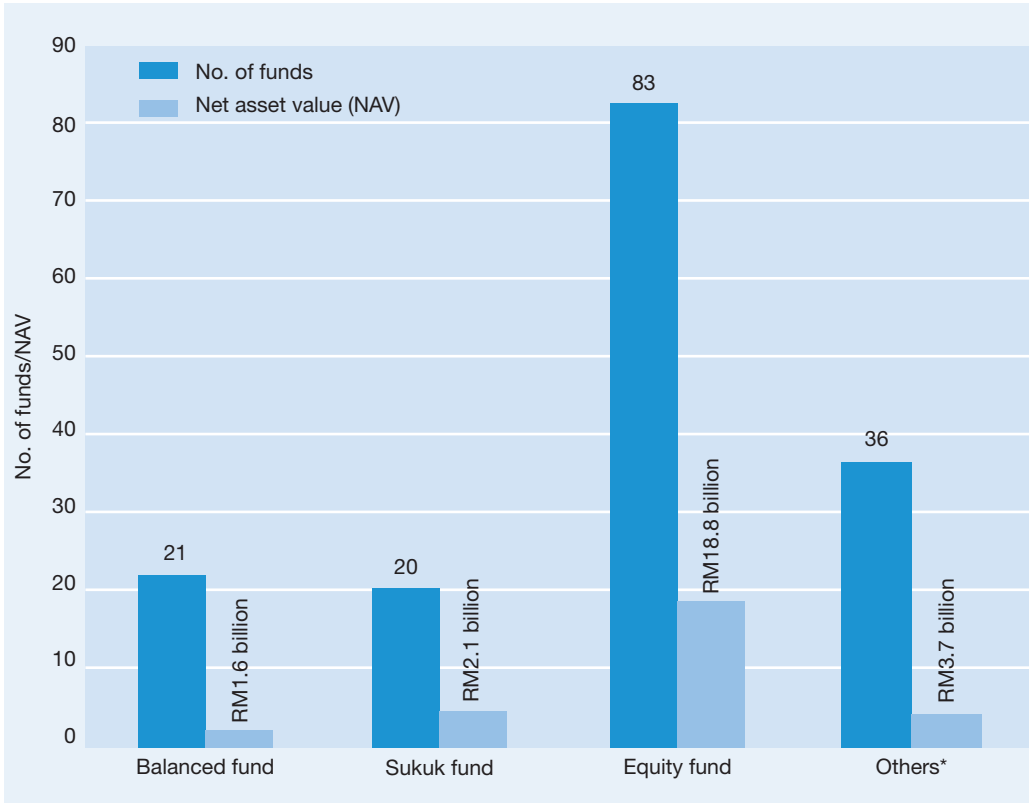
TABLE 2.4 Islamic Unit Trust Funds in Malaysia

Number of Approved Funds	June 2010	June 2011
Islamic unit trust funds	156	160
Total industry*	575	595
Number of Approved Funds	**June 2010**	**June 2011**
Islamic unit trust funds (RM billion)	22.69	26.18
Total industry*(RM billion)	207.11	249.61
% to total industry	11%	10%

*Including feeder funds, fixed income funds, money market funds and structured products.

Source: Quarterly Bulletin of Malaysian Islamic Capital Market 6, no. 2 (September 2011).

FIGURE 2.1 Islamic Unit Trust Funds by Category



Source: Quarterly Bulletin of Malaysian Islamic Capital Market 6, no. 2 (June 2011).

Islamic Real Estate Investment Trust (*i*REIT) is another scheme: a trust fund that has gained acceptance among international Islamic investors. It is a collective investment vehicle that pools money from investors and uses these funds to buy, manage, and sell real estate. The Malaysian government is very concerned about this development, and through SC, it has developed the first guidelines in Islamic REIT, which provided Shariah guidance on the investment and business activities of the Islamic REIT in 2005. The Al-'Aqar KPJ REIT, launched by KPJ Healthcare Bhd, is the first Islamic REIT in the world and was listed on the Main Board of Bursa Malaysia on August 10, 2006. The Al-Hadharah Boustead REIT is the second Islamic REIT to be listed on the Main Board of Bursa Malaysia. To date, the total number of Islamic REIT is three, with market capitalisation reaching RM2.5 billion.

Islamic Stock Broking

Malaysia offers a holistic set of ICM infrastructures, ranging from products, stockbrokers, trust funds, and so forth. Presently, there is one full-fledged Islamic stockbroking company and

three conventional stockbroking companies that provide Islamic windows in the Malaysian ICM. The first and the only full-fledged Islamic stockbroking company was established in 1994: BIMB Securities Sdn Bhd, a subsidiary of Bank Islam Malaysia Berhad.

The role and activities of Islamic stockbroking are regulated under Resolutions of the Securities Commission Shariah Advisory Council. A stock broker in the context of Islamic investment must abide by the necessary Shariah screening criteria in their activities. At the global level, the International Islamic Financial Market (IIFM) requires that stock brokers transact and trade in securities approved by the Shariah Advisory Council (SAC).

In terms of short-selling activity, the SAC requires two preconditions to be met:

1. First, short-selling must be regulated in the sense that the securities that are sold must be "approved," as defined by Rule 704 of the Rules of Bursa Malaysia Securities Bhd.
2. Second, the securities borrowing and lending (SBL) principles, that must be incorporated along with regulated short-selling (RSS), shall be structured under the platform of ***bay'*** (buy and sale) and ***istihsan*** principles.[10]

Malaysia International Islamic Financial Centre (MIFC)

Malaysia has been recognised as the pioneer and at the forefront in Islamic finance. To prove the country's commitment as a major hub for international Islamic finance, the Malaysia International Islamic Financial Centre (MIFC) was established in August 2006. The MIFC initiative aims to position Malaysia as the Islamic finance hub through sukuk origination, Islamic funds and wealth management, international Islamic banking, international takaful operations, and human capital development.[11]

1. The MIFC aims to fortify Malaysia's position as a vibrant, innovative, and competitive Islamic financial hub, with significant roles in facilitating relationships between the international Islamic financial markets; and bridging and expanding investment and trade relations between East Asia and the Middle Eastern, West Asian, and North African regions.
2. The Malaysian government has streamlined its public service delivery channels to facilitate the advancement of the MIFC with the formation of the MIFC Executive Committee (the Committee).
3. The Committee comprises a high-level group of 28 top officials from key federal ministries, government departments and agencies, financial and market regulators and key representatives from the banking and takaful sectors.
4. The Committee provides high-level policy direction while overseeing the review of existing policies toward ensuring the comprehensive and coordinated promotion of the

MIFC. The MIFC Secretariat, formed by Bank Negara Malaysia, functions as the single contact point for the MIFC.

MIFC has been chosen as the "Best International Islamic Finance Center" in 2008, 2009, and 2010 at the Annual London Sukuk Summit Awards of Excellence. MIFC was also acknowledged as the "Islamic Finance Hub of the Year 2009" by ***The Asset Magazine***, while Bank Negara Malaysia (BNM) was awarded the "Best Central Bank in Promoting Islamic Finance" at the Islamic Finance Awards of 2009.

Malaysia, undoubtedly, is among the main players of Islamic finance in the world, particularly for the Islamic Capital Market. Table 2.5 depicts the journey of Malaysia in becoming one of the leading countries in the world's Islamic capital market development.

Chapter Summary

- The three phases of Islamic banking development in Malaysia are: (1) 1960 to 1990, establishment of Islamic financial institutions; (2) 1990 to 2000, conventional banks allowed to offer Islamic financial products and services under the Islamic banking scheme; and (3) 2000 to 2010, establishment of Islamic subsidiaries and the international integration of the Islamic banking system.
- Tabung Haji, established in 1969, is known as the first Islamic financial institution in Malaysia. Its main function was to mobilise the savings of Malaysian Muslims who intend to perform the ***Hajj*** (pilgrimage) and to strengthen the economy of Muslims in Malaysia.
- Bank Islam, the first Islamic bank in Malaysia and Southeast Asia, began operating on July 1, 1983, after the National Economic Congress of 1980, which produced a resolution for the government to allow Tabung Haji to establish an Islamic bank in Malaysia.
- Takaful Malaysia commenced operations on July 22, 1985, although it was established on November 29, 1984, with Bank Islam Malaysia Berhad as its major shareholder.
- In 1990, the issuance of the first Islamic corporate bond by Shell MDS Sdn Bhd marked the development of the Islamic capital market in Malaysia, especially the sukuk market.
- The inception of Islamic collective investments was started by the Arab-Malaysian Bank when it established the Tabung al-Ittikal in 1991, followed by Tabung Amanah Bakti by the Asia Unit Trust Berhad in 1993. BIMB and the states of Sarawak, Selangor, and Kedah established a trust fund in the following year, 1994.
- The first full-fledged Islamic stockbroking company was established in 1994, which is BIMB Securities Sdn Bhd, a subsidiary of Bank Islam Malaysia Berhad.
- The Malaysia International Islamic Financial Center (MIFC) was established in August 2006, and is aimed to make Malaysia the Islamic finance hub through sukuk origination, Islamic fund and wealth management, international Islamic banking, international takaful operations, and human capital development.

TABLE 2.5 Development of Islamic Capital Market in Malaysia

Key Highlights of the Islamic Capital Market in Malaysia	
1990	Issuance of the first Islamic corporate bonds by Shell MDS Sdn Bhd.
1993	Launch of the first Islamic equity unit trust fund by Arab-Malaysian Unit Trust Bhd., Tabung Ittikal.
1994	Establishment of the first full-fledged Islamic stockbroking company, BIMB Securities Sdn Bhd.
1995	The SC formed an Islamic capital market unit, which later evolved into a full-fledged department.
1996	Establishment of the Shariah Advisory Council (SAC) by the SC to advise on Shariah-compliance matters for Islamic capital market activities. Launch of the country's first Islamic equity index by Rasyid Hussain Bhd.
1997	Khazanah Nasional Berhad, an investment arm of the Ministry of Finance, launched the Islamic zero-coupon bond function as a benchmark for the Islamic bond market. Introduction of an official list of Shariah-approved securities traded on the KLSE by the SC (the list is updated twice a year, in April and October).
1999	Launch of the country's second Islamic equity index, the KLSE syariah index.
2000	Launch of the first Islamic bond fund by RHB Unit Trust Management Bhd. Establishment of Labuan International Financial Exchange (LFX) to, among other things, facilitate the listing and trading of offshore Islamic and conventional instruments.
2001	Minister of Finance launched the Capital Market Masterplan of which 13 recommendations were formulated, establishing Malaysia as an international center for Islamic capital market activities. Issuance of the first Islamic accounting standard MASB 1-I on Presentation of Financial Statements of Islamic Financial Institutions by the Malaysian Accounting Standards Board (MASB). Introduced the first global corporate sukuk, the Guthrie sukuk, which created a paradigm shift in the international Islamic financial market.
2002	Issuance of the world's first global sovereign Islamic bond by the Malaysian government. Launch of the first Shariah Index Fund by MBF Unit Trust Management Bhd. Release of two practice notes, PN 18 and 19 by the SC, relating to Shariah-based unit-trust schemes to enhance quality of management and administration of Islamic investment funds and unit trusts. Announcement of a tax deduction for expenses incurred for the issuance of Islamic corporate bonds, based on the principles of mudharabah, musharakah, and Ijarah, which are acceptable to Middle East investors, for five years commencing 2003.
2003	In Budget 2004, the government proposed a measure to increase financing through the use of Islamic corporate bonds with a more comprehensive tax treatment, similar to conventional bonds. It was also proposed that a tax deduction for expenses incurred on the issuance of Islamic bonds, based on the Islamic principle of *istisna'* for five years, commencing in 2003.
2006	August 14, 2006 marked the launch of a nationwide initiative to promote Malaysia as the International Islamic Financial Center – MIFC.
2008	Standard & Poor's reported that Malaysia remained Asia's regional hub for Islamic finance and is a leading market for sukuk issuance. This is due to government support in order to strengthen regulations and provide infrastructure for Islamic banking and financial system.
2009	In the 2009 Budget announcement, the Malaysian government had announced more incentives to attract foreign investors with a tax-exemption for three years for fees and profits earned by institutions undertaking activities related to sukuk issued in Malaysia and distributed outside Malaysia. The other incentive that has been mentioned in the 2009 Budget is a tax reduction from 20 percent to 10 percent on dividends received by foreign institutional investors in REITs.

Source: Securities Commission Malaysia (2009), p. 46, with some additional information.

Chapter Questions

1. List three financial institutions that were established to become the nucleus for the establishment of Islamic finance in Malaysia.
2. Briefly explain the differences between the function of Tabung Haji and Bank Islam Malaysia Berhad.
3. Describe briefly the phases of Islamic financial development in Malaysia.
4. What are the six objectives of capital market masterplan?
5. Briefly describe the differences between Islamic equity unit trusts and Islamic real estate investment trusts.

Notes

1. Iqbal and Mirakhor, 2007.
2. Gafoor, 1995.
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4. www.bankislam.com.my (accessed January 3, 2011).
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6. www.ifsb.org.
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CHAPTER

3

Regulators and Transactions Platform for Capital and Money Markets

Learning outcomes

At the end of this chapter, you should be able to:

1. Understand the role of Bank Negara Malaysia on the development of Islamic financial markets in Malaysia.
2. Appreciate the role of the Securities Commission on the development of Islamic financial markets in Malaysia.
3. Distinguish the role of Bursa Malaysia on the development of Islamic financial markets in Malaysia.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

Since the inception of Islamic finance in the 1960s, Malaysia is among the countries that have provided a wide range of Islamic financial products and activities and therefore has become the main player of Islamic finance in the world today, particularly in the Islamic Capital Market (ICM) area. These achievements cannot be separated from the role of the Malaysian government through its bodies/institutions, such as Bank Negara Malaysia (BNM), Securities Commission (SC), and Bursa Malaysia (BM). They have played very important roles for the past decade and have made Malaysia the leading country in ICM.

Bank Negara Malaysia (BNM)

Bank Negara Malaysia (BNM), the central bank of Malaysia, was established on January 26, 1959, under the Central Bank of Malaysia Act of 1958, which has since been repealed by the Central Bank of Malaysia Act of 2009.

The principal objects of the BNM, according to the Central Bank of Malaysia Act of 1958, shall be:

1. To issue currency in Malaysia and to keep reserves safeguarding the value of the currency.
2. To act as a banker and a financial adviser to the government.
3. To promote monetary stability and a sound financial structure.
4. To influence the credit situation to the advantage of Malaysia.

In 1997, when the Thailand Baht was devaluated, the Malaysian Ringgit was also attacked by speculators, which turned the overnight rate from 8 percent to over 40 percent. This situation led to a general sell-off on the stock and currency markets. The Malaysian Ringgit had lost 50 percent of its value, falling from above 2.50 to under 4.10 to the dollar. Observing that the fluctuation was outside the limits, the monetary authority (BNM), in pursuing its principal objectives of safeguarding the value of the currency and promoting monetary stability, intervened in the market and fixed the Malaysian Ringgit against the U.S. dollar for a rate of RM3.8 per $1 on September 1998. These policies were accompanied by a wide range of capital control policies to insulate the monetary policy from external volatility by removing channels of transferring Ringgit abroad or vice versa.[1] Bank Negara Malaysia also refused the aid offered by International Monetary Funds (IMF).

Currently BNM is led by Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz. She has become the most powerful person in Malaysian economic and monetary regulation after being appointed by the Yang Di Pertuan Agong on May 2000. The first governor of BNM is Tan Sri William Howard Wilcock, the only foreigner to lead the Central Bank of Malaysia. In 1962, he handed over his position to Tun Ismail bin Mohamed Ali, who governed BNM for about 18 years and

TABLE 3.1 Governors of Bank Negara Malaysia

Governor	Year
Tan Sri William Howard Wilcock	January 1959 to July 1962
Tun Ismail bin Mohamed Ali	July 1962 to July 1980
Tan Sri Abdul Aziz bin Taha	July 1980 to June 1985
Tan Sri Dato' Jaffar bin Hussein	June 1985 to May 1994
Tan Sri Dato' Ahmad bin Mohd Don	May 1994 to August 1998
Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman	September 1998 to April 2000
Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz	May 2000 to the present

Source: www.bnm.gov.my.

set the tone for the bank's core values and instilled a culture of accountability, professionalism, integrity, and service. The next governors were Tan Sri Abdul Aziz bin Taha, from July 1980 to June 1985; Tan Sri Dato' Jaffar bin Hussein, from June 1985 to May 1994; Tan Sri Dato' Ahmad bin Mohd Don, from May 1994 to August 1998; and Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman, from September 1998 to April 2000 (see Table 3.1).

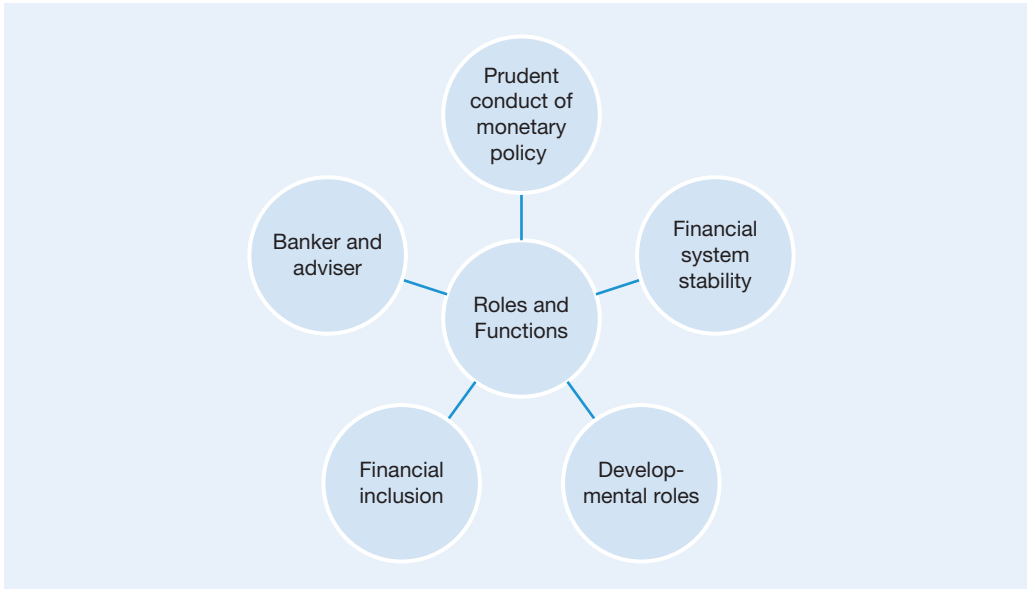
Role and Functions

According to the Central Bank of Malaysia Act of 2009 (CBA, 2009), the principal objectives of the Bank shall be to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy. BNM also should undertake its primary functions, mentioned in CBA 2009, which are:

1. To formulate and conduct monetary policy in Malaysia.
2. To issue currency in Malaysia.
3. To regulate and supervise financial institutions that are subject to the laws enforced by the Bank.
4. To provide oversight over money and foreign exchange markets.
5. To exercise oversight over payment systems.
6. To promote a sound, progressive, and inclusive financial system.
7. To hold and manage the foreign reserves of Malaysia.
8. To promote an exchange rate regime consistent with the fundamentals of the economy.
9. To act as the financial adviser, banker, and financial agent of the government.

Based on these primary functions of the BNM, among the major roles that can be played by the BNM is the prudent conduct of monetary policy, which is to ensure generally low and stable inflation within the country region and therefore maintain or increase the purchasing power of the Malaysian Ringgit (see Figure 3.1). Another important role that can be played by the BNM is to create a sound and progressive financial sector, particularly for

FIGURE 3.1 Roles and Functions of Bank Negara Malaysia



Source: **www.bnm.gov.my.**

Islamic finance, so that it can meet the increasingly sophisticated needs of customers and businesses, as it is now a growth driver of the economy.

In order to create a comprehensive, robust, and resilient financial system, the developmental role of BNM is very important. This includes the development of financial system infrastructure, such as improving the nation's efficient and secure payment system. Other roles are to establish more special-purpose institutions to monitor and evaluate the performance of Malaysian financial systems like the Securities Commission, Malaysia International Islamic Financial Centre (MIFC), Bursa Malaysia, Bursa Suq-al-Sila, and International Shariah Research Academy for Islamic Finance (ISRA).

To support the balanced economic growth of the nation, BNM should improve the people's access to financial institutions and services. This can be done under the financial inclusion role of BNM. The other role of BNM is as a banker and adviser for the government in terms of managing public debt and producing macroeconomic policies. BNM also holds the sole authority in issuing currency and managing the country's international reserves.

BNM Administered Legislation

In order to meet the objectives of the central bank, BNM had produced comprehensive legal powers under the following legislation to regulate and supervise the monetary and financial system of Malaysia. These produced legislation including the Exchange Control Act of 1953, Central Bank of Malaysia Act of 1958, Islamic Banking Act of 1983 and so forth. See Table 3.2 for a concise explanation about the content of those Acts.

TABLE 3.2 BNM Administered Legislation

Legislation	Focus
Exchange Control Act of 1953	Confers powers and imposes duties and restrictions in relation to gold, currency, payments, securities, debts, and the import, export, transfer, and settlement of property, and for purposes connected with the matters mentioned previously.
Central Bank of Malaysia Act of 1958	Provides the establishment, administration, and powers of the bank. This act was repealed with the Central Bank of Malaysia Act of 2009 starting on November 25, 2009.
Islamic Banking Act of 1983	Provides for the licensing and regulation of Islamic banking business.
Takaful Act of 1984	Provides for the regulation of takaful business in Malaysia and for other purposes relating to or connected with takaful.
Banking and Financial Institutions Act of 1989 (BAFIA)	Provides new laws for the licensing and regulation of institutions such as banking, finance companies, merchant banking, discount houses, and money-brokering businesses, for the regulation of institutions carrying on certain other financial businesses, and for matters incidental thereto or connected therewith.
Insurance Act of 1996	Provides new laws for the licensing and regulation of the insurance business, insurance broking business, adjusting business and financial advisory business and for other related purposes.
Money-Changing Act of 1998	Provides for the licensing and regulation of money-changing businesses and for other matters related thereto.
Anti-Money Laundering and Anti-Terrorism Financing Act of 2001	Provides for the offense of money laundering, to determine the measures to be taken for the prevention of money laundering and terrorism financing offenses, and to provide for the forfeiture of terrorist property and property involved in, or derived from, money laundering and terrorism financing offenses, and for matters incidental thereto and connected therewith.
Development Financial Institutions Act of 2002	Focuses on promoting the development of effective and efficient developmental financial institutions (DFIs) to ensure that the roles, objectives, and activities of the DFIs are consistent with government policies and that the mandated roles are effectively and efficiently implemented. DFIA also emphasises efficient management and effective corporate governance, provides a comprehensive supervision mechanism and a mechanism to strengthen the financial position of DFIs through the specification of prudential requirements.
Payment System Act 2003	Makes provisions for the regulation and supervision of payment systems and payment instruments and for matters connected therewith.
Central Bank of Malaysia Act 2009	Provides for the continued existence of the Central Bank of Malaysia and for the administration, objects, functions and powers of the Bank, for consequential or incidental matters.

Source: www.bnm.gov.my.

Role of BNM on ICM Development

The role of BNM toward the development of ICM in Malaysia can be categorised into at least three areas—planner, supervisor, and development of human resources. In its first role as a planner for ICM development, BNM together with the Securities Commission and other professionals from all around the world developed and launched the Capital Market Master Plan (CMP), which includes a discussion about Islamic Capital Market. Among the most important aspects of the strategic plan of the CMP is to establish Malaysia as an international Islamic capital market center.

The second role perhaps is the most important role of any central bank in any country, which is to give and withdraw licenses, provide regulations, and supervise each of the financial institutions within the country. Although it is directly mentioned about the Islamic capital market, the financial institutions regulated and supervised by BNM, such as Islamic banks and takaful companies, are very much related with the Islamic capital market. Therefore, the healthier and more sound these financial institutions, the better the performance of its Islamic capital market.

The third role of BNM is the development of human resources for ICM through the International Centre for Education in Islamic Finance (INCEIF) and the International Shariah Research Academy for Islamic Finance (ISRA). The main objective of establishing INCEIF and ISRA is to increase the number of experts in Islamic banking and finance areas by providing two sides of Islamic finance, the general knowledge of banking and finance and Shariah knowledge.

The Securities Commission (SC)

The Securities Commission Malaysia (SC) is a statutory body entrusted with regulating and systematically developing Malaysia's capital markets. It has direct responsibility for supervising and monitoring the activities of market institutions and regulating all persons licensed under the Capital Markets and Services Act of 2007 (see Figure 3.2).

Before the establishment of the SC on March 1993, Malaysia's capital market was regulated by six different government bodies: Capital Issues Committee (CIC), Ministry of Finance; Panel on Takeovers and Mergers, Prime Minister's Department; Foreign Investment Committee, Prime Minister's Department; Companies Commission of Malaysia; Ministry of International Trade and Industry (MITI); and Bank Negara Malaysia (BNM/Central Bank).

The key characteristics of the SC are that it has the power to investigate and enforce the areas within its jurisdiction. The SC is a self-funding organisation where its income is derived from the collection of levies and application fees. The SC is required to table its annual report in the Parliament.

Role of SC on ICM Development

The establishment of the SC undertakes the following five objectives:[2] (1) to promote the development of the capital market in Malaysia, (2) to take responsibility for streamlining

FIGURE 3.2 Roles and Functions of Securities Commission Malaysia

Source: **www.sc.com.my.**

the regulations of the securities market, (3) to ensure speedy processing and approval of corporate transactions, (4) to assume speedy ultimate responsibility of protecting investors, and (5) to execute regulatory and investigating powers with regard to compliance under the Securities Industry Act of 1983 and the Securities Industry (Central Depositories) Act of 1991.

These objectives are not only for conventional capital markets: The Islamic capital market initiative has always been an integral part of the SC's agenda overall capital market development. In meeting the objective of this institution, the SC has taken the following two approaches: (1) supply the necessary infrastructure for research, discussions, and dialogues; and (2) undertake specific efforts to develop and strengthen the market. It is very clear that from these two approaches, a dual market system will be created, similar to the existing banking and insurance sectors.

To ensure the development of ICM in Malaysia, the SC has also established a special unit, namely the Islamic Capital Market Department (ICMD) and a study group, the Islamic Instrument Study Group (IISG) in 1994. The main role of the special unit ICMD is to conceptualise and propose initiatives for the development of the ICM, while the objective of the IISG is to foster greater cross-fertilisation of ideas and understanding of ICM issues. In addition, IISG is also an avenue for Islamic scholars and practitioners to assess existing capital market instruments and provide guidance to all market stakeholders.

The other important movement done by the SC to support the development of ICM in Malaysia was establishing the Shariah Advisory Council (SAC) in May 1996. Its establishment was endorsed by the Minister of Finance of Malaysia and it was given the mandate to ensure that the implementation of the Islamic capital market complied with Shariah principles.

Members of the SAC are qualified individuals who can present Shariah opinions and have vast experience in the application of the Shariah, particularly in the areas of Islamic economics and finance. The SAC was also responsible for issuing a list of Shariah-compliant securities that were used as the basis for developing the Shariah index launched by Bursa Malaysia in April 1999. From here, investors will be able to monitor the performance of their investments more effectively and efficiently. Members of the SAC are appointed by the SC once every two years. Table 3.3 lists the past and present members of the SAC.

TABLE 3.3 List of Securities Commission Shariah Advisory Council

Name/Designation	1996–1998	1998–2000	2000–2002	2002–2004	2004–2006	2010–2012
1. Dato' Sheikh Azmi Ahmad	√	√				
2. Dato' Dr. Abdul Halim Ismail	√	√	√	√	√	√
3. Dato' Dr. Othman Ishak	√	√				
4. Dato' Dr. Haron Din	√	√				
5. Datuk Md Hashim Yahaya	√	√	√	√	√	√
6. Dato' Hassan Ahmad	√	√	√	√	√	
7. Tan Sri Sheikh Ghazali Abdul Rahman		√	√	√	√	√
8. Dato' Dr. Abdul Monir Yaacob		√	√	√	√	
9. Tan Sri Nor Mohamed Yakcop	√					
10. Dr. Mohd Daud Bakar	√	√	√	√	√	√
11. Assoc. Prof. Dr. Abdul Halim Muhammad			√	√	√	
12. Dr. Mohd Ali Baharum			√	√	√	
13. Tun Abdul Hamid Haji Mohamad						√
14. Assoc. Prof. Dr. Shamsiah Mohamad						√
15. Prof. M. Hashim Kamali						√
16. Prof. Dr. H. Fathurrahman Djamil						√
17. Dr. Aznan Hasan						√
18. Ahmad Suhaimi Yahya						√
19. Rafe Haneef						√

Source: www.sc.com.my.

Bursa Malaysia (BM)

Prior to the establishment of the Malayan Stockbrokers' Association in 1937, the first formal securities business organisation in Malaysia was the Singapore Stockbrokers' Association, established in 1930. Thirty years later, the Malayan Stock Exchange was established in 1960 and the public trading of shares commenced. The board system had trading rooms in Singapore and Kuala Lumpur, linked by direct telephone lines.

The Stock Exchange of Malaysia was established in 1964. After the separation of Singapore from Malaysia in 1965, the Stock Exchange of Malaysia became known as the Stock Exchange of Malaysia and Singapore. However, after the currency interchangeability between Malaysia and Singapore ceased in 1973, the Stock Exchange of Malaysia and Singapore was divided into the Kuala Lumpur Stock Exchange Berhad and the Stock Exchange of Singapore. The Kuala Lumpur Stock Exchange, which was incorporated on December 14, 1976, as a company limited by guarantee, took over the operations of the Kuala Lumpur Stock Exchange Berhad in the same year.

On April 14, 2004, it changed its name to Bursa Malaysia Berhad (BM) which was purposively to enhance the competitive position and to respond to global trends in the exchange sector by making BM more customer-driven and market-oriented. BM now focused on various initiatives aimed at improving its product and service offerings, increasing the liquidity and velocity of its markets, improving the efficiency of its businesses, and achieving economies of scale in its operations.

BM operates a fully integrated exchange, offering the complete range of exchange-related services including trading, clearing, settlement, and depository services. In achieving the best performance of its tasks, BM has set subsidiaries to handle some principal activities supporting the performance of BM. The list of BM's subsidiaries is shown in Table 3.4.

Role of BM on ICM Development

People in this particular industry are aware that Malaysia has dedicated itself as the proponent of Islamic finance development by creating legal and efficient regulatory infrastructure including legislation such as the Islamic Banking Act of 1983, the Takaful Act of 1984, and the Capital Markets and Services Act of 2007, as well as the Islamic Stockbroking Best Practices Guidelines to govern the Islamic finance industry.

BM today is designed to meet the tremendously increasing demands of Shariah-compliant investment from both local and foreign investors. If the roles of BNM and SC are aimed toward the regulatory and developing institutions, the BM's role, then, is to create the Islamic market as the exchange market. BM now offers a complete range of innovative Islamic market products from derivatives, equities, and commodities across all sectors and industries.

TABLE 3.4 List of Subsidiaries of Bursa Malaysia

Subsidiaries	Principal Activities
Bursa Malaysia Securities Bhd	Provide, operate, and maintain securities exchange.
Bursa Malaysia Derivatives Bhd	Provide, operate, and maintain a futures and options exchange.
Labuan International Financial Exchange Inc.	Provide, operate, and maintain offshore financial exchange.
Bursa Malaysia Bonds Sdn Bhd	Provide, operate, and maintain registered electronic facility for secondary bond market.
Bursa Malaysia Securities Clearing Sdn Bhd	Provide, operate, and maintain a clearinghouse for the securities exchange.
Bursa Malaysia Derivatives Clearing Bhd	Provide, operate, and maintain a clearinghouse for the futures and options exchange.
Bursa Malaysia Depository Sdn Bhd	Provide, operate, and maintain a central depository.
Bursa Malaysia Depository Nominees Sdn Bhd	Act as a nominee for the central depository and receive securities on deposit for safe-custody or management.
Bursa Malaysia Information Sdn Bhd	Provide and disseminate prices and other information relating to securities quoted on exchanges within the group.
Bursa Malaysia Islamic Services Sdn Bhd	Operate all Islamic Markets businesses and activities initiated under Bursa Malaysia.

Source: www.klse.com.my.

Shariah-Compliant Stocks and ETF

Bursa Malaysia is the exchange that has the largest number of Shariah-compliant stocks in the world and is the first to list Islamic ETF in Asia. Eighty-eight percent of securities listed on BM are Shariah compliant and this represents two-thirds of Malaysia's market capitalisation. The Dow Jones Islamic (DJIM) index tracks amongst the largest blue chip listed Malaysian companies that comply with Shariah investment guidelines. With 88 percent of the securities listed on Bursa Malaysia being Shariah-compliant, BM makes itself a perfect place to create a variety of Islamic ETFs that are transparent and cost-effective, providing greater access for investors to efficiently diversify. So the first role is to encourage companies to list their stocks on a Shariah-compliant stock list to meet the investors' desire.

Islamic Equity Indices

Bursa Malaysia provides two Islamic equity indices which are FTSE Bursa Malaysia EMAS Shariah index (FBM EMAS Shariah) and FTSE Bursa Malaysia Hijrah Shariah Index (FBM Hijrah Shariah) to provide a broad benchmark for Shariah-compliant investments. These indices are for investors, both local and foreign, who wish to invest in stocks that are

compliant with Shariah principles. BM is the only exchange with three comprehensive and transparent Shariah screening processes: FTSE Group, Yasaar Ltd, and the SC's Shariah Advisory Council (SAC). Therefore, the second role of BM toward the development of ICM is to perform the regulatory plus the risk management duties.

Islamic REITs and Sukuk Market

Malaysia, through Bursa Malaysia, also provides the market for Islamic Real Estate Trusts (Islamic REITs) and sukuk (Islamic bonds). Apart from being the first to introduce Islamic REITs guidelines, Malaysia has the world's first plantation REITs and hospital REITs. In addition, Malaysia is also the first jurisdiction in the global Islamic financial universe, as well as the first market in the world, to list Islamic REITs.

Bursa Malaysia provides a facilitative and progressive environment for sukuk issuance by local and international issuers. Issuing sukuk in Malaysia is cost-effective, as international issuers have the flexibility to issue either ringgit- or no ringgit-denominated sukuk using international documentation, based on UK or U.S. laws and the choice of international credit rating agencies.

Hence, the other role which can be played by BM toward the development of ICM is to explore for potential growth and develop the infrastructure of the Islamic capital market.

Chapter Summary

- Bank Negara Malaysia (BNM), the central bank of Malaysia, was established on January 26, 1959, under the Central Bank of Malaysia Act of 1958, which has since been repealed by the Central Bank of Malaysia Act of 2009.
- According to the Central Bank of Malaysia Act of 2009 (CBA, 2009), the principal objects of the Bank shall be to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy.
- The role of BNM toward the development of ICM in Malaysia can be categorized into at least three areas: planning, supervising, and developing human resources.
- The Securities Commission Malaysia (SC) is a statutory body entrusted with the responsibility of regulating and systematically developing Malaysia's capital markets.
- The key characteristics of the SC are that it has the power to investigate and enforce the areas within its jurisdiction.
- One important movement by SC is to support the development of ICM in Malaysia by establishing the Shariah Advisory Council (SAC) on May 1996.
- The Kuala Lumpur Stock Exchange was incorporated on December 14, 1976, and changed its name to Bursa Malaysia Berhad (BM) on April 14, 2004.
- The role of BM, then, is to create the Islamic market as the exchange market.

Chapter Questions

1. List three financial institutions that formed the nucleus for the establishment of Islamic finance in Malaysia.
2. Briefly explain the differences between the functions of Tabung Haji and Bank Islam Malaysia Berhad.
3. Describe briefly the phases of Islamic financial development in Malaysia.
4. What are the six objectives of the Capital Market Master Plan (CMP)?
5. Briefly distinguish between Islamic equity unit trust and Islamic real estate investment trusts.

Notes

1. For further discussion, see: IMF MRED (1999): IMF Staff Country Report 99/85: Malaysia: Recent Economic Developments, Washington, D.C. August 1999.
2. Securities Commission Malaysia (2009), p. 75.

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CHAPTER

4

Islamic Money Market

Learning outcomes

At the end of this chapter, you should be able to:

1. Explain the many functions performed by money markets.
2. Identify the key participants in the money market.
3. Understand how banks invest surplus funds and obtain funding for deficits.
4. Understand the characteristics of the Malaysian Islamic money market instruments.
5. Calculate the price or proceeds of Islamic money market instruments.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

The money market is an essential and integral component of the financial system. The money market, capital market, derivative market, commodity market, and foreign exchange market together constitute the country's financial market. They share a common function by providing an avenue for transactions of financial assets between buyers and sellers and between lenders and borrowers. The money market can be described as the financial market for transactions in wholesale short-term funds. The tenor in money market transactions is from overnight to 12 months, although the most common tenor is three months or less. In many countries, transactions in the primary and secondary money market are over-the-counter (OTC) via electronic telecommunication, but some are done in an exchange such as the Bursa Suq Al-Sila' in Malaysia.

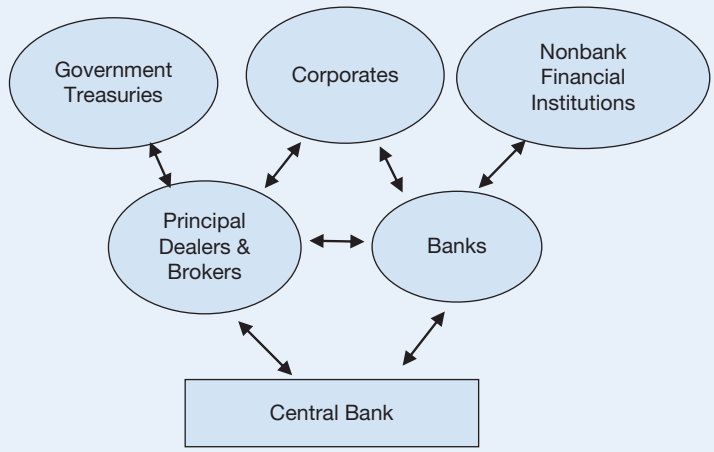
The capital market caters to long-term financial transactions with maturities longer than 12 months. The financial instruments in the capital market are more varied than the money market and they include sukuk, bonds, and equities. Transactions in capital market instruments are either exchange-traded or OTC. Derivative markets are markets for financial instruments whose values are derived from underlying instruments, such as from those in money and capital markets. The instruments traded include futures, options, swaps, and forward rate agreements. The derivative market caters to future delivery in contrast to other markets where settlement is done on a spot basis. The commodity market offers trading in commodities and precious metals and is used by hedgers and traders. They are traded either in an exchange or in OTC. The foreign exchange market is a market for transactions in foreign currencies, both on a spot and forward-delivery basis. All transactions in this market are OTC and in currencies such as the U.S. dollar, British pound sterling, euro, Singapore dollar, and Japanese yen.

Money Market Participants

The main participants (shown in Figure 4.1) in the money markets are banks, nonbank financial institutions such as takaful and insurance companies, business corporations, the government treasury, and the Central Bank. Banks use the money market for liquidity purposes, especially to adjust the mismatch of assets and liability in their balance sheet. They will use the money market to obtain liquidity or to place their surplus funds for a limited period. They could also buy money market instruments such as Malaysian Islamic Treasury bills and NIDCs to invest surplus funds, or sell their holdings of these instruments to raise funds.

Business corporations as well as government agencies also use the money market for short-term investments. Likewise, large business corporations, by virtue of their high credit ratings, source short-term funds by issuing commercial papers. The central bank, being the regulator, and whose role it is to promote market stability, uses the money market to transmit its monetary policy. One such example is the use of open-market operations[1] as a means of influencing the liquidity level and short-term interest rates in the domestic financial system. Changes to the liquidity and short-term interest rates will affect long-term rates in the financial

FIGURE 4.1 Money Market Participants



system. Finally, the government, another important player in the money market, uses the market as a source of short-term funding via the issuance of securities.

Functions of the Islamic Money Market

The functions of an Islamic money market can be divided into three main categories. The first function is liquidity management. The money market serves as an avenue for IFIs to source daily funding or to invest short-term. Access to the money market enables IFIs to maintain optimal liquidity, thereby allowing them to meet the demands of their customers at any time. This therefore allows the IFIs to cope with short-term pressures that may arise. It gives flexibility to the IFIs to face every liquidity situation that might arise due to different timing of cash inflows and outflows. Nonfinancial institutions use the money market to manage the fluctuations in their working capital needs, by obtaining either short-term funding or placement. Consequently, they will be able to enjoy low-cost funding or investment returns with low risk.

The money market also serves as the avenue for secondary trading of money market instruments. Money market participants, depending on their view of rates of return, will either buy or sell money market instruments in anticipation of obtaining investment returns. The instruments available in the money market provide investors with different levels of risks, returns, and maturity.

Finally, the money market is used as a channel for the central bank to conduct its monetary policies. As mentioned in the previous section, the central bank will use open market operations by undertaking repos and reverse repos,[2] purchasing and selling eligible securities, and providing short-term financing directly to banks that are in a deficit situation. In this way, the central bank is able to manage liquidity and influence benchmark rates in the money

market. Changes in the liquidity and benchmark rates in the money market will thereby influence liquidity and rates of return in other markets. As such, the effect of a monetary policy change is first reflected in the money market, and that will ultimately lead to adjustments in other markets such as sukuk and bond, equity, and banking systems.

Differences between Islamic and Conventional Money Markets

The Islamic money market enables market players to perform similar functions as in conventional markets, but with the exception that the instruments used to perform these functions must be based on Shariah laws and principles. Islamic money market provides an avenue for money market players to invest surplus funds or to obtain short-term funding in a Shariah-compliant way. Similarly, it allows the players to trade Shariah-compliant money market instruments as well as to carry out Shariah-compliant swaps.

Table 4.1 shows that the Islamic money market uses a host of Shariah contracts, especially for the issuance and trading of Islamic money market instruments, whereas the conventional money market uses only one type of contract based on debt. Returns in the Mudarabah Interbank Investment as well as wakalah investment are also not predetermined upon placement, but rather fixed only upon maturity of investment. On the other hand, returns from Commodity Murabahah are fixed and the investor is informed of the return at the onset of placement of funds.

An interesting feature of the Islamic money market is that it is not only accessible to Islamic financial institutions but also to conventional banks, insurance companies, and other conventional nonbank financial institutions. This is the case especially for the Islamic money

TABLE 4.1 Comparison between Islamic and Conventional Money Markets

	Islamic	Conventional
Interbank Market	Utilizes Shariah-compliant contracts such as mudarabah, murabahah, and wakalah.	Debt contract is used for placement of funds.
Money market instruments		
Issuance process	Must be Shariah-compliant and approved by both Shariah Council of Bank Negara Malaysia and Securities Commission Malaysia.	Approved by regulatory authorities only.
Types of structure	Structured based on assets, equity, and debt.	Structure based on debt only.
Investors	Both Islamic and conventional investors.	Conventional investors only.

Source: Adapted from BNM.

market instruments. Conventional financial institutions have unlimited access to invest in Islamic money market instruments as well as bid for Islamic papers in the primary market.

Components of the Malaysian Islamic Money Market

The Islamic Money Market, known in Malaysia as the Islamic Interbank Money Market, came into existence 10 years after the establishment of Malaysia's first Islamic bank, Bank Islam Malaysia Berhad, in 1983. Prior to the establishment of IIMM in January 1994, the Government Investment Certificate (GIC)[3] was the only available Shariah-compliant short-term instrument available to Islamic banks for liquidity management. The problem experienced using this instrument was that the secondary market for the instrument was not available, as the instrument was issued under the principle of ***qard al-hasan*** (benevolent loan), which made it nontradable. Thus, BNM remains the sole option for Islamic banks to deal with regarding liquidity management. They invest in GICs when they have excess liquidity and sell them back when they are in need of liquidity. Considering the growth rate of the Islamic banking sector, a single instrument for managing liquidity is inadequate. This development coupled with the dual banking system practice in Malaysia and other similar Muslims countries called for an urgent need for a full-fledged and developed IIMM. However, there is no example of how to design the Islamic money market. Therefore, what has been done is basically to structure the Islamic money market using the conventional money markets' template by removing all aspects that contradict Shariah principles.

Today the Malaysian Islamic money market comprises two components:

1. Islamic interbank market.
2. Trading of Islamic money market instruments.

Islamic Interbank Market

Generally, the Islamic interbank market is considered the largest component of any Islamic money market and in particular the overnight subcomponent. An active interbank market is essential in providing signals to central banks to determine the volume of open market operations.

The overnight market is where IFIs trade among themselves their reserve balances to meet their day-to-day liquidity requirements. For instance, banks with surplus liquidity can place their excess funds at other banks overnight. The overnight rate adjusts to balance the supply of and demand for bank reserves. A short-term market rate, in particular the interbank overnight rate may be used to serve as an operational guide for monetary operations of central banks Table 4.2 shows that the overnight market comprises 83 percent of the total interbank market while the other tenor remains an insignificant percentage. The Shariah contracts currently used in the Malaysian Islamic interbank market are mudarabah, murabahah, and wakalah.

TABLE 4.2 Islamic Interbank Money Market Monthly Volume by Tenor for 2009

	MYR Million				
Month	Overnight	One Week	One Month	Three Months	Others
January	13,329	421	370	20	695
February	10,535	475	0	70	1,570
March	14,630	340	425	150	1,984
April	14,407	633	100	0	1,748
May	12,779	682	160	0	1,515
June	7,489	455	180	0	650
July	9,298	571	770	140	630
August	10,673	546	830	50	1,563
September	13,920	535	610	0	1,330
October	11,608	476	270	0	1,075
November	7,105	1,076	110	0	1,935
December	11,516	486	180	100	2,091
Total	137,289	6,696	4005	530	16,786

Source: Bank Negara Malaysia.

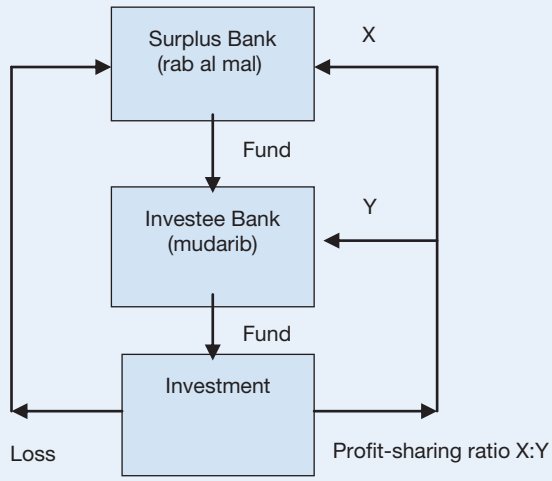
Mudarabah Interbank Investment

The first Islamic interbank investment commenced in Malaysia in early 1994 with the establishment of Mudarabah Interbank Investment. In this arrangement a surplus bank as ***rab al mal*** or fund provider will place its excess funds for a limited period with a deficit bank that is a mudarib (or the manager of fund) on a preagreed profit sharing ratio. In line with mudarabah principles, any losses will be borne by the surplus bank. This is illustrated in Figure 4.2.

Under the current BNM rules, the minimum amount of investment is RM50,000, while the tenor can be anywhere from overnight to 12 months. When MIIs were first introduced, the rate of return paid by the deficit bank was based on its gross profit rate on a one-year investment. However, this method was not transparent, as some banks underdeclared their return through the exclusion of certain types of income. Following this, in 1995 BNM came up with a new rule by introducing a benchmark rate that is equivalent to the prevailing rate of the Government Investment Issue (GII) plus a spread of 0.5 percent. Hence, the minimum rate of return payable to the surplus bank is the prevailing rate of return from GII plus 0.5 percent. This rate of return computation methodology was used until 2004 when BNM replaced it with a more comprehensive framework, where it sets out the calculation of distributable profits and the derivation of rates of return to the depositors.[4]

The framework consists of two components: the calculation table and the distribution table. The calculation table specifies the income and expense items that must be reported and

FIGURE 4.2 Mudarabah Interbank Investment



establishes the standard calculation in arriving at the net distributable income. It also introduced Profit Equalization Reserve (PER) as a tool to mitigate the fluctuation of rates of return and to ensure that rates remained competitive and stable.

The distribution table then prescribes the allocation of the net distributable income among demand, savings, and general investment deposits according to their structures (mudarabah or nonmudarabah), maturities, and the preagreed profit-sharing ratios. BNM further requires Islamic banks to calculate their rates of return on a monthly basis and to declare their monthly rates of return on a specified date, usually the 15th of each month. The declared rate of return will remain effective until the following announcement date.

Profit Calculation for Mudarabah Interbank Investment

The profit payable to the investing bank in the mudarabah interbank investment is determined by two factors: (1) the agreed-on profit-sharing ratio (PSR) and (2) the declared gross profit rate of the receiving bank on one-year investments. The first one is agreed upon at the onset of the investment, while the second one is known only at the maturity of the investment. However, an investing bank knows that the profit payable due to it can be predicted based on the declared rate of return if the tenor of investment falls before the next announcement date. If, on the other hand, the tenor of investment crosses the next announcement date, the profit payable will be based on the newly declared gross profit rate.

The formula to calculate the profit payable to the investing bank is as follows:[5]

$$X = \frac{Prt(K)}{36{,}500}$$

Where:

X = Amount of profit (in Ringgit) to be paid to investing bank
P = Face value/principal amount of investment
t = Tenor in days of investment
r = Gross profit rate before distribution declared by receiving bank on one-year investments
K = Profit-sharing ratio

The total amount payable to the investing bank on maturity will be comprised of the principal invested plus X, the profit earned based on the agreed-on profit-sharing ratio.

Example: Mudarabah Interbank Investment (MII)

Suppose KFH (Kuwait Finance House) has RM5 million surplus funds and wishes to place out for 30 days. Similarly, assume that Bank Islam Malaysia Berhad is in need of a similar amount for the same tenor. Further, assume both banks agreed that the profit sharing ratio for this investment is 70:30, where 70 percent is in favor of KFH.

Let us assume that Bank Islam declared a gross profit rate of 5.8 percent per annum before distribution. KFH will therefore receive a net profit of RM16,684.93, or a return of 4.06 percent per annum for the 30-day investment.

The profit payable to KFH is calculated as follows:

$$X = \frac{5{,}000{,}000 \times 5.8 \times 30 \times 0.7}{36{,}500}$$

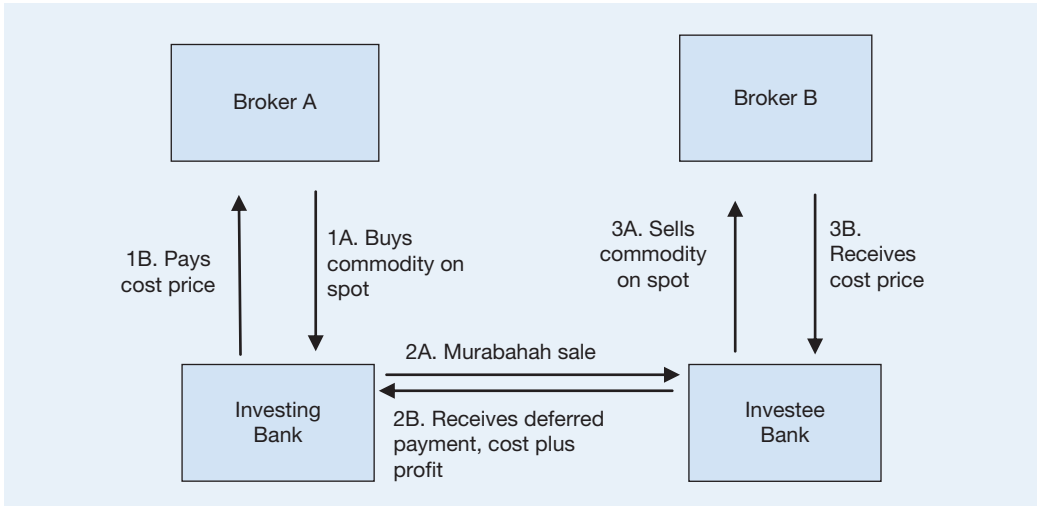
$$= \text{RM}16,684.93, \text{ i.e., a return of } 4.06 \text{ percent p.a.}$$

Therefore, on day 30, Bank Islam is liable to pay RM5,016,684.93 to KFH (i.e., the principal plus profit due).

Commodity Murabahah

Also known as Tawarruq, this is a liquidity management program originally introduced by BNM in March 2007, as an avenue for Islamic banks to invest their excess funds with the central bank. Now it is being used as an interbank investment among the Islamic money market participants. In Malaysia Bursa Suq Al-Sila' has been established to provide a platform for commodity

FIGURE 4.3 Commodity Murabahah



murabahah transactions.[6] The underlying asset used in this exchange is Crude Palm Oil (CPO) although other assets such as aluminium have also been used in the GCC countries. Under this arrangement, an investing bank purchases an underlying asset say CPO from a broker and sells it to the investee bank at cost-plus with an agreement that it pays the investing bank on a deferred payment basis. The investee bank may then appoint the investing bank as its agent to sell the commodity to another broker on a spot basis or may sell the commodity on its own to another broker. The reverse of this transaction is also known as reverse tawarruq, and can be done if a bank is in need of short-term funds. The commodity murabahah arrangement is depicted in Figure 4.3.

In contrast to MII where the rate of return is determined upon the maturity of the investment, the rate of return for commodity murabahah is fixed upfront and known to the investing bank. The formula to calculate the profit payable to the investing bank is as follows:

$$X = \frac{Prt}{36{,}500}$$

Where:

X = Amount of profit (in Ringgit) to be paid to the investing bank
P = Face value/principal amount of investment
t = Tenor in days of investment
r = Annual Profit rate

Similar to MII, the total amount payable to the investing bank on maturity will consist of the principal invested plus X, the profit earned based on murabahah.

Example: Commodity Murabahah Interbank Investment

Suppose Bank Muamalat Malaysia Berhad (BMMB) has RM5 million surplus funds and wishes to place out for 30 days. Similarly, assume that Bank Rakyat Malaysia Berhad is in need of a similar amount for the same tenor.

Both banks will then execute their Commodity Murabahah transactions through the Bursa Suq Al-Sila. BBMB will first purchase CPO from Bursa Suq Al-Sila' at the spot price (RM5 million) and then sell the CPO to Bank Rakyat at a deferred payment, say with 5 percent per annum profit margin. Bank Rakyat will subsequently sell the CPO to Bursa Suq Al-Sila' at spot (RM5 million), thereby generating a placement. At the end of 30 days, BBMB will therefore receive the cost price of RM5 million plus a profit of 5 percent per annum or RM20,547.95.

The profit payable to KFH is calculated as follows:

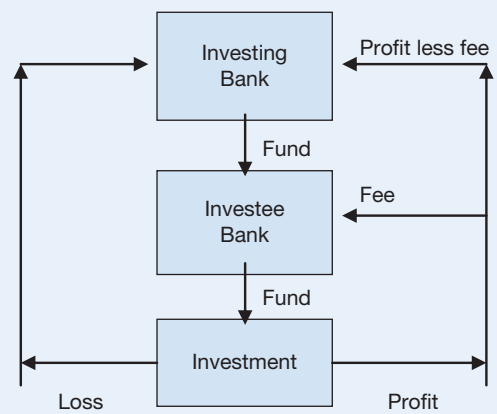
$$X = \frac{5{,}000{,}000 \times 5 \times 30}{36{,}500}$$

$$= \text{RM}20{,}547.95, \text{ that is, a return of 5 percent p.a.}$$

Wakalah Investment

Wakalah investment (shown in Figure 4.4) is an agency concept whereby the muwakkil (investing bank) appoints the investee bank (wakkil) as their agent to invest in Shariah-compliant transactions on behalf of the muwakkil. The investee bank as the wakkil will notify the investing bank of the profits expected to be generated upon placement of funds. Any profits exceeding the quoted

FIGURE 4.4 Wakalah Investment



expected profits will be retained as an incentive by the investee bank. The investee bank is also entitled to draw an agency fee from the incentive obtained. The investing bank as principal shall bear all risks associated with the transactions except for those risks resulting from the investee bank's willful act or gross negligence. The formula to calculate the profit payable to the investing bank under Wakalah investment is the same as commodity murabahah investment.

Trading of Islamic Money Market Instruments

Trading in the Islamic money market instruments represents the second component of the Islamic money market. It is aimed at facilitating placement among the money market players just like the interbank investment, but through the issuance/purchase of financial instruments. The money market instrument is more flexible relative to the interbank investment described previously in the sense that the instruments can easily be traded in the secondary market. This therefore makes it easy for banks that purchase money market instruments to sell or liquidate them whenever they want without waiting until the maturity of the instruments. An active secondary market is therefore necessary to facilitate the trading of money market instruments before maturity, thereby reducing liquidity risk and enhancing the efficiency in the market.

Unlike interbank investment that is mainly restricted to approved interbank institutions, participants in this market constitute both financial and nonfinancial institutions. The instruments offered in the market are different from one another in terms of risk profile, yield, tenor, marketability, and liquidity. It should also be noted that the term ***money market instruments*** refers to short-term investment papers, including long-term instruments, such as government securities that have almost reached their maturity date. The outstanding amount according to the types of Islamic securities issued as of December 31, 2009, is shown in Table 4.3.

TABLE 4.3 Outstanding Amount of Islamic Securities as of December 31, 2009

Financial Instrument	Outstanding Amount (RM Mil)
ABS (Islamic bonds)	5,921
CAGAMAS BAISs	1,465
Corporate bonds/sukuk (Islamic)	72,889
Government investment issues	66,000
Islamic commercial papers	3,859
Islamic medium-term notes	88,614
Khazanah bonds	1,000
Malaysian Islamic Treasury bills	2,000
Sukuk Bank Negara Malaysia Ijarah	400
Total Outstanding Amount (RM Mil)	**242,148**

Government Investment Issue (GII)

Formerly known as Government Investment Certificates (GIC), Government Investment Issues (GII) were first introduced in July 1983, in conjunction with the establishment of Malaysia's first Islamic bank, Bank Islam Malaysia Berhad. BNM, on behalf of the Malaysian government, issued for the first time noninterest bearing Government Investment Issue to meet the special needs of the bank and other corporations who are interested in these securities. The Government Investment Act 1983 under which certificates are issued, provides certificates with maturities of one year or more to be issued and for dividends, instead of interest, to be paid on the certificates. The original GIC was issued under the principle of ***qard al-hasan*** (benevolent loan), which restricts its trading in the secondary market. Financial institutions needing liquidity will have to surrender or sell their GICs back to BNM, after which dividends will be paid. The determination of the dividend is not ex-ante but rather ex-post.

The above constraints led BNM to replace GIC with GII in 2001. GII is structured on the contract of ***bai' al inah*** (sale and buyback). For example, BNM will identify a Shariah-compliant asset and then invites tenders from Islamic financial institutions for the asset. IFI, which offers the most competitive price will be selected to be the buyer cum investor and gets to buy the asset on spot sale. The investing bank in turn will resell the asset back to BNM on the principle of ***bai bithaman ajil*** (deferred sale) if the coupon is to be paid periodically, or ***murabahah*** (cost plus) if the GII is a zero coupon instrument.[7] The debt incurred by BNM through the deferred buyback is securitised in the form of GII. Thus, the spot price paid by the investing bank will be at face value if the GII is issued on the principle of bai bithaman ajil or discounted value if the GII is issued under murabahah. The investing bank can either hold the GII until maturity or sell it in the secondary market. At maturity, BNM redeems the security by paying the full purchase price of the assets (or face value of GII) to GII holders.

The price of GII is given below:

$$\begin{aligned}\text{Price} = &\{\text{Discounted Value of Redemption Value at Maturity}\} \\ &+ \{\text{Discounted Value of Stream of Coupon Payments}\}\end{aligned}$$

$$\text{Price} = \left\{\frac{RV}{\left[1+\frac{r}{200}\right]^{N-1+T/E}}\right\} + \left\{\sum_{K=1}^{N}\frac{C/2}{\left[1+\frac{r}{200}\right]^{K-1+T/E}}\right\}$$

Where:

FV = Face value
RV = Redemption value (= FV, if redemption is at par)
C = Coupon rate
r = Market yield for a similar maturity period
N = Number of semi-annual coupon payments between the value date and maturity date

T = Number of days from the value date to the next coupon payment date
E = Number of days in the coupon period in which settlement takes place
K = Time period in which the coupon or principal payment occurs

Example: Calculation of GII price

BMMB purchase a GII with the following details:

Issuance date: April 7, 2006
Maturity Date: April 7, 2009
Transaction date: October 15, 2007
Coupon: 6% per annum, paid semiannually
Maturity value: RM100
Yield: 7% per annum

What is the price for this instrument?
Answer:

$$\text{Price} = \left\{ \frac{100}{\left[1 + \frac{7}{200}\right]^{3-1+(175/183)}} \right\} + \left\{ \sum_{K=1}^{N} \frac{3}{\left[1 + \frac{7}{200}\right]^{3-1+(175/183)}} \right\}$$

$$= \text{RM}98.75$$

Malaysian Islamic Treasury Bills (MITB)

MITB are short-term securities issued by the government of Malaysia as an alternative to the conventional Treasury bills. Unlike GII, which are issued to finance the development expenditure of the Malaysian government, MITB are issued to finance the government's operating expenditure. The MITB are structured based on the bai' al-inah principle where BNM on behalf of the Malaysian government will sell the identified government's assets on a competitive tender basis, to form the underlying transaction of the deal. Allotment is based on highest price tendered (or lowest yield). Price is determined after the profit element is imputed (discounting factor). The successful bidders will then pay cash to the government.

The bidders will subsequently sell back the assets to the government at par based on the credit term. The government will issue MITB to bidders to represent the debt created. MITB are usually issued weekly with original maturities of one year and are priced on a discounted

basis. Both conventional and Islamic institutions can buy and trade on MITB. The discounting formula shown below is used to determine the proceeds on MITB.

$$\text{Proceed} = FV\left(1 - \frac{r \times t}{365}\right)$$

Where:

FV = Face Value
r = Discounting rate
t = Number of days remaining to maturity

Example: Calculation of Proceeds on MITB

What is the price of MITB that has a face value of RM5,000,000 and sold at a discount rate of 4.8 percent, assuming that the number of days to maturity is 30 days?

Answer:

$$\begin{aligned}\text{Proceed} &= RM5{,}000{,}000\left(1 - \frac{4.8\% \times 30}{365}\right)\\ &= RM5{,}000{,}000(1 - 0.00395)\\ &= RM5{,}000{,}000(0.996)\\ &= RM4{,}980{,}250\end{aligned}$$

Bank Negara Monetary Notes (BNMN)

These are short-term money market instruments issued by BNM to replace the Bank Negara Negotiable Notes (BNNN). The underlying contract used to be bai' al-'inah but now has been replaced with murabahah. The issuance of BNMN is based on commodity Murabahah, as explained earlier. The issuance is normally made through publication in FAST and the tenor for this instrument ranges from 1 to 12 months, although now it has been extended to three years. The debt created from the commodity murabahah is tradable in the secondary market under the concept of bai' al-dayn. New issuance may be based on discount or coupon bearing. Discount-based BNMN is traded using a convention similar to the existing BNNN and Malaysian Islamic Treasury Bill (MITB), while profit-based BNMN is traded using the market convention of Government Investment Issue.

Sukuk Bank Negara Malaysia Ijarah (SBNMI)

This is an Islamic money market instrument that is issued under the Ijarah (lease) principle. To facilitate the issuance of SBNMI, BNM established a special purpose vehicle named as BNM Sukuk Berhad (BNMSB). The first stage of the sukuk issuance involves BNM selling the identified assets to BNMSB and BNMSB paying BNM for the assets from the proceeds of the sukuk issuance. The assets will then be leased to BNM for rental payment consideration, which is distributed to investors as a return on a semiannual basis. Upon maturity of the sukuk ijarah, which will coincide with the end of the lease tenure, BNMSB will then sell the assets back to BNM at a predetermined price. One advantage of using Ijarah principle is that the rental can be set as fixed or variable, thus mimicking a floating rate bond.

The inaugural issuance took place on February 16, 2006, with an issue size of RM400 million. The pricing formula for a fixed rental SBNI is similar to the fixed rate GII, as shown previously.

Islamic Negotiable Instruments (INI)

This is a Shariah-compliant instrument equivalent to the conventional Certificate of Deposits (CDs). INI may be issued based on bai bithaman ajil or mudarabah. The instrument based on bai bithaman ajil is called the Negotiable Islamic Debt Certificate (NIDC), while the one based on mudarabah is called the Islamic Negotiable Instruments of Deposit (INID). The explanations of both are discussed in the following sections.

Negotiable Islamic Debt Certificate (NIDC)

NIDC is a document issued by an IFI to evidence that a sum of money has been deposited with the issuer for a specific period. The NIDC stipulates that the issuer has the obligation to pay the bearer the amount deposited together with profit at a specified future date. This document is issued based on bai bithaman ajil. The issuing bank will first identify an asset whose value is based on the amount to be deposited and sells this asset to the investor at an agreed-on cash price. Subsequently, the investor agrees to resell the same asset back to the issuing bank at the original sale price plus mark-up, which is payable on a deferred basis. To evidence the indebtedness from the deferred sale, the issuing bank issues NIDC to the investor. Upon maturity, the investor or bearer presents the NIDC to the issuing bank against payment for its nominal value plus the profit portion.

NIDC are bearer instruments and are initially issued to the investee bank. They can be resold at discount before maturity. NIDCs are traded on a price basis, which means that the principal value is quoted in terms of price per RM100 nominal value.

The formula below is used to calculate the price of NIDC that is less than 1 year maturity:

$$\text{Price} = \frac{RV}{1 + \left[\frac{T \times Y}{36{,}500}\right]}$$

(Prices are rounded up to the nearest decimal point.) Where:

RV = Redemption value per RM100 nominal value
T = Number of days from settlement date to maturity date
Y = Yield or profit rate per annum

The formula to calculate an NIDC with maturity of more than 1 year is shown below:

$$\text{Price} = \frac{RV}{\left[1 + \frac{YLD}{200}\right]^{n-1+DSC/DCC}}$$

Where:

RV = Redemption value per RM100 nominal value
YLD = Yield in percent p.a.
DSC = Number of days from settlement date to next quasi coupon date (treated as if the instrument pays semiannual profit)
DCC = Number of days in quasi coupon profit period (Note: In the event that the first quasi coupon profit period has a duration of less than six months, the start date of DCC should be backdated accordingly to create a quasi-semiannual period
n = Number of remaining quasi coupon profit periods

Example: Calculation of Price of NIDC of Less Than One Year

What is the price of an NIDC purchased by BIMB with a nominal value of RM1,000,000 and has the following details:

Issuance Date = March 7, 2009
Maturity date = July 7, 2009
Transaction date = April 7, 2009
Yield = 4% p.a.

Answer:

$$P = \frac{100}{1 + \left(\frac{91 \times 4}{36{,}500}\right)}$$

$$= \frac{100}{1.00997}$$

$$= 99.0126$$

Therefore, the proceeds for one NIDC are as follows:

$$\text{Proceeds} = \frac{1{,}000{,}000 \times 99.0126}{100}$$

$$= 990{,}125.87$$

Note:
T=91 days, that is, from April 7, 2009 to July 7, 2009

Example: Calculation of Price NIDC with Maturity of More Than One Year

KFH purchase a long-term NIDC instruments with the following details:

Issuance date: March 20, 2007
Maturity date: March 20, 2009
Transaction date: July 21, 2008
Maturity value: RM1,500,000
Yield: 4% p.a.
Coupon dates: March 20 and September 20 each year

What is the price for this instrument?
Answer:

$$\text{Price} = \frac{100}{\left[1 + \frac{4}{200}\right]^{2-1+\frac{61}{184}}}$$

$$\text{Price} = \frac{100}{[1.02]^{1.3315}}$$

$$= \frac{100}{1.0268}$$

$$= 97.3977$$

Therefore, the proceeds for one NIDC are as follows:

$$\text{Proceeds} = \frac{1{,}500{,}000 \times 97.3977}{100}$$

$$= RM1{,}460{,}965.44$$

Islamic Negotiable Instruments of Deposit (INID)

INID is a certificate representing a sum of money deposited by an investor with an issuing bank, which is repayable to the bearer on a specified future date at the nominal value of the instrument plus profit. It is issued based on the mudarabah (profit-sharing) principle. The investor is the rab al mal while the mudarib is the issuing bank. Just like NIDC, INIDs are bearer instruments and are traded on the basis of price, which means that the principal value is quoted in terms of price per RM100 nominal value. The price of INID is computed using the following formula:

$$\text{Price} = FV\left[\frac{(a+b)}{36{,}500} + 1\right] * 100$$

Where:

a = Expected dividend rate

b = Number of days from the issue date or last dividend date to the value date of the transaction

Example: Calculation of Proceeds for an INID

Issue date: December 13, 2008
Maturity: December 13, 2009
Nominal value: RM5,000,000
Profit sharing ratio: 75:25
Expected dividend rate: 11.5%
Profit date: Quarterly with the first dividend date on March 31

$$\text{Price} = \left[\frac{(8.625 \times 90)}{36{,}500} + 1\right] * 100$$

$$= 102.1267$$

The proceeds to be paid by the buyer will be computed as follow:

$$\text{Proceeds} = RM5{,}000{,}000 \times 102.1267/100$$
$$= RM5{,}106{,}335$$

Islamic Accepted Bill (IAB)

Islamic Accepted Bill (IAB) is the Shariah equivalent to the conventional Banker's Acceptance. IAB is a bill of exchange drawn on or drawn by a bank, payable at a specific date in the future, to evidence the debt that arises out of a trade transaction.

This bills may be used as part of the trade finance facilities by importers to finance their imports or purchases or exporters to finance their exports or sales. Among the conditions set by BNM for the issuance of IAB are as follows: The financing facility must be for a genuine trade, the goods involved must be tangible and Shariah-compliant, it must not involve the selling or purchasing of services, and the parties involved must not be a single entity. Under the current BNM rules, the minimum denomination for an IAB is RM50,000 and in multiples of RM1,000.

Import and Local Purchases

In import IAB, the Islamic bank will first appoint the customer as its agent to purchase the required asset from the exporter or seller on behalf of the bank. The asset is consequently resold to the customer on a murabahah basis at a marked-up price with the agreement to repay based on deferred payment, which can be up to 365 days. Upon maturity, the customer pays to the bank the cost of the goods and the bank's profit margin. The sale of goods by the bank to its customer on a deferred basis represents debt, which is securitised in the form of a bill of exchange that is drawn by the bank on, and accepted by the customer for, the full amount of the selling price that will be paid at maturity. The Islamic bank as the drawer of the IAB can hold the IAB until maturity, when it will receive the full selling price, or alternatively sell the IAB prior to its maturity at a discount to any investors using the principle of bai' al-dayn.

Export/Local Trade

After an exporter has obtained the approval of his bank for export trade finance facilities, and fulfilled the export documentations required under the export or sales contract, the documents are sent to the importer's bank. The exporter later draws on his bank a new bill of exchange as a substitution bill that represents the IAB. The acceptance by the bank indicates a promise that it will pay the full value of the bill to the bearer upon maturity. The bank then purchases the IAB from the exporter at a discount under the Islamic principle of bai al-dayn. The bank can hold the

IAB until maturity and receive the full selling price or it can sell the bill before maturity to a third party at discount.

The price of IAB under bai al-dayn is calculated based on a discounting formula, as shown below:

$$\text{Proceed} = FV\left[1 - \frac{r \times t}{365}\right]$$

Where:

FV = Face value
r = Discounting rate
t = Number of days remaining to maturity

Example: Price Calculation of IAB under Bai al-Dayn

Suppose an IAB with a face value of RM3,000,000 is sold at a discount rate of 5 percent and has 42 days remaining to maturity. What is the price for this IAB?

$$\begin{aligned}\text{Proceed} &= RM3{,}000{,}000\left[1 - \frac{5\% \times 42}{365}\right] \\ &= RM3{,}000{,}000(1 - 0.005753) \\ &= RM2{,}982{,}741\end{aligned}$$

Sell and Buy Back Agreement (SBBA)

This is similar to a conventional Repurchase Agreement (Repo) but structured in a Shariah-compliant way. Repo in conventional banking is an agreement under which a seller of securities sells the securities to a buyer at an agreed price and repurchases the securities from a buyer at a specified price on a future date. The difference between the repurchase price and the original sale price is the interest earned by the buyer who is also a lender. Under the Sell and Buy Back Agreement (SBBA), the transacting parties enter into two separate agreements. The first agreement is between the seller (owner) of securities and the buyer (investor) who buys the securities at a specified price agreed upon by both parties. The second agreement is a forward purchase agreement whereby the buyer (investor) promises to sell back the securities to the original owner and the latter promises to buy it back at a specified price on a specified future date. The first contract is an outright sale and thus the securities will cease to be part of the seller's investment portfolio. BNM requires that at least one of the parties to an SBBA

transaction must be an Islamic Banking Institution, while the tenor for a SBBA transaction must not exceed 1 year and the minimum value must be at least RM50,000.[8]

The proceeds from SBBA transaction can be computed using the following formula:

$$\text{Proceed} = FV\left[1 - \frac{rt}{36{,}500}\right]$$

Where:

P = Market price
FV = Face value
r = Annual rate of profit
t = Number of days

Example: Sell and Buy Back Agreement

Assume Maybank Islamic Berhad enters into SBBA agreement on March 8, 2007, to sell IAB security to Bank Islam Malaysia Berhad with an undertaking that Maybank Islamic will purchase the same securities back on March 17, 2007. What is the value of the proceeds if the IAB rate of profit is 4 percent p.a, the face value is RM1,000,000, and has 70 days remaining to maturity?

$$\text{Price} = RM1{,}000{,}000\left[1 - \frac{4 \times 70}{36{,}500}\right]$$

$$\text{Price} = RM1{,}000{,}000(1 - 0.00767123)$$

$$= RM992{,}328.77(\text{total proceeds paid by Bank Islam on March 8, 2007})$$

On maturity of the SBBA contract on the March 17, 2007, Maybank Islamic will buy back the IAB, which has 61 days remaining to maturity from Bank Islam at a price computed as follow:

$$\text{Price} = RM1{,}000{,}000\left[1 - \frac{4 \times 61}{36{,}500}\right]$$

$$RM1{,}000{,}000(1 - 0.0066849)$$

$$= RM993{,}315.07 \text{ (Total proceeds paid by Maybank Islamic on March 17, 2007)}$$

The total proceeds earned by Bank Islam for nine days of short-term placement via SBBA is RM986.30 (RM993,315.07 − RM992,328.77).

Cagamas Sukuk

Cagamas Berhad, the National Mortgage Corporation, was established as a special vehicle to mobilise low-cost funds to support the national home ownership policy and to spearhead the development of the private debt securities market in Malaysia.[9] To that end, Cagamas issued a number of Islamic fixed income securities that are traded in the money market. The securities are Sanadat Mudarabah Cagamas and Sanadat Cagamas.

Sanadat Mudarabah Cagamas (SMC)

This is an asset-based sukuk issued by Cagamas Berhad under the concept of mudarabah. The main objective of this instrument is to finance the purchase of Islamic housing debts issued under the principle of bai bithaman ajil and the purchase of Islamic hire purchase debts issued under the principle of ijarah thumma al-bai. Based on the Mudharabah concept, the sukuk holder bears any loss that results in a reduction of the value of the sukuk while profit is shared between the sukuk holders and Cagamas according to the agreed-on profit sharing ratio. Coupon is paid semiannually on coupon day. The sanadats are redeemable at par on the maturity date unless there is principal diminution. The maturity of sanadat can run up to 10 years. Price and proceeds of SMC is calculated using the following formula:

$$P = \left[\frac{100\left(100 + \left(\frac{C + E}{365}\right)\right)}{100 + \left(\frac{r \times T}{365}\right)}\right] - FV\left(\frac{C \times t}{36{,}500}\right)$$

$$\text{Proceed} = \frac{NV \times P}{100} + NV \times \left(\frac{C \times t}{36{,}500}\right)$$

Where:

P = Price per RM100 face value
C = Indicative coupon for current coupon period
E = Number of days in current coupon period
T = Number of days from transaction date to next coupon payment day
r = Yield to maturity
t = Number of days from last coupon payment date to the value date
NV = Nominal value of SMC transaction

Example: Sanadat Mudarabah Cagamas (SMC) Calculation

Maybank Islamic Berhad bought RM25 million SMC with the following details:

Issuance date: 7/04/2006
Maturity: 7/04/2008
Transaction date: 20/08/2006
Next coupon date: 7/10/2006
Indicative coupon: 5.47%
Yield to maturity: 5.57%

What is the price for this instrument?
Answer:

$$P = \left[\frac{100\left(100 + \left(\frac{5.47 \times 184}{365}\right)\right)}{100 + \left(\frac{5.57 \times 48}{365}\right)}\right] - 100\left(\frac{5.47 \times 74}{36{,}500}\right)$$

$$= \left(\frac{10{,}275.7479}{100.7325}\right) - 100(0.011089)$$

$$= 102.01025 - 1.1089$$

$$= 100.9014$$

$$= 100.90$$

$$\text{Proceed} = \left(\frac{RM25{,}000{,}000 \times 100.90}{100}\right) + \left(RM25{,}000{,}000 \times \frac{5.47 \times 74}{36{,}500}\right)$$

$$= 25{,}225{,}000 + 277{,}246.5753$$

$$= RM25{,}502{,}246.58$$

Sanadat Cagamas

Sanadat Cagamas, also known as Cagamas BAIS, is another type of Islamic security issued by Cagamas to finance the purchase of Islamic housing finance debts and Islamic hire/purchase

debts. This sanadat however is issued under the principle of bai bithaman ajil, in which the cost of the assets purchased is equivalent to the par value of the sanadat and the profit earned is equivalent to the coupons of the sanadat. Coupons are paid semiannually while the par value is redeemable upon maturity. The tenor of the sanadat can be 10 years. The pricing formula for this sanadat is similar to the fixed rate GII if the sanadat's tenor is more than 1 year, while if the tenor is less than 1 year the pricing formula will be based on NIDC, which has a tenor of more than a year.

Islamic Corporate Sukuk

These are Shariah-compliant bonds or sukuk first introduced in Malaysia in 1990 by Sarawak Shell. They can be structured based on a number of Islamic finance contracts, such as bai bithaman ajil, murabahah, salam, istisna, ijarah, mudarabah, musharakah, and wakalah.[10] These sukuks can be issued on either a discounted basis or profit or rental basis. Hence, the pricing formula will also be based on the type of sukuks issued and the relevant formula as discussed earlier will be applied accordingly.

Chapter Summary

- The money market can be described as the financial market for transactions in wholesale short-term funds. The tenor in money market transactions is from overnight to 12 months, although the most common tenor is three months or less.
- The main participants in the money markets are banks, nonbank financial institutions such as takaful and insurance companies, business corporations, government treasuries, and the Central Bank.
- The Islamic money market fulfills three important functions: liquidity management, avenue for trading of Islamic money market instruments, and channel for the Central Bank to transmit its monetary policy.
- The Islamic money market enables market players to perform similar functions to those of the conventional market, but with the exception, that the instruments used to perform these functions must be based on Shariah laws and principles.
- The first Islamic interbank investment commenced in Malaysia in early 1994 with the establishment of Mudarabah Interbank Investment.
- Commodity murabahah is also known as Tawarruq. This is a liquidity management program originally introduced by BNM in March 2007 as an avenue for Islamic banks to invest their excess funds with the Central Bank. Now it is being used as interbank investment among the Islamic money market participants.
- Wakalah investment is an agency concept whereby the Muwakkil (investing bank) appoints the investee bank (wakkil) as their agent to invest in Shariah-compliant transactions on behalf of the muwakkil.

- MITBs are short-term securities issued by the Government of Malaysia as an alternative to the conventional Treasury bills. Unlike GII, which are issued to finance the development expenditure of the Malaysian government, MITB are issued to finance the government's operating expenditure.
- Negotiable Islamic Debt Certificate (NIDC) is a document issued by an IFI to evidence that a sum of money has been deposited with the issuer for a specific period.
- Islamic Negotiable Instruments of Deposit (INID) is a certificate representing a sum of money deposited by an investor with an issuing bank, which is repayable to the bearer on a specified future date at the nominal value of the instrument plus profit. It is issued based on the mudarabah or profit-sharing principle.
- Islamic Accepted Bill (IAB) is the Shariah equivalent to the conventional Banker's Acceptance. IAB is a bill of exchange drawn on or drawn by a bank, payable at a specific date in the future, to evidence the debt that arises out of a trade transaction.

Chapter Questions

1. Why do Islamic financial institutions need an Islamic money market?
2. Compare and contrast between Islamic and conventional money markets.
3. Kuwait Finance House (KFH) Kuala Lumpur has excess cash reserves amounting to RM225 million, a condition expected to last for the next five business days, and is weighing to place out in the Kuala Lumpur Islamic money market. Recommend and describe to KFH at least three avenues of placement available in the Islamic money market.
4. Assumed Al-Rajhi Bank is in need of RM130 million for the next 90 days and decided to obtain that amount via Bursa Suq Al-Sila (BSAS). The current 90 days yield is 3.5 percent.
   a. Briefly explain how Al-Rajhi Bank can obtain this fund at BSAS.
   b. Calculate how much Al-Rajhi Bank must pay to settle the 90-day murabahah contract.
5. Suppose Maybank Islamic purchases 5-year GII on October 24, 2012, that provides 4 percent per-annum coupon and is paid semiannually. The GII was issued on June 21, 2011 and matures on June 21, 2016. If the principal maturity value of GII is RM100, while the current yield is 4.2 percent, calculate the current price for this GII.

Notes

1. Open market operations refer to the act of buying and selling of government securities by the central bank for the purpose of influencing liquidity and interest rates in the financial system.
2. In Islamic Money Market this is known as Sale and Buyback Agreements and Reverse Sale and Buyback Agreements. The reader can refer to the explanation of this instrument in the relevant section below.

3. GIC was later replaced with Government Investment Issues (GII), which use bai' al-inah as well as bai' bithaman ajil. For further information on this, see discussion on GII in the section further on.
4. The methodology is called "The Framework of the Rate of Return." Retrieved September 1, 2010, from http://iimm.bnm.gov.my/view.php?id=7&dbIndex=0&website_id=14&ex=1286807103&md=y%E6%C6%06%C6%FD%DA%9F%07D%8Fe0%93%AA7.
5. The 36,500 in the denominator is 365 days × 100. Thus, in the numerator the percent "*r*" will be entered as a whole number and not as a decimal.
6. For more information on the bursa, please refer to www.klse.com.my/website/bm/products_and_services/islamic_capital_market/BMIS/.
7. The advantage of using such contracts is that they allow secondary trading of the instrument on the basis of bai al-dayn (trading of debt).
8. "Guidance Notes on Sell and Buyback Agreement Transactions," BNM, August 2002.
9. See www.cagamas.com.my/caga-docs/pictures/evolution.pdf.
10. A detailed discussion on sukuk is beyond the scope of this chapter. The reader is advised to refer to the Chapter 5 on sukuk in this book.

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CHAPTER

5

An Overview of Sukuk

Learning outcomes

At the end of this chapter, you should be able to:

1. Differentiate between sukuk, bonds, and shares.
2. Identify basic contracts in sukuk structures.
3. Distinguish between the various sukuk structures.
4. Differentiate between asset-based and asset-backed sukuk.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

Nowadays, the term ***sukuk*** is more widely known than it was a decade ago. Sukuk is a claim or claims that are similar to notes or certificates, such as a trust certificate.[1] The Accounting and Auditing Organization for Islamic Finance (AAOIFI) defines ***investment sukuk*** as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services, or in the ownership of the assets of particular projects or special investment activities; however, this is true after the receipt of the value of the sukuk, the closing of the subscription, and employment of the funds received for the purpose for which the sukuk were issued. Meanwhile, the Securities Commission (SC) of Malaysia defines sukuk as certificates of equal value that represent undivided ownership or investment in the assets using Shariah principles and concepts approved by the SAC. However, unlike the conventional claim, sukuk is an ownership claim and therefore not a debt of the issuer, but rather an undivided ownership share in specific assets/projects/services.

"Sukuk" is derived from the word ***sakk***, or "صَكّ" which can mean legal instrument, deed, and cheque. In ***lisan al-Arab***, the meaning of ***sakk*** is "to strike one's seal on a document" or "imprint one's mark on a clay tablet." The derived word ***sakkaik*** is used to mean "minting coins."[2] Since traders from Arab countries traveled throughout Africa and Europe, it is reasonable to suppose that the word ***cheque*** came from ***sakk***,[3] and those terms are related to coinage and financial tools or activities related to them.

The Prophet Muhammad ***Shalallahu 'alaihi wa sallam*** also mentioned ***sakkaik***, the plural of ***sakk***, in some of his hadiths (sayings of the Prophet Muhammad, p.b.u.h).

> **أَنَّ ابْنَ عُمَرَ وَزَيْدَ بْنَ ثَابِتٍ كَانَا لاَ يَرَيَانِ بَأْسًا بِشِرَاءِ الرَّزْقِ إِذَا خَرَجَتِ الْقُطُوطُ ، وَهِيَ : الصِّكَاكُ ، وَيَقُولُونَ : لاَ تَبِعْهُ حَتَّى تَقْبِضَهُ.**
>
> Indeed Ibn Umar and Zaid bin Thabit both not looking at anything to sell food (which has not held or occupied), if it is in the form of sukuk Qathut and they say, "***Do not*** sell it until you possess it."
>
> عَنْ نَافِعٍ ، قَالَ : نُبِّئْتُ، أَنَّ حَكِيمَ بْنَ حِزَامٍ كَانَ يَشْتَرِي صِكاك الرَّزْقِ ، فَنَهَى عُمَرُ أَنْ يَبِيعَ حَتَّى يَقْبِضَ.
>
> From Nafi, he said, "It was reported to me that Judge bin Hizam bought sukuk of food and Umar forbade him selling it until he possess it."[4]

From these two hadiths, we can conclude that sukuk was recognised during the era of Prophet Muhammad ***Shalallahu 'alaihi wa sallam***. However, sukuk, as understood in its contemporary form, is described in a decision of the Islamic Jurisprudence Council of February 1988, which provided that[5]

> Any combination of assets (or the usufruct of such assets) can be represented in the form of a written financial instrument which can be sold at a market price provided that the composition of the group of assets represented by the sukuk consists of a majority of tangible assets.

Although the Islamic capital market started in 1993,[6] and the first global corporate sukuk was first introduced in 2001,[7] the "Investment Sukuk Standard" was published in May 2003 by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI), which later on shifted the paradigm in the development of Islamic financial products to be more associated with the conventional counterparts.[8]

The main function of sukuk is to provide an alternative to conventional bonds, in other words, to provide the benefits associated with conventional bonds but in a Shariah-compliant manner. Although by nature sukuk is outside the conventional frame of references, for the purposes of listing sukuk on exchanges or to help identify the group within a bank or law firm that will deal with documentation, sukuk terms are made similar to their conventional counterpart.

Comparing Sukuk, Bonds, and Shares

We may have seen that the origin of sukuk is somehow different from bonds. While bonds represent pure debt obligations from the issuer to the investors or bondholders, the sukuk represent ownership of a well-defined asset. Therefore, unlike bond obligations, the asset-related expenses in sukuk are attached to sukuk holders.

Accordingly, the sale of sukuk, both in primary and secondary markets, is a sale of a share of an asset, while selling a bond is basically the sale of a debt. Since typical bonds are basically loans that then represent a contract whose subjects are purely earning money on money, which is the classic definition of riba, then selling a bond is like selling a riba-based instrument and hence is forbidden from the Islamic point of view.

In terms of pricing, sukuk prices are market driven and depend on the fluctuation of the market value of the underlying assets. In the case of the issuer's default, sukuk holders will possess the asset and they can sell it to other buyers or keep it as an asset. On the other hand, bondholders depend solely on the creditworthiness of the issuer without any specific assets to be relied on. Therefore, in the case of an issuer's failure, unsecured bondholders will be jointly seeking the assets of a bankrupt company.

When we go to shares, there are differences between shares and sukuk. From the point of ownership, sukuk is an undivided ownership share in specific assets while holding shares means holding an ownership share in a corporation or company. The other difference is that ordinary shares do not require the company to be Shariah-compliant and the percentage of tangible assets are not determined. In sukuk, the assets should not be against Shariah principles and a minimum of 51 percent are tangible assets. In the event that something happens with a project (sukuk) or a company (shares), the responsibilities of sukuk holders are defined duties relating to the underlying assets/projects/transactions and limited to the extent of participation in the issue, while the responsibilities of a company's shareholders for the affairs of the company are limited to the extent of their holdings in the company. Table 5.1, which is adapted from Thomas and Adam (2004), provides a summary of differences between sukuk, conventional bonds, and company shares.

TABLE 5.1 Differences between Sukuk, Conventional Bonds, and Company Shares

	Sukuk	Bonds	Shares
Nature	Not a debt of issuer but undivided ownership share in specific assets/projects/ services.	Debt of issuer.	Ownership share in a corporation.
Asset-backed	A minimum of 51 percent tangible assets (or their contracts) are required to back issuance of *sukuk al-ijarah*.	Generally not required.	Not required.
Claims	Ownership claims on the specific underlying assets/ projects/services and so on.	Creditors claim on the borrowing entity, and in some cases liens on assets.	Ownership claims on the company.
Security	Secured by ownership rights in the underlying assets or projects in addition to any additional collateral enhancements structured.	Generally unsecured debentures except in cases such as first mortgage bonds, equipment trust certificates, and so on.	Unsecured.
Principal and return	Not guaranteed by issuer.	Guaranteed by issuer	Not guaranteed by company.
Purpose	Must be issued only for Islamically permissible (halal) purposes.	Can be issued for any purposes.	Can be offered for any purposes.
Trading of security	Sale of an ownership interest in a specific asset/project/ service and so on.	Sale of a debt instrument.	Sale of shares in a company.
Responsibility of holders	Responsibility for defined duties relating to the underlying assets/ projects/ transactions limited to the extent of participation in the issue.	Bondholders have no responsibility for the circumstances of the issuer.	Responsibility for the affairs of the company limited to the extent of holdings in the company.

Source: Adam and Thomas (2004), 54.

Muhammad Taqi Usmani, President of the AAOIFI Shariah council, wrote an article entitled "Sukuk and their contemporary applications"[9] to show the distinction between sukuk and conventional bonds, which can be summarised in the following five points:

1. Sukuk should be issued for new commercial and industrial ventures. If they are issued for established businesses, then the sukuk must ensure that sukuk holders have complete ownership in real assets.
2. The returns of enterprises should be returned to sukuk holders regardless of what amounts they reach after costs, including the manager's fees, or the share of the mudarib

in profits. If there is to be an incentive for a manager, then let it be based on the profits expected from the enterprise and not on an interest rate.

3. It is unlawful for a manager to lend money when actual profits are less than expected.
4. It is unlawful for a manager, whether a mudarib or a partner or an agent, to commit to repurchase of assets at face value. Instead, their resale must be undertaken on the basis of the net value of the assets, or at a price that is agreed upon at the time of purchase.
5. Shariah supervisory boards must abide by the Shariah Standards issued by the Shariah Council.

Sukuk Types

Based on the ownership and sale status of the underlying assets, sukuk can be classified into two types, namely asset-backed sukuk and asset-based sukuk, as shown in Table 5.2. Asset-backed sukuk allow the inclusion of the actual asset, which may not be legally recognised as owned outright by the sukuk holders. Asset-backed sukuk grants the sukuk holder a share of the concrete asset or business venture, and a share of the risk commensurate with the "true sale" ownership of the asset. In this case, sukuk securitisation is structured around the sukuk holders' legal ownership of the underlying asset, which forms the sole source of profit and principal payments.

Sukuk Structures

The AAOIFI Financial Accounting Standard No. 17 (AAOIFI FAS 17) classifies Islamic bonds (sukuk) into at least five types:

1. Leased-based sukuk, for example, sukuk ijarah.
2. Partnership-based sukuk, for example, sukuk Mudharaba and sukuk musharakah.
3. Sale-based sukuk, for example, sukuk murabaha, sukuk istisna, and sukuk salam.

TABLE 5.2 Differences between Asset-Based and Asset-Backed Sukuk

	Asset-Based Sukuk	Asset-Backed Sukuk
Feature	Use Shariah compliant-assets/ business venture to facilitate issuance of sukuk.	Use asset-backed Shariah-compliant assets/ business ventures, which form *primary* source of income/return to investor.
Key accounting concept/ treatment	On balance sheet (for originator/ obligor).	Off balance sheet (for originator). True sale criterion: legal and off-balance-sheet accounting.
Funding cost	Market driven, mainly depending on originator/issuer credit rating/ standing.	Mainly based on the strength of the asset cash flow.
Rating	Corporate rating of issuer/obligor.	Strength of cash flow.

4. Hybrid sukuk, for example, sukuk al-Istithmar.
5. Other types of sukuk, for example, sukuk wakalah.

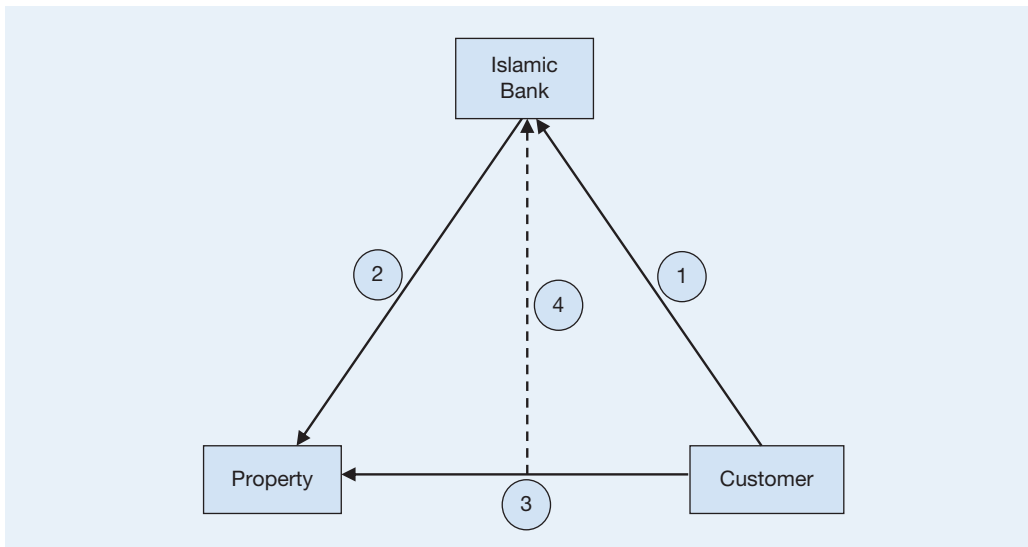
Sukuk al-Ijarah

Al-ijarah, or leasing, is defined as the transfer of ownership of permitted usufruct for a known period in exchange for compensation. Some scholars like Al-Hasan al-Basri and Al-Nahrawani did not allow the ijarah contract because the usufruct is not received at the time of the contract and therefore this constitutes the sale of a nonexistent good. However, the majority of Shariah scholars accept this contract, saying that although not existent at the time of the contract, the usufruct's existence in the future is extremely likely.

There are two types of ijarah contracts implemented in current Islamic finance practice. First is normal ijarah. It is a ***manfaah*** (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to his client at an agreed-on rental fee and predetermined lease period upon the ***aqad*** (contract). The ownership of the leased asset/equipment remains with the lessor. Second is al-ijarah muntahiya bit-tamlik. It is similar to normal ijarah with the exception that the lessor will transfer the ownership of the asset back to the lessee at the end of the lease period, via a sale or gift. This is the most popular structure used in sukuk al-ijarah.

In Islamic banking, the ijarah contract is quite famous and desired by both bankers and customers. Al-Ijarah Muntahiya Bit-Tamlik, for instance, is among the contracts developed under the ijarah contract. It is the concept whereby banks lease the property to customers, and the customers at the end of the tenure period can take ownership of the property after the financing is completed. Figure 5.1 shows how al-Ijarah Muntahiya Bit-Tamlik is working in Islamic banking financing.

FIGURE 5.1 Structure of al-Ijarah Muntahiya Bit-Tamliq



1. A customer goes to an Islamic bank and proposes a financing scheme for him to own a particular property.
2. The Islamic bank will first evaluate whether or not this particular customer is eligible to get financing. If it is okay, then the Islamic bank will go see the property desired by the customer. Negotiations will be done between the bank and the owner of the property regarding the price and all matters related with the buying and selling of the property.
3. Once the property is bought by the bank, it will be leased to the customer.
4. The customer has to pay the rental price until the contract matures. Once it matures, the customer can take ownership of the property by buying it from the bank.

Mini–Case Study

Sukuk al-ijarah is the most popular sukuk structure with almost 50 percent of sukuk issued in 2007 and 2008 in the form of it.[10] There are, of course, some reasons why most of the sukuk issuers and investors prefer this ijarah structure for their investment. From the issuers' point of view, sukuk al-ijarah is preferred due to its simplicity and acceptance by most of the scholars. In addition, sukuk al-ijarah also has been described as the classic sukuk structure from which all other sukuk structures are developed.

From the investors' point of view, return generated from this type of investment is very important. With regard to the returns generated for investors, for all sukuk structures, it relies on the performance of the underlying asset and the contractual arrangement. Sukuk al-ijarah, in this case, provides a regular payment along the way until its maturity. In addition, when the sukuk matures, an asset buyback agreement between the issuer and investors is widely accepted by Shariah scholars. These reasons have made sukuk al-ijarah widely used in the sukuk market.

One good example of sukuk ijarah is the Aras Sejagat Sukuk of Air Asia in 2008. The originator is AirAsia Berhad whose principal business is providing air transportation services. It is Asia's largest low-cost carrier operating both domestic and international flights. It is listed on Bursa Malaysia with a valuation of RM3.2 billion. The substantial shareholders are Tune Air Sdn Bhd, Dato' Seri Dr. Tony Fernandes, and Dato' Kamarudin Meranun with 26.44, 26.54%, and 26.5 percent of issued shared capital, respectively. The issuer SPV is Aras Sejagat Snd. Bhd., and it was established mainly to facilitate the issuance of the RM500 million bank-guaranteed Sukuk. It is 100 percent owned by Air Asia (the parent company). Its authorised capital, RM100,000, is made up of 100,000 ordinary shares of RM1.00 for each partner. Its paid-up capital is RM2.00, consisting of two ordinary shares of RM1.00 for each partner. Both capitals are as of February 29, 2008.

The issuer decided to select a particular structure for the following reasons:

1. There is flexibility in the timing of inflows and outflows as it is not necessary that the flow of usufruct benefits should coincide with the timing of rent payments.

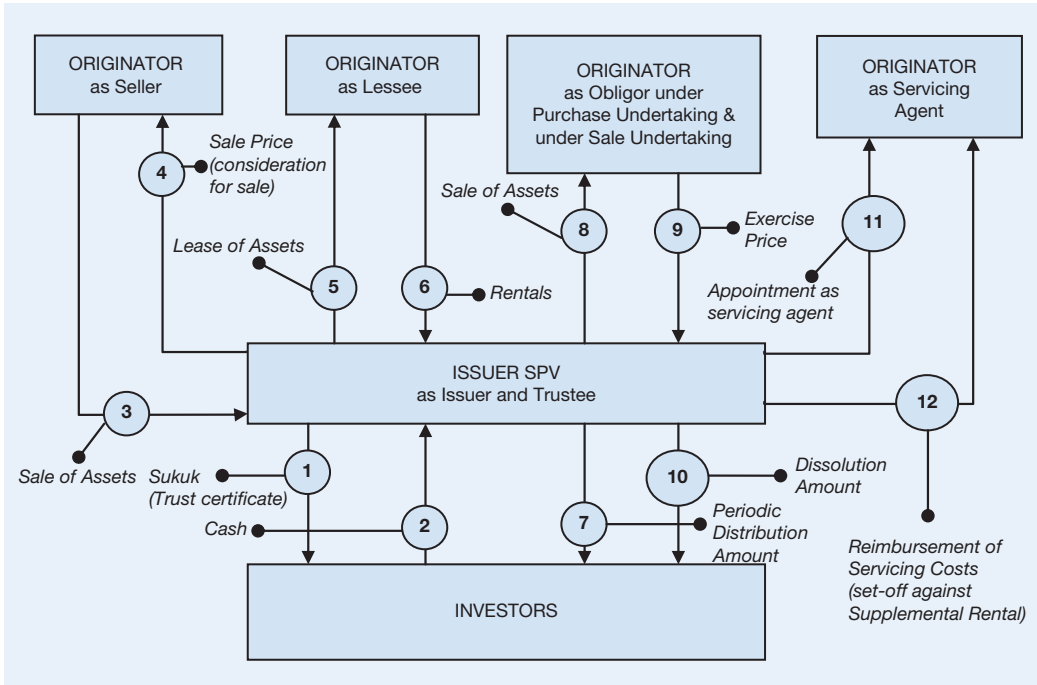
2. There is flexibility in the term of the contract. The ijarah contract can be of any length as long as the asset that is the subject of the ijarah contract remains in existence and renders its usufruct.
3. The rent determination is done in a number of different flexible ways.
4. The underlying assets can be substituted either in whole or in part, pursuant to the terms of a property substitution undertaking.

The sukuk is accompanied by a bank guarantee and in this case the guarantor is Kuwait Finance House (Malaysia) Berhad. Thereafter, Aras Sejagat leases the identified beneficial assets to Air Asia, who makes periodic rental payments to Aras Sejagat. Aras Sejagat makes periodic distributions to sukuk holders. Upon termination of the lease period, the transfer undertaking is executed whereby the identified beneficial assets are transferred back to Air Asia.

TABLE 5.3 Term Sheet of Aras Sejagat Bank Guarantee Sukuk

Country	Malaysia
Sukuk name	Aras Sejagat Bank Guarantee Sukuk
Issuer name	Aras Sejagat Sdn. Bhd
Principal activities of issuer	To facilitate the issuance of the RM500 millions bank guaranteed sukuk
Originator (obligor) name	Air Asia Sdn Bhd
Principal activities of originator	Operation of domestic and international flights
Date of issue	May 5, 2008
Issue size	RM500 millions
Tenor (years)	5 years
Issue price	At par RM1,000.00
Listing status	Will not be listed on Bursa Malaysia or any stock exchange
Sukuk structure	Ijarah
Rating	AA+
Profit/coupon	To be determined and agreed-upon prior to issuance of the Bank Guarantee Sukuk
Profit/coupon payment frequency	Semiannual payments
Underlying assets	A pool of Shariah-compliant assets identified for the purpose of the sukuk program. Such assets are to be endorsed by the Shariah advisers.
Purpose of issue	The sukuk was issued by Aras Sejagat to pay the assets purchase price/head lease rental to Air Asia, who in turn uses it for Shariah-compliant purposes such as: Financing the capital expenditure requirements of Air Asia for the sum of RM350.00 million. Payment of expenses relating to the Bank Guarantee sukuk for the sum of RM1.1 million. Using the remaining balance for working capital purposes.

FIGURE 5.2 Sukuk al-Ijarah Structure



Source: Sukuk Guidebook, Dubai International Financial Centre (DIFC) and Clifford Chance (2009), 14.

The General Structure of Sukuk al-Ijarah

The following 12 explanations of the structure are given by the Dubai International Financial Centre (DIFC):

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.
2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
3. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, certain assets (the "Assets") from Originator.
4. Trustee pays the purchase price to Originator as consideration for its purchase of the Assets in an amount equal to the Principal Amount.
5. Trustee leases the Assets back to Originator under a lease arrangement (ijara) for a term that reflects the maturity of the sukuk.

6. Originator (as Lessee) makes Rental payments at regular intervals to Trustee (as Lessor). The amount of each Rental is equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g., LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.[11]
7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Rental it has received from Originator.
8. Upon:
   a. An event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or
   b. The exercise call option/purchase undertaking (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking)

   Trustee will sell, and Originator will buy back, the Assets at the applicable Exercise Price, which will be equal to the principal amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.
9. Payment of Exercise Price by Originator (as Obligor).
10. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from Originator.
11. Trustee and Originator will enter into a service agency agreement whereby the Trustee will appoint Originator as its Servicing Agent to carry out certain of its obligations under the lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the Assets. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the "Servicing Costs") the Rental for the subsequent lease period under the lease arrangement will be increased by an equivalent amount (a "Supplemental Rental").
12. This Supplemental Rental due from Originator (as Lessee) will be set off against the obligation of Trustee to pay the Servicing Costs. (DIFC, 2009, pp. 14–15)

Documents Required for Sukuk al-Ijarah Issuance

From the previous explanation about the structure, the following are basic documents required to issue and transact sukuk al-ijarah:[12]

1. Document	**:**	**Sale and Purchase Agreement**
Parties	**:**	**Originator (seller) and Trustee/SPV (purchaser)**
Purpose(s)	**:**	**a. For the Originator, this is the document under which it receives funding.**
		b. For the Trustee, this is the document that gives ownership of the revenue-generating asset.
2. Document	**:**	**Lease Agreement**

Parties	:	Originator (lessee) and Trustee (Lessor)
Purpose(s)	:	**a.** For the Originator, it gives right to use the Assets so that its principal business can continue without interruption.
		b. For the Trustee, it generates returns for the Trustee on behalf of the investors.
3. Document	:	Service Agency Agreement
Parties	:	Originator (Servicing Agent) and Trustee (Lessor)
Purpose(s)	:	**a.** For the Originator, it gives an opportunity to set off any additional amount, which is added to exercise price at maturity or any supplementary rental payment under ijara against service charges claimed.
		b. For the Trustee, it allows them to pass the responsibility of major maintenance of the Assets back to the originator.
4. Document	:	Sale and Purchase Undertaking (Wa'd)
Parties	:	Originator (Guarantor) and Trustee (on behalf of investors)
Purpose(s)	:	**a.** For the Originator, it allows the originator to buy back the Assets at maturity.
		b. For the Trustee, it allows them to sell the Assets back to Originator if an event of default occurs or at maturity, in return for which the Originator is required to pay all outstanding amounts (through an Exercise Price) so that the Trustee can pay the Investors.

Key Features of Sukuk al-Ijarah Structure

1. The rental must be at an agreed-on amount for an agreed-on period that reflects the sukuk maturity time.
2. The underlying assets must have a valuable use from which the usufruct can be taken by the lessee while the ownership will remain with the SPV on behalf of the investors. Therefore, the lessee cannot use the underlying assets of the sukuk for any purposes other than what has been written on the contract paper.
3. As the owner of the assets, SPV on behalf of the investors is liable for any risk related with the assets until the end of the lease period. However, any liabilities relating to the use of the assets rest with the lessee. In the case of the assets' function being lost, for which it was leased; the SPV can replace the assets with similar function assets. However, if the damage is caused by the negligence of the lessee, the lessee (originator) is liable to compensate the SPV.
4. Sukuk al-ijarah is completely negotiable and can be traded in the secondary markets.
5. Sukuk al-ijarah offers a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, awqaf, or any other asset users, private or public, can issue these sukuk. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.

Sukuk al-Musharakah

Linguistically, the term for partnership (sharikah/musharakah) indicates mixing of two or more properties in such a way that makes it impossible to define the separate parts. The majority of jurists nowadays interpret the musharakah as a contract between a group of individuals who share the capital and profits. The legality of this contract was established in the Qur'an, Sunnah, and consensus of the Muslim scholars and community.

Allah (swt) say in the Qur'an "If more than two, then they share in a third" [4:12] and "truly many are the partners (in business) who wrong each other: not so do those who believe and work deeds of righteousness . . . " [38:24]. In the hadith qudsi,[13] proof of legality of partnerships is also found, when Allah (swt) says:

أَنَا ثَالِثُ الشَّرِيكَيْنِ مَا لَمْ يَخُنْ أَحَدُهُمَا صَاحِبَهُ فَإِذَا خَانَهُ خَرَجْتُ مِنْ بَيْنِهِمَا.

> "I am the third of every two partners as long as neither one betrays the other. However, if one betrays the other, I leave their partnership."[14]

There are two main categories of musharakah: general partnership or capital partnership (***shirkatul amlak***) and contractual partnership (***shirkatul 'uqud***). Generally, the first type of contract gives very little flexibility to the partners compared to the second one, which permits a variety of partnership forms.[15]

Shirkatul amlak means joint ownership of two or more persons in a particular property. This kind of shirkah may come into existence in two different ways:

1. Voluntary (Ikhtiariyyah): At the option of the parties, for example, if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called "***Shirkatul-amlak Ikhtiari.***" Here this relationship has come into existence at their own option, voluntarily, as they themselves elected to purchase the equipment jointly.
2. Involuntary (Jabriyyah): This comes into operation automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

Shirkatul 'uqud is the second type of shirkah, which means, "a partnership effected by a mutual contract." For the purpose of conciseness it may also be translated as "joint commercial enterprise." ***Shirkatul 'uqud*** is broadly divided into two types:

1. ***Shirkat al-mufawada:*** (Capital and labor at par): All partners share capital, management, profit, and risk in absolute equals. It is a necessary condition for all four categories to be shared among all the partners; if any one category is not shared, then the partnership

becomes Shirkat-ul-Ainan. Every partner who shares equally is a Trustee, Guarantor, and Agent on behalf of the other partners.

2. ***Shirkatul-inan*** A more common type of shirkat-ul-aqd where equality in capital, management, or liability might be equal in one case but not in all respects, meaning either profit is equal, but not labor, or vice versa.

Mini–Case Study

Sukuk al-Musharakah was the most popular sukuk structure among corporate issuers in the years 2006 and 2007. However, in early 2008, AAOIFI clarified the prohibition of the use of nominal value purchase undertakings in musharakah and mudharabah sukuk structures. The AAOIFI ruling confirmed that, while it is permissible in a sukuk al ijara for the lessee to agree to purchase the sukuk assets at nominal value upon redemption, it is not permissible for a ***sharik*** (partner) in a sukuk al musharaka or a ***wakil*** (agent) in a sukuk al wakala bil istithmar to undertake to do so. The Shariah considers such undertakings to effective guarantees of principal, which are not permitted by Shariah in partnership and agency contracts. The AAOIFI ruling created a significant impact in the issuance of sukuk al musharaka and sukuk al mudaraba. There was a marked slowdown in the issuance of musharaka and mudaraba sukuk compared to other structures in 2008 and 2009. Sukuk al ijarah, with its leasing structure, gained prominence and was used by a large number of issuers; the ease of asset backing with this structure also contributed to its popularity (Figure 5.3).

An example for sukuk al-musharakah is WCT Engineering Berhad Redeemable Sukuk Musharakah with Detachable Warrants (WCT Sukuk). The principal activities of the Company are civil engineering works specialising in earthworks, construction of highways, buildings and related infrastructure works, investment and property holding, and provision of management services to the subsidiaries. WCT has successfully ventured abroad and established a growing presence in the Middle East. Major projects involving WCT include constructing F1, an international racing circuit in Sepang Malaysia and Bahrain; Kuala Lumpur International Airport (KLIA); a hydroelectric dam; township planning and development; commercial property development and management; and an expressway and highway in West Bengal, India, and Dukan Highway in Qatar.

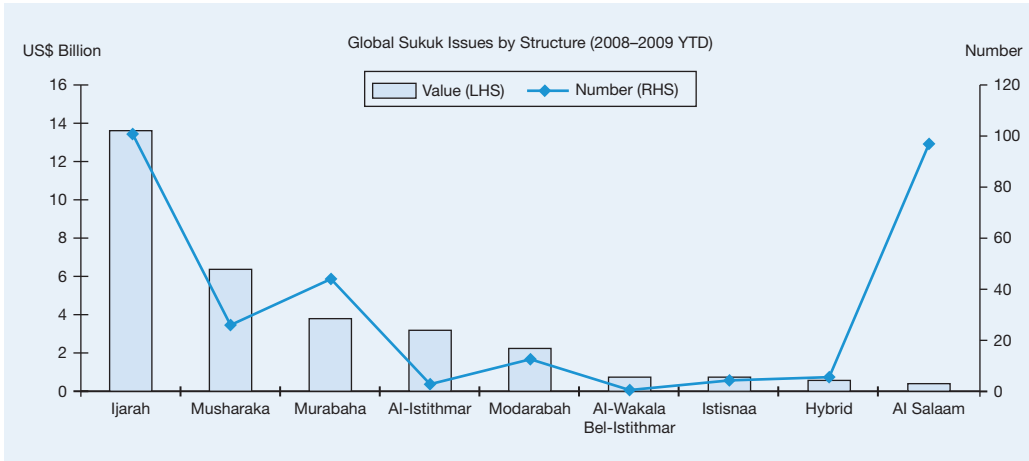
In order to develop their core business and spread it to other countries, WCT Engineering has issued a redeemable sukuk using musharakah structure in 2008 and used Pacific Trustees Berhad as its SPV. The term sheet is presented in Table 5.4.

The General Structure of Sukuk al-Musharakah

The following 12 explanations of the structure are offered by DIFC:

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset, transaction, or project. They also represent a right against

FIGURE 5.3 Sukuk Issued Globally by Structure, 2008–2009 YTD



Source: Zawya Sukuk Report 2009.

TABLE 5.4 Term Sheet of WCT Engineering Sukuk

Country	Malaysia
Sukuk name	WCT Engineering Berhad Redeemable Sukuk Musharakah with Detachable Warrants
Trustee	Pacific Trustees Berhad
Primary subscriber	Aseam bankers (for RM300 million nominal value)
Principal activities of issuer	To facilitate the issuance of the RM300 million sukuk
Originator (obligor) name	WCT Engineering Berhad
Principal activities of originator	Civil engineering works, investment, and property holding
Date of issue	March 26, 2008
Issue size	RM300 million
Tenor (years)	5 years
Issue price	Issued at discount and redemption at nominal value
Listing status	Listed on Bursa Malaysia
Sukuk structure	Musharakah
Rating	AA
Profit/coupon	2 percent per annum
Profit/coupon payment frequency	Semiannual payments
Underlying assets	A pool of syariah compliant assets identified for the purpose of the Sukuk program. Such assets are to be endorsed by the Shariah advisers.
Purpose of issue	Working capital and/or future investments relating to the core business activities (RM298.1 million) Defraying expenses relating to the issue (RM1.9 million)

FIGURE 5.4 Sukuk Structure of WCT Engineering Berhad

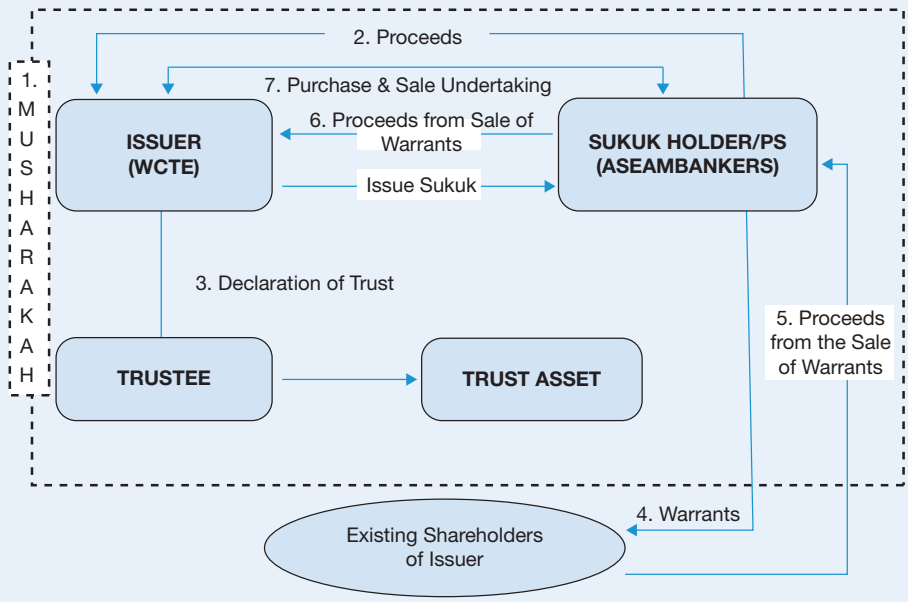
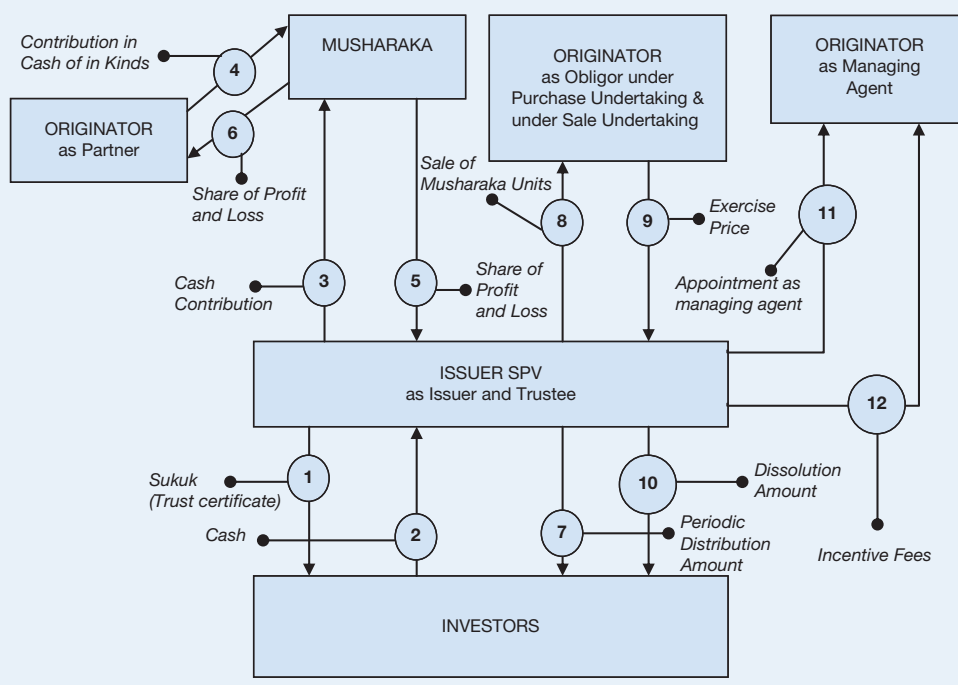


FIGURE 5.5 Sukuk al-Musharakah Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 21.

Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
3. Trustee enters into a musharaka arrangement with Originator, pursuant to which Trustee contributes the proceeds from the issuance of the sukuk into the musharaka and is allocated a number of units in the musharaka in proportion to its capital contribution.
4. Originator enters into a musharaka arrangement with Trustee, pursuant to which Originator makes a contribution in cash or in kind into the musharaka and is allocated a number of units in the musharaka in proportion to its capital contribution to the musharaka. The contributions by the Trustee and the Originator collectively form the musharaka assets (the "Musharaka Assets").
5. On each periodic distribution date Trustee shall receive a pre-agreed percentage share of the expected profits generated by the Musharaka Assets and, where the Musharaka Assets generate a loss, Trustee shall share that loss in proportion with its capital contribution to the musharaka. Trustee's share of profits will typically be a percentage high enough to at least equal the Periodic Distribution Amounts payable under the sukuk.
6. On each periodic distribution date Originator shall receive a pre-agreed percentage share of profits generated by the Musharaka Assets and, where the Musharaka Assets generate a loss, Originator shall share that loss in proportion with its capital contribution.
7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the profit it has received from the Musharaka Assets.
8. Upon:
   a. An event of default or at maturity (at the option of Trustee under the Purchase Undertaking).
   b. The exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking).

   Trustee will sell, and Originator will buy, all of Trustee's units in the musharaka at the applicable Exercise Price, which will be an amount equal to the Trustee's share in the fair market value of the Musharaka Assets at the time of sale. The Exercise Price will be used to pay the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.
9. Payment of Exercise Price by Originator (as Obligor).
10. Issuer SPV pays the Dissolution Amounts to the Investors using the Exercise Price it has received from the Originator.
11. Trustee and Originator will enter into a management agreement whereby Trustee shall appoint Originator as Managing Agent to manage the musharaka in accordance with an agreed-on business plan. To the extent that the profit received by

Trustee in any period is greater than the Periodic Distribution Amounts for that period, the Managing Agent shall be entitled to such excess as an advance performance fee. Under Shariah, all payments made under the musharaka are deemed to be "on account" and will be adjusted on the musharaka end date to reflect the actual and final profits/losses of the musharaka.

12. As a result of this, any excess profit paid to the Managing Agent is considered to be an advance performance fee that is refundable at all times until the musharaka end date. Typically, in the event that on any periodic distribution date there is a shortfall between the profit received by Trustee and the Periodic Distribution Amount then due, Managing Agent will be obliged to return such advance performance fees to remedy the shortfall. However, on the musharaka end date, any advance performance fees not required to be returned can be conclusively retained by the Managing Agent.

Documents Required for Sukuk al-Musharakah Issuance[16]

1. Document	:	Musharakah Agreement
Parties	:	Originator (partner) and Trustee/SPV (partner)
Purpose(s)	:	**a.** For the Originator, this is the document under which it receives funding.
		b. For trustee, this is the document that gives ownership in the Musharaka Assets and share of revenue generated by the Assets.
2. Document	:	Management Agreement
Parties	:	Originator (Managing Agent) and Trustee (Partner)
Purpose(s)	:	**a.** For the Originator, it gives right to use the Assets in accordance with the agreed-on business plan.
		b. For the Trustee, it allows them to appoint the Originator to manage the Assets in accordance with the agreed-on business plan.
3. Document	:	Sale and Purchase Undertaking (Wa'd)
Parties	:	Originator (Obligor) and Trustee (on behalf of investors)
Purpose(s)	:	**a.** For the Originator, it allows originator to buy back the share of Trustee upon the musharakah Assets at maturity.
		b. For the Trustee, it allows them to sell the share upon the musharakah Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Key Features of Sukuk al-Musharakah Structure

1. The Managing agent must operate the musharakah business according to the agreed-on business plan and comply with Shariah principles.

2. The ratio of the profit must be agreed upon before the contract concluded. While the losses are shared according to the share ratio upon the musharakah assets, it is not compulsory for the profit ratio to follow the share proportion of the musharakah assets.
3. On termination of the sukuk al-musharakah, all tangible (minimum 33.33 percent of the assets) and intangible assets must be liquidated and distributed between the originators and investors in proportion to the contributed capital.
4. Since the certificate holders become the owners of the project or the assets of the activity as per their respective shares, Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

Sukuk al-Mudarabah

In a ***mudarabah*** (silent partnership) contract, the owner of capital gives it to a worker to trade on their behalf, and profits generated from that trade are shared according to an agreed-on proportion. All financial losses are borne by the capital provider (***rabbul maal***/the silent partner) while the entrepreneur (***mudarib***) can only lose his effort.

This definition highlights two important distinctions between mudarabah and other types of partnerships:

1. It is not valid to establish mudarabah partnership where the provided capital takes the form of a usufruct[17] or a debt on the entrepreneur or somebody else. The silent partner must give capital to the entrepreneur to establish the silent partnership.
2. The profit-sharing arrangement establishes the difference between a silent partnership and an agency (***wakala***).

In mudarabah, the silent partner (rabbul maal) deserves his share of profits as compensation for the use of his capital while the entrepreneur (mudarib) deserves his share as a compensation for his effort. If it is specified that all the profits go to the silent partner (rabbul maal), then it is not mudarabah but mubada'a whereby the worker voluntarily works on behalf of the rabbul maal. At the other extreme, if it stipulated that all the profits go to the entrepreneur, then the contract is qard (loan).

There are two types of mudarabah:

1. Unrestricted mudarabah: The rabbul maal gives capital to the entrepreneur while specifying only the profit sharing rules and leaves unspecified the details of time, place, and so forth.
2. Restricted mudarabah: The rabbul maal specifies in detail a list of conditions relating to the work, its time, place, and so forth.

While the Hanafis and Hanbalis permitted the specification of a time-framework, places, and so forth for the work to be done, the Malikis and Shafiis required all silent mudarabah to be

fully unrestricted. The Malikis and Shafiis argue that if a period were indeed specified, then if the entrepreneur fails to complete a trade within the time period, the contract is deemed defective.[18]

Contemporary corporations can be viewed as variations of mudarabah. In a modern joint liability company, the partners share in capital ownership, while some of them work as active partners working on behalf of the silent partners. The similar situation is for joint stock Company, where the stockholders are considered silent partners, and the company works on their behalf.

Mini–Case Study

Mudarabah is among the most popular contracts in Islamic finance. In Islamic banking, mudarabah is used for both liabilities and assets. However, many reasons offered by bankers for not using mudarabah contracts in a large volume center on the asset side, and therefore mudarabah is mostly used on the liability side as a method for banks to secure a source of funds.

Nowadays, mudarabah is also adapted for use as the underlying structure in a sukuk issuance. In sukuk al-mudarabah, each share of sukuk purchased by the investor shall represent units of equal value in the mudarabah capital and are registered in the names of the sukuk certificate holders on the basis of undivided ownership of shares in the mudaraba capital. The returns to the Investors would represent accrued profit from the mudaraba capital at a pre-agreed ratio between the Rab al-Maal and the Mudarib, which would then pass to the Investors, according to each Investor's percentage of investments in sukuk mudaraba. According to Zawya Sukuk Monitor,[19] in 2006, sukuk al-mudarabah structure was the third largest sukuk issuance in global business, valued around US$3.41 billion.

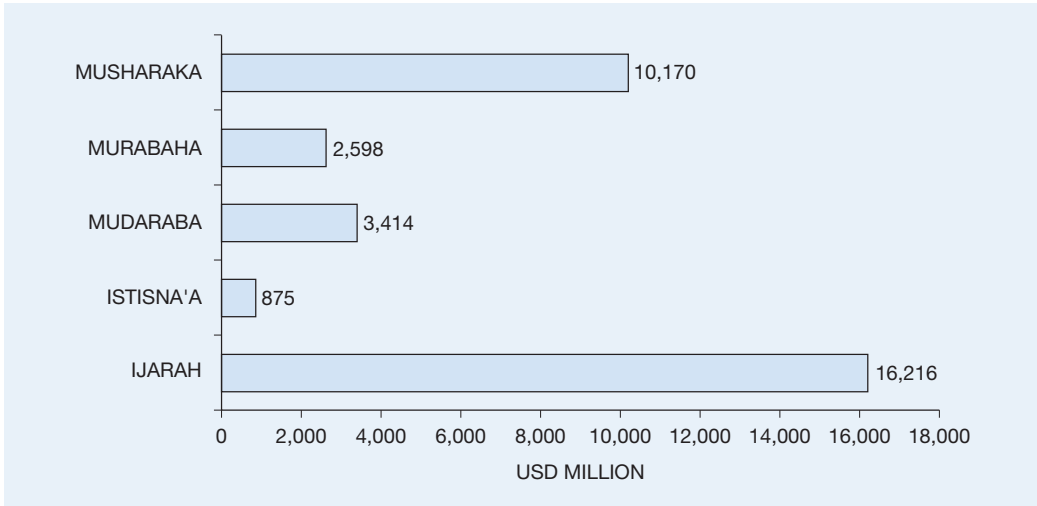
An example for sukuk al-mudarabah is sukuk issued by the International Investment Group (IIG). IIG is a Shariah-compliant investment company licensed by the central bank of Kuwait. It has a broad range of business activities including real estate project industry, energy and oil industry, services sector, insurance, and so on. IIG also acts as a strategic advisor to its associate companies, carries on an asset management business, and provides corporate finance services.

The General Structure of Sukuk al-Mudharabah

The following nine explanations of the structure are from DIFC:

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset, transaction, or project. They also represent a right against Issuer SPV to payment of expected periodic return from Mudaraba profits.
2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets or Mudaraba interests acquired using the proceeds) and thereby acts as Trustee on behalf of the Investors.
3. Issuer SPV and Originator enter into a Mudaraba Agreement with Originator as Mudarib and Issuer SPV as Rab al-Maal, under which Issuer SPV agrees to

FIGURE 5.6 Composition of Sukuk Market 2007

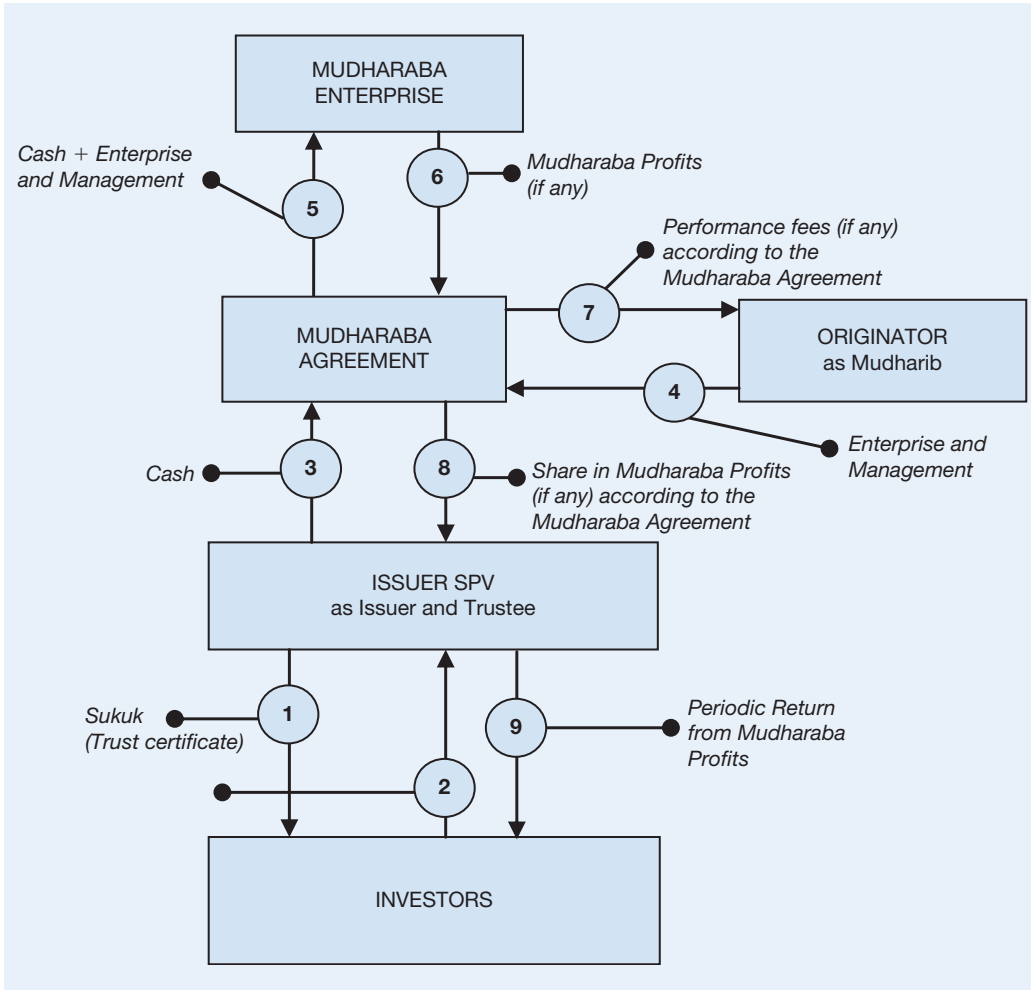


Source: Zawya, *Sukuk Monitor*, April 2007.

TABLE 5.5 Term Sheet of IIG Sukuk al-Mudharabah

Country	Kuwait
Sukuk name	IIG Sukuk al-Mudarabah
Trustee	IIG Funding Limited The issuer will act as trustee in respect of the trust assets for the benefit of certificate holders.
Originator (obligor) name	IIG Funding Limited
Principal activities of originator	Real estate project industry, energy and oil industry, services sector, insurance, and so on.
Date of issue	June 6, 2007
Issue size	U.S. $200,000,000.00
Tenor (Years)	5 years
Issue price	100 percent of the aggregate face amount of the certificate
Listing status	Listed on Dubai International Financial Exchange and the Professional Securities Market of the London Stock Exchange.
Sukuk structure	Mudarabah
Rating	N/A
Profit/coupon	6.75 percent per annum
Profit/coupon payment frequency	Quarterly payments (January, April, July, October)
Underlying assets	A pool of Shariah-compliant assets identified for the purpose of the Sukuk program.
Purpose of issue	Capital of the mudarabah to be invested by the mudarib in accordance with the investment plan and the terms of mudarabah.

FIGURE 5.7 Sukuk al-Mudharabah Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 29.

contribute the Principal Amount for the purpose of a Shari'a-compliant Mudaraba enterprise.

4. Originator, as Mudarib under the Mudaraba Agreement, agrees to contribute its expertise and management skills to the Shari'a-compliant Mudaraba enterprise, with responsibility for managing the rab al-maal's cash contribution in accordance with specified investment parameters.
5. Issuer SPV and Originator enter into the Mudaraba enterprise with the purpose of generating profit on the Principal Amount.
6. Profits generated by the Mudaraba enterprise are divided between Issuer SPV (as Rab al-Maal) and Originator (as Mudarib) in accordance with the profit

sharing ratios set out in the Mudaraba Agreement but accrued for the duration of the Mudaraba enterprise.

7. In addition to its profit share, Originator (as Mudarib) may be entitled to a performance fee for providing its expertise and management skills if the profit generated by the Mudaraba enterprise exceeds a benchmarked return. This performance fee (if any) would be calculated at the end of the Mudaraba term and upon liquidation of the Mudaraba.
8. Issuer SPV receives the Mudaraba profits and holds them as Trustee on behalf of the Investors.
9. Issuer SPV (as Trustee) pays each periodic return to Investors using the Mudaraba profits it has received under the Mudaraba Agreement. (DIFC 2009, pp. 29–30)

Documents Required for Sukuk al-Mudarabah Structure[20]

1. Document	:	Mudarabah Agreement
Parties	:	Originator (Mudarib) and Trustee/SPV (Rabb al-Maal)
Purpose(s)	:	**a.** For originator, this is the document under which it receives funding and agreed-on profit sharing.
		b. For trustee, this is the document under which they should invest the principal amount and have the right upon the agreed-on profit sharing ratio.
2. Document	:	Sale and Purchase Undertaking (Wa'd)
Parties	:	Originator (Obligor) and Trustee (on behalf of investors)
Purpose(s)	:	**a.** For originator, it allows originator to buy back the mudarabah Assets at maturity.
		b. For trustee, it allows them to sell the mudarabah Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Key Features of Sukuk al-Mudarabah

1. The underlying contract is the mudarabah muqayadah or restricted mudarabah in which the investment plan must be specified and obeyed and for Shariah purposes the investment must be at least 33.33 percent in tangible assets.
2. Profit sharing ratio must be agreed upon before the mudarabah agreement is concluded. Meanwhile, any losses would be borne only by the sukuk holders.
3. The wa'ad or purchase undertaking granted by originator under undesired situations will mitigate the risk of transferring any losses to investors.
4. On the maturity of the Sukuk, the Sukuk holders are given the right to transfer the ownership by selling it back to the originator at his discretion.

Sukuk al-Salam

Generally, the Shariah will validate the sale contract if the object forming the subject matter of the sale is in existence and in the physical or constructive possession of the seller. However, there are exceptions for this general requirement. The exceptions are sales affected pursuant to salam and istisna' contracts.

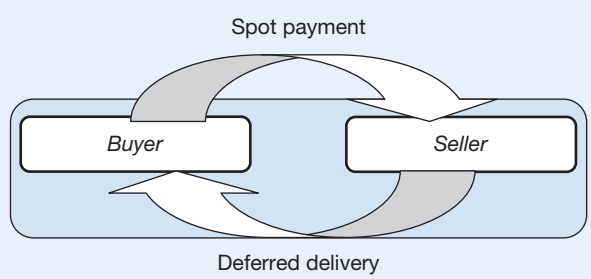
Salam is a contract in which the buyer pays the price in advance while the goods will be delivered by the future-specific date by the seller. It is necessary that the quality and all measures of the goods is fully specified and explicitly mentioned so that it will not leave ambiguity, which can lead to dispute among the parties transacted (see Figure 5.8).

Mini–Case Study

There are very limited numbers of salam contract-based sukuk in the sukuk market. It is an underused instrument in the sukuk market. The Sukuk al-Salam series that was introduced in 2001 by the Central Bank of Bahrain (CBB) continues to operate without attracting the attention from others that it deserves. Every month, the CBB issues an Islamically structured short-term government bill for $40 million. When the series started, the amount was $25 million per month. Allowing for redemptions, a simple calculation would give the CBB $120 million per year and would provide a short-term investment opportunity for Islamic financial institutions.

CBB has chosen aluminium as the underlying asset for a sukuk al-salam that will be sold to the buyer. Following the salam contract, as consideration for the advance payment, the government of Bahrain undertakes to supply a specified amount of aluminum at a future date. On behalf of the government, the CBB securitises the sale by issuing sukuk al salam. These are purchased by Islamic financial houses as a means of parking their excess liquidity. The purchaser then appoints the government as an agent to sell the aluminium at the time of delivery through its distribution channels at a price that will yield a return equivalent to that available to salam sukuk holders through other conventional short-term money market instruments.

FIGURE 5.8 The Structure of Salam Contract

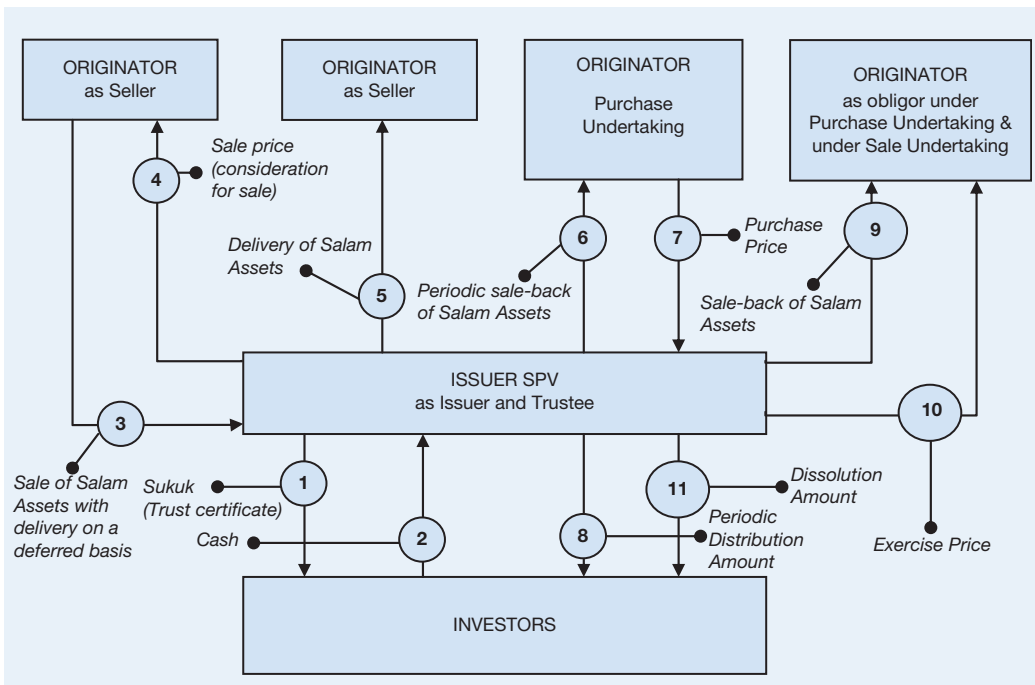


The General Structure of al-Salam Sukuk

The following 11 explanations of the structure are given by DIFC:

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in certain assets (the "Salam Assets") to be delivered by the Originator. They also represent a right against the Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.
2. The Investors subscribe for sukuk and pay the proceeds to the Issuer SPV (the "Principal Amount"). The Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
3. Originator enters into a sale and purchase arrangement with the Trustee, pursuant to which the Originator agrees to sell, and the Trustee agrees to purchase, the Salam Assets from the Originator on immediate payment and deferred delivery terms. The quantity of the Salam Assets sold will typically be engineered at the outset to be an amount that is sufficient to make periodic deliveries of a proportion of the Salam Assets during the life of the sukuk (in order to allow for payments of Periodic Distribution Amounts, see below for further information) and to make a single delivery of the remaining proportion of Salam Assets on maturity or an early redemption of the sukuk (in order to allow for payments of the Exercise Price, see below for further information).

FIGURE 5.9 Sukuk al-Salam Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 35.

4. The Trustee pays the sale price to the Originator as consideration for its purchase of the Salam Assets in an amount equal to the Principal Amount.
5. Prior to each date on which the Periodic Distribution Amounts are due to the Investors, the Originator delivers a proportion of the Salam Assets to Trustee.
6. The Originator (as Obligor) purchases a proportion of the Salam Assets from the Trustee for an agreed-on Purchase Price.
7. The Originator pays the Purchase Price as consideration for purchasing a proportion of the Salam Assets. The amount of each Purchase Price is equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount will be calculated by reference to a fixed rate or variable rate (e.g., LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.
8. The Issuer SPV pays each Periodic Distribution Amount to the Investors using the Purchase Price it has received from the Originator.
9. Upon:
   a. An event of default or at maturity (at the option of the Trustee under the Purchase Undertaking).
   b. The exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of the Originator under the Sale Undertaking).

   The Originator will be obliged to deliver all of the Salam Assets (which have not yet been delivered) to the Trustee and the Trustee will sell, and the Originator will buy, the Salam Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.
10. Payment of Exercise Price by the Originator (as Obligor).
11. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from the Originator. (DIFC 2009, 35–36)

Documents Required for Sukuk al-Salam[21]

1. Document : Salam Agreement
Parties : Originator (Seller) and Trustee/SPV (Purchaser)
Purpose(s) :
- **a.** For the Originator, this is the document under which it receives funding.
- **b.** For the Trustee, this is the document that gives right to receive the delivery of the Salam assets. Once the asset is received, it will directly be sold to generate revenue to service the sukuk.

2. Document : Sale and Purchase Undertaking (Wa'd)
Parties : Originator (Obligor) and Trustee (on behalf of investors)
Purpose(s) :
- **a.** For the Originator, it allows the originator to buy back the Salam Assets at maturity.
- **b.** For the Trustee, it allows them to sell the Salam Assets back to the Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Key Features of Sukuk al-Salam

1. The Salam assets must be assets for which a specification can be drawn up at the time of sale so that the Originator can be held to that specification.
2. The quality, quantity, and time of delivery of the Salam Assets must be clearly known by both parties to remove any uncertainty or ambiguity.
3. The sale of the Salam Assets from the trustee to the Originator can only be done after the Originator has delivered the Salam Assets to the Trustee.

Sukuk al-Istisna

The Arabic term ***istisna*** means requesting a ***san'ah***. San'ah refers to the work of a small- or large-scale manufacturing worker. In general, Shariah jurists use the term ***istisna*** to refer to the request of manufacturing a specific item in a specific form. Therefore, istisna is a contract commissioning a worker to manufacture an item that is defined as a liability on him.

Salam and istisna contracts are evidence that Islam is not, never was, and never will be a heavy burden on people in terms of their economic and contractual freedom. The permission of these contracts was explicitly inferred by jurists to make it easier for people to meet their lawful economic needs without imposing unnecessary hardship.

Mini–Case Study

Istisna evolved into Islamic jurisprudence historically due to specific needs in the areas of manual work in the areas of leather products, shoes, carpentry, and so forth. However, it has grown in the modern era as one of the contracts that make it possible to fulfil major infrastructure and industrial projects such as the building of ships, airplanes, and various large machines. Accordingly, the prominence of the commission manufacture contract has increased with the scope of the financed projects.

In the world of sukuk, an istisna contract is among the five most popular contracts. MRCB's Senior and Junior Sukuk Istisna and Makro Utama's Sukuk are among the sukuk formed under the istisna contract. The former issues RM840 million nominal value for Senior sukuk and RM199 million for Junior sukuk, with the payment schedule on a semi-annual basis. Meanwhile, the latter issues up to RM100 million nominal value with variety of tenor from two to four years.

The General Structure of al-Istisna Sukuk

The following 12 explanations of the structure are offered by DIFC:

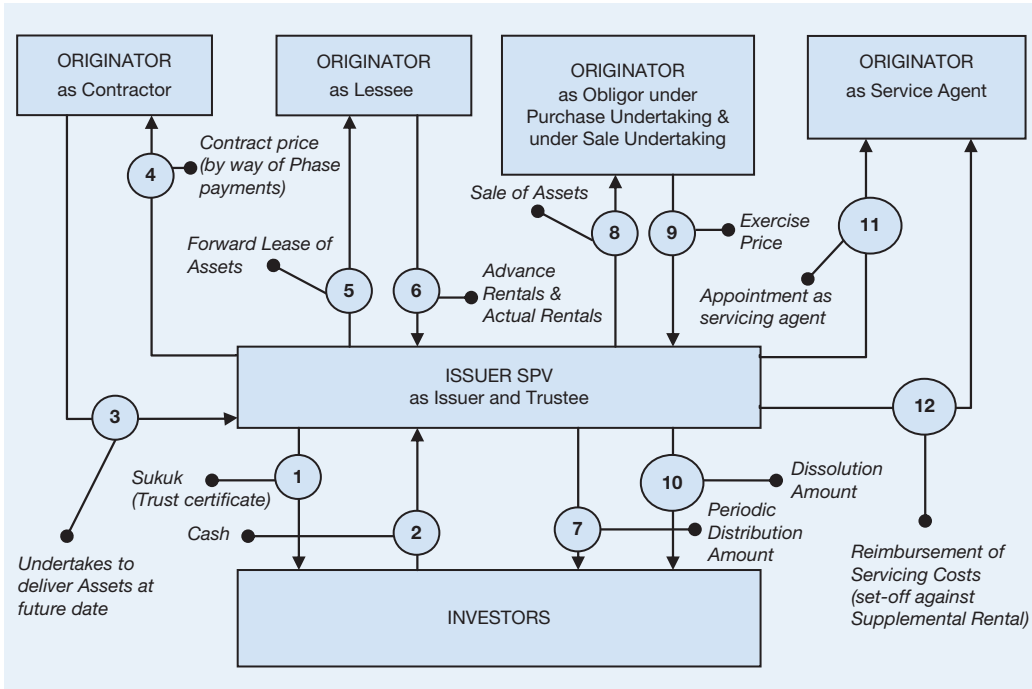
1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

TABLE 5.6 Term Sheet of MRCB and Makro Utama Sukuk

	MRCB's Sukuk	Makro Utama's Sukuk
Country	Malaysia	Malaysia
Sukuk name	MRCB's Senior and Junior Sukuk Istisna	Makro Utama's Sukuk
Trustee	CIMB Trustee	AmTrustee
Originator (obligor) name	MRCB Southern Link	Redmax (Makro Utama)
Principal activities of originator	To undertake the construction, development, design, project management, and financing of Eastern Dispersal Link.	Redmax is a construction and engineering company for a flood mitigation project in Sungai Muda, the Malaysian state of Kedah.
Date of issue	June 23, 2008	August 20, 2009
Issue size	RM840 million (US$256.6 million) for senior sukuk, and RM199 million (US$60.78 million) for junior sukuk.	RM100 million (US$28.3 million).
Tenor (years)	17 years for senior sukuk and 19 years for junior sukuk.	Two to four years.
Issue price	Istisna sukuk should be issued at par.	Istisna sukuk should be issued at par.
Listing status	Listed in KLSE	Listed in KLSE
Rating	AA3 for senior and A2 for junior	A+ID
Profit/coupon	Up to 8.35 percent per annum for senior, and up to 10.4 percent per annum for junior.	N/A
Profit/coupon payment frequency	Semiannual basis	N/A
Underlying assets	The Eastern Dispersal Link, Johor Bharu commencing at the new CIQ complex at Jalan Stulang and ending at the connection to the North-South Expressway.	Flood mitigation dam and buildings.
Purpose of issue	To repay MRCB's existing borrowings and other Shariah compliance expenses of the Expressway project.	To repay Redmax's existing borrowings and other Shariah compliance expenses of the flood mitigation project.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
3. Originator enters into an istisna arrangement with Trustee, pursuant to which Originator agrees to manufacture or construct certain assets (the "Assets") and undertakes to deliver those Assets at a future date, and Trustee agrees to commission those Assets for delivery at a future date.

FIGURE 5.10 Sukuk Istisna' Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 41.

4. Trustee pays a price (typically by way of staged payments against certain milestones) to Originator as consideration for the Assets in an aggregate amount equal to the Principal Amount.
5. Trustee undertakes to lease the Assets to Originator under a forward lease arrangement (known as ijara mawsufah fi al-dimmah) for an overall term that reflects the maturity of the sukuk.
6. Originator (as Lessee) makes payments of:
   a. Advance Rental prior to the delivery of the Assets
   b. Actual Rental following the delivery of the Assets at regular intervals to Trustee (as Lessor) in amounts which are equal to the Periodic Distribution Amount payable under the sukuk at that time. These amounts may be calculated by reference to a fixed rate or variable rate (e.g., LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.
7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Advance Rental or, as the case may be, the Actual Rental it has received from the Originator.

8. Provided that delivery of the Assets has occurred, upon:
   a. An event of default or at maturity (at the option of Trustee under the Purchase Undertaking)
   b. The exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking)
9. Payment of Exercise Price by Originator (as Obligor) or, if termination occurs prior to delivery of the Assets, payment of the Istisna Termination Payment by Originator (as Contractor).
10. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price (or, if termination occurs prior to delivery of the Assets, the Istisna Termination Payment) it has received from the Originator.
11. Trustee and Originator will enter into a service agency agreement whereby the Trustee will appoint the Originator as its Servicing Agent, on and from delivery of the Assets, to carry out certain obligations under the forward lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful), and payment of taxes in connection with the Assets.
12. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the "Servicing Costs") the Actual Rental for the subsequent lease period under the forward lease arrangement will be increased by an equivalent amount (a "Supplemental Rental"). This Supplemental Rental due from the Originator (as Lessee) will be set off against the obligation of the Trustee to pay the Servicing Costs. (DIFC 2009, 41–43)

Documents Required for Sukuk al-Istisna' Structure[22]

1. Document : Istisna' Agreement
   Parties : Originator (Contractor) and Trustee/SPV (Purchaser)
   Purpose(s) : **a.** For originator, this is the document under which it receives funding.
   b. For trustee, this is the document that gives ownership of a revenue generating assets at a future date.
2. Document : Forward Lease Agreement (Ijarah Mawsufah fi al-Dimmah)
   Parties : Originator (Lessee) and Trustee (Lessor)
   Purpose(s) : **a.** For originator, it allows originator to pay the rentals prior to delivery of the Assets and to lease the Assets following the delivery of the Assets.
   b. For trustee, it allows them to receive a debt-based return generated from actual rentals.
3. Document : Service Agency Agreement
   Parties : Originator (Servicing Agent) and Trustee (Lessor)

Purpose(s) : **a.** For originator, it gives an opportunity to set off any additional amount, which is added to exercise price at maturity or any supplementary rental payment under ijara against service charges claimed.

b. For trustee, it allows them to pass the responsibility of major maintenance of the Assets back to the originator.

4. Document : Sale and Purchase Undertaking (Wa'd)

Parties : Originator (Obligor) and Trustee (on behalf of investors)

Purpose(s) : **a.** For originator, it allows originator to buy back the Istisna' Assets at maturity.

b. For trustee, it allows them to sell the Istisna' Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Key Features of Sukuk al-Istisna's Structure

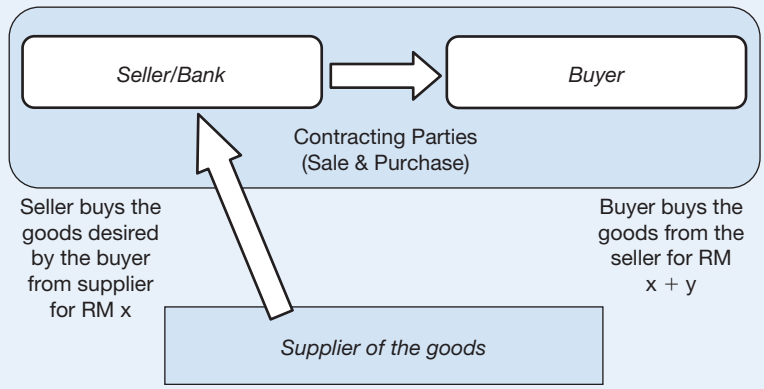
1. The price of the assets and delivery time should be specified and fixed at the outset.
2. Implementation of Forward Lease Agreement (*Ijarah Mawsufah fi al-Dimmah*): advance rentals are taken into account (as rental which has been paid) and have to be fully refunded if the assets never had been sent for leasing.
3. After the delivery of the assets, basic principles of an ijarah contract would be applied.
4. Shariah prohibits the sale of these debt certificates to a third party at any price other than their face value. Thus, it is very difficult to trade such certificates in the secondary markets.

Sukuk al-Murabahah

Murabaha is a cost-plus sale. It is a contract between a seller and a buyer under which the seller sells specific goods allowed by Shariah principles to the buyer at a cost-plus agreed-on profits payable in cash on the spot or by installment. It is a legally permissible contract by the testimony of the majority of jurist and companions of the Prophet Muhammad (p.b.u.h).

This type of sale satisfies all the legal requirements for sale, and it provides a valuable service in economic markets since it allows those knowledgeable of market conditions to make a profit and those without such knowledge to obtain the goods at a good price. However, there are some conditions that should be fulfilled so that the murabaha contract is valid. First, the buyer must know the price at which the seller obtained the object of sale. In this regard, the sale is considered defective if the initial price is not known during the contract session. Second, since the profit margin is a component of the price at which the buyer obtains the goods, knowledge of that margin is essential to be shared to the buyer. Third, the profit should be fixed and added to the cost price and be mentioned in the contract.

FIGURE 5.11 Murabah Contract Application in Islamic Banking



Mini–Case Study

Murabaha is used in the Islamic banking industry on the asset side as a fixed income producer for the bank. Although some people still think that this type of contract is similar to loan in conventional banking, jurists are in the consensus to accept this contract as a Shariah compliance contract. In sukuk world, murabaha contract based sukuk is not so many. As the sukuk certificates under this contract essentially represent entitlements to shares in receivables from the purchaser of the underlying murabaha, they are not negotiable instruments that can be traded on the secondary market except at par value. Shariah does not permit trading in debt. That is the way sukuk murabaha is less commonly used in comparison to some other sukuk structures.

CJ Capital Sukuk Murabaha is among the sukuk formed under the murabaha contract. It is a Malaysian based sukuk and targets investors based in Malaysia. The size of CJ Capital Sukuk Murabaha is RM114 million (US$37 million) and the proceeds from the issuance were utilised for payments to contractors and repayment of existing borrowings in relation to phase 1 of Kota Iskandar development in the Malaysian state of Johor.

The General Structure of al-Murabaha Sukuk

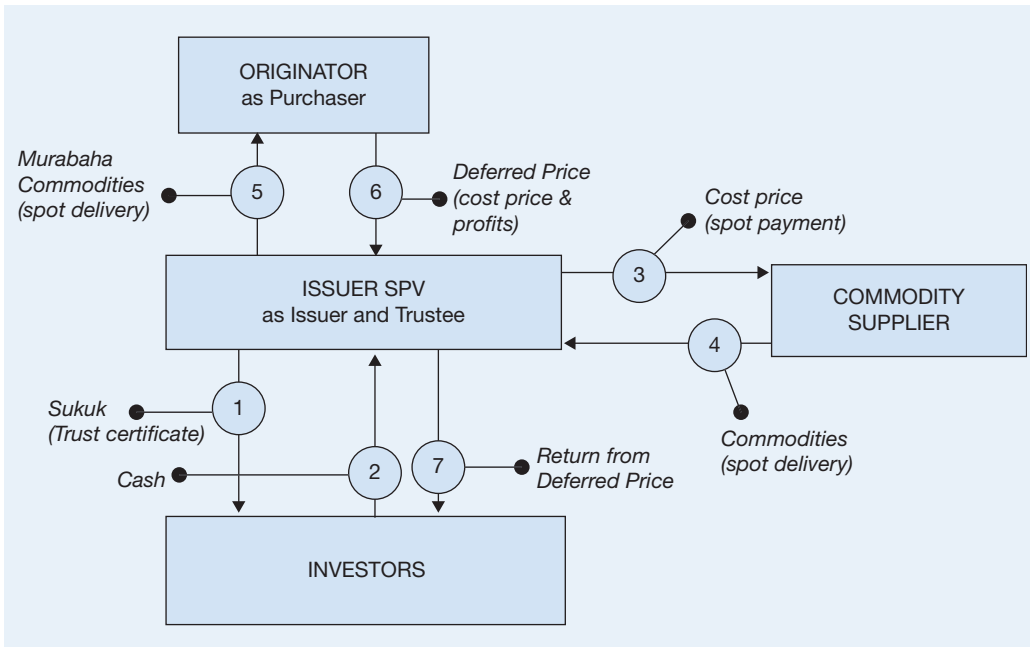
Explanation of the structure:

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Deferred Price.
2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.

TABLE 5.7 Term Sheet of CJ Capital Sukuk Murabaha

Country	Malaysia
Sukuk name	CJ Capital Sukuk Murabaha
Trustee	Equity Trust (Malaysia)
Obligor name	CJ Capital
Principal activities of originator	To undertake the construction, development, design, project management and financing of development of Kota Iskandar, Malaysian State of Johor.
Date of issue	July 15, 2010
Issue size	RM114 million (US$37 million)
Tenor (years)	10 years
Listing status	Listed in KLSE
Rating	AAA
Profit/coupon	3.3 to 5.54 percent per annum
Profit/coupon payment frequency	Annual basis
Purpose of issue	To repay existing borrowings and other Shariah compliance expenses of the project.

FIGURE 5.12 Sukuk al-Murabaha Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 47.

3. Originator (as Purchaser) enters into a murabaha agreement with Trustee (as Seller), pursuant to which Trustee agrees to sell, and Originator agrees to purchase, certain commodities (the "Commodities") from Trustee on spot delivery and deferred payment terms. The period for the payment of the deferred price will reflect the maturity of the sukuk. Trustee purchases the Commodities from a third party Commodity Supplier for a Cost Price representing the Principal Amount for spot payment.
4. Commodity Supplier makes spot delivery of the Commodities to Trustee in consideration for the Cost Price.
5. Trustee (as Seller) on-sells to Originator the Commodities upon delivery from Commodity Supplier in accordance with the terms of the murabaha agreement.
6. Originator (as Purchaser) makes payments of deferred price at regular intervals to Trustee (as Seller). The amount of each deferred price installment is equal to the returns payable under the sukuk at that time.
7. Issuer SPV pays each deferred price installment to the Investors using the proceeds it has received from Originator. (DIFC 2009, pp. 47–48)

Documents Required for Sukuk al-Murabaha Structure[23]

1. Document	:	Murabah Agreement
Parties	:	Originator (Purchaser) and Trustee/SPV (Seller)
Purpose(s)	:	**a.** For originator, this is the document under which it receives commodities with deferred payment. **b.** For trustee, this document explains about selling commodities to originator on spot delivery and deferred payment.
2. Document	:	Sale and Purchase Agreement
Parties	:	Trustee (Buyer) and Commodity supplier (Supplier)
Purpose(s)	:	Trustee buys commodities from commodity supplier on spot delivery and spot payment.

Key Features of Sukuk al-Murabaha Structure

1. The price of the commodities, delivery time, and deferment period should be specified and fixed at the outset.
2. The commodities can be delivered by the Trustee to the Originator after commodity supplier sent it to Trustee or using wakala agreement, whereas the commodities sent to the Originator as the buying agent of the Trustee and the Trustee are sold to the Originator as purchaser.
3. Tax liabilities from acquisition and sale of the commodities should be considered in the calculation of the principal amount in the cost price.

4. It is very difficult for Sukuk al-Murabahah to be traded at the secondary market since the certificates represent a debt owing from the subsequent buyer of the Commodity to the certificate-holders and such trading amounts to trading in debt on a deferred basis, which will result in riba. However, it is acceptable before sale of goods/commodity to the end buyer. Once the goods are sold, then trading in secondary markets is only accepted at par value.

Sukuk al-Istithmar

The term ***istithmar*** is broadly understood as "investment." However, it does not mean a particular contract. It can be a combination of contracts in one package. Under a sukuk al-istithmar structure it is possible for ijara contracts (and the relevant underlying assets), murabaha receivables, and/or istisna receivables (each generated by the originator), as well as shares and/or sukuk certificates to be packaged together and sold as an investment. The income generated by such investment can then be used to make payments to the investors under the sukuk.

Mini–Case Study

An example of sukuk al-istithmar is the Cagamas Sukuk Al-Amanah Li al-Istithmar or commonly known as Sukuk ALIm. Cagamas is the National Mortgage Corporation and among the leading securitisation house in Malaysia. The Sukuk ALIm structure is formed to comply with the Shariah standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Sukuk ALIm structure is a type of Sukuk Istithmar but precludes the principles of inah (sale and buyback), bai' dayn (trading of debt), and wa'ad (undertaking).

The General Structure of al-Istithmar Sukuk

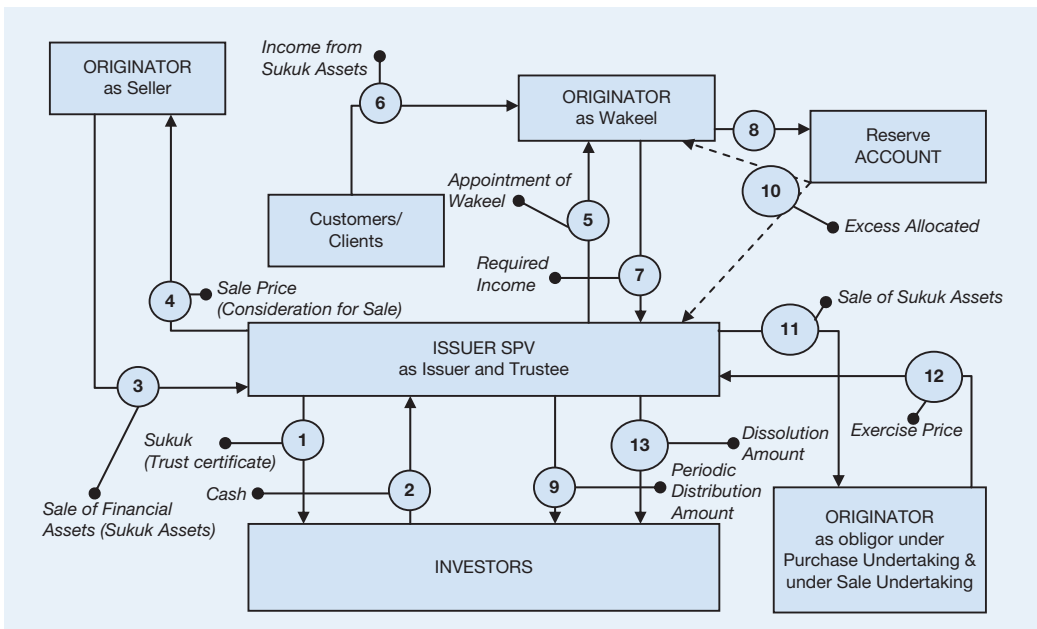
The following 13 explanations of the structure are offered by DIFC:

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.
2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors.
3. Originator enters into a sale and purchase arrangement with the Trustee, pursuant to which the Originator agrees to sell, and the Trustee agrees to purchase, a portfolio of certain financial assets (the "Sukuk Assets") from the Originator.

TABLE 5.8 Term Sheet of Cagamas Sukuk Al-Amanah Li al-Istithmar (ALIm)

Country	Malaysia
Sukuk name	Cagamas Sukuk Al-Amanah Li al-Istithmar (ALIm)
Trustee	Malaysian Trustees
Originator (obligor) name	Cagamas
Principal activities of originator	Purchase of mortgage loans and hire purchase and leasing debts from primary lenders and the issue of bonds and notes to finance the purchases. Cagamas also purchases Islamic financing facilities such as home financing, personal financing, and hire purchase financing, which are funded by issuance of sukuk.
Date of issue	August 19, 2010
Issue size	RM1 billion (US$319 million)
Tenor (Years)	3 years
Listing status	Listed in KLSE
Rating	AAA
Profit/coupon	3.48 percent
Profit/coupon payment frequency	Semiannual basis
Purpose of issue	Working capital and for general corporate Shariah compliance purposes.

FIGURE 5.13 Sukuk al-Istithmar Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 52.

4. Trustee pays the purchase price to the Originator as consideration for its purchase of the Sukuk Assets in an amount equal to the Principal Amount.
5. The Trustee appoints the Originator as its wakeel (or agent) with respect to the Sukuk Assets for a term that reflects the maturity of the sukuk. Originator is responsible for servicing the Sukuk Assets and, in particular, collection of the income (comprising principal and profit) therefrom.
6. Originator collects income in respect of the Sukuk Assets from the relevant customers/clients and will deposit these amounts into a collection account (the "Collection Account").
7. At regular intervals, corresponding to Periodic Distribution Dates, Originator will be required to make income payments to Trustee in respect of the Sukuk Assets. This will be achieved through a target amount (the "Required Income"), which is agreed upon for each collection period. The amount of Required Income during a collection period will be equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g., LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.
8. During a particular collection period, if the income amount collected in respect of the Sukuk Assets (as reflected in the Collection Account) is in excess of the Required Income such excess can either be:
   a. Credited to a reserve account (the "Reserve Account") with Originator; or
   b. In a case where a financial asset has matured (and principal therefrom has been repaid by the customer/client), and in order to avoid excess cash in the structure, used to purchase additional financial assets under the purchase arrangement referred to in number 3 above (and which will then become Sukuk Assets).

   The balance in the Reserve Account (if any) can also be used to cover a shortfall in collections to meet the Required Income in any given collection period. In the event that there is a shortfall in both collections and the Reserve Account, it may be permissible for Originator to make an on-account payment or to provide Shariah-compliant liquidity funding to bridge any gap in funding.
9. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Required Income it has received from the Originator.
10. Upon redemption of the sukuk, the balance of the Reserve Account (if any) will be paid (being the "Distributed Reserve Amount") to Trustee in order to enable the payment of the Dissolution Amount to the Investors. The excess (if any) will be retained by Originator as incentive fees.
11. Upon:
    a. An event of default or at maturity (at the option of Trustee under the Purchase Undertaking).

b. The exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking).

The Trustee will sell, and the Originator will purchase, the Sukuk Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors less the Distributed Reserve Amount (if any)

12. Payment of Exercise Price by Originator (as Obligor).
13. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price and the Distributed Reserve Amount (if any) it has received from Originator. (DIFC 2009, pp. 52–54)

Documents Required for Sukuk al-Istithmar Structure[24]

1. Document	:	Sale and Purchase Agreement
Parties	:	Originator (Seller) and Trustee/SPV (Purchaser)
Purpose(s)	:	**a.** For originator, this is the document under which it receives funding.
		b. For trustee, this is the document that gives ownership of a revenue generating financial assets.
2. Document	:	Wakala Agreement
Parties	:	Originator (Wakeel) and Trustee (Principal)
Purpose(s)	:	**a.** For originator, it allows originator to control the sukuk assets so that its principal business can continue without any interruption.
		b. For trustee, it allows them to receive a return from the business.
3. Document	:	Sale and Purchase Undertaking (Wa'd)
Parties	:	Originator (Obligor) and Trustee (on behalf of investors)
Purpose(s)	:	**a.** For originator, it allows originator to buy back the Istithmar Assets at maturity.
		b. For trustee, it allows them to sell the Istithmar Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Key Features of Sukuk al-Istithmar Structure

1. The principal amount from underlying financial assets should never be used to service coupon payments under the sukuk.
2. The clients to whom the financial assets (sukuk assets) are related should be informed about the sale of those financial assets to the Investors. The Originator is only a wakeel and acting on behalf of the Trustee/Investors.
3. Sometimes it is necessary to use a custodian to ensure that the sukuk assets are properly segregated from the other financial assets of the Originator.

Sukuk al-Wakala

The term "wakalah" literally means "preservation." It is also used to mean delegation of one's affairs to another. Hanafi scholars had defined wakalah legally as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing. In this regard, the agent (wakil) deals in other's property and preserves it. Dealings that are permissible for agency contracts include financial dealings such as trading, and also many other actions that allow for legal representation.

Mini–Case Study

One example of sukuk al-wakala is Dar Al Arkan Sukuk Wakalah in Saudi Arabia and was the first sukuk done within the Middle East after the Dubai Nakheel Sukuk debacle in late 2009. Dar al-Arkan Real Estate Development Company (DAAR) is the guarantor of this sukuk, which is issued by its SPV, Dar Al Arkan International Sukuk Company II. DAAR can be said to be the largest real estate developer in Saudi Arabia and was incorporated in the year of 1994 in Riyadh. Its main activities are to purchase underdeveloped land and develop infrastructure for residential projects, like construction of housing units catering primarily to the middle market segment in Saudi Arabia.

TABLE 5.9 Term Sheet of Dar Al Arkan Sukuk Wakalah

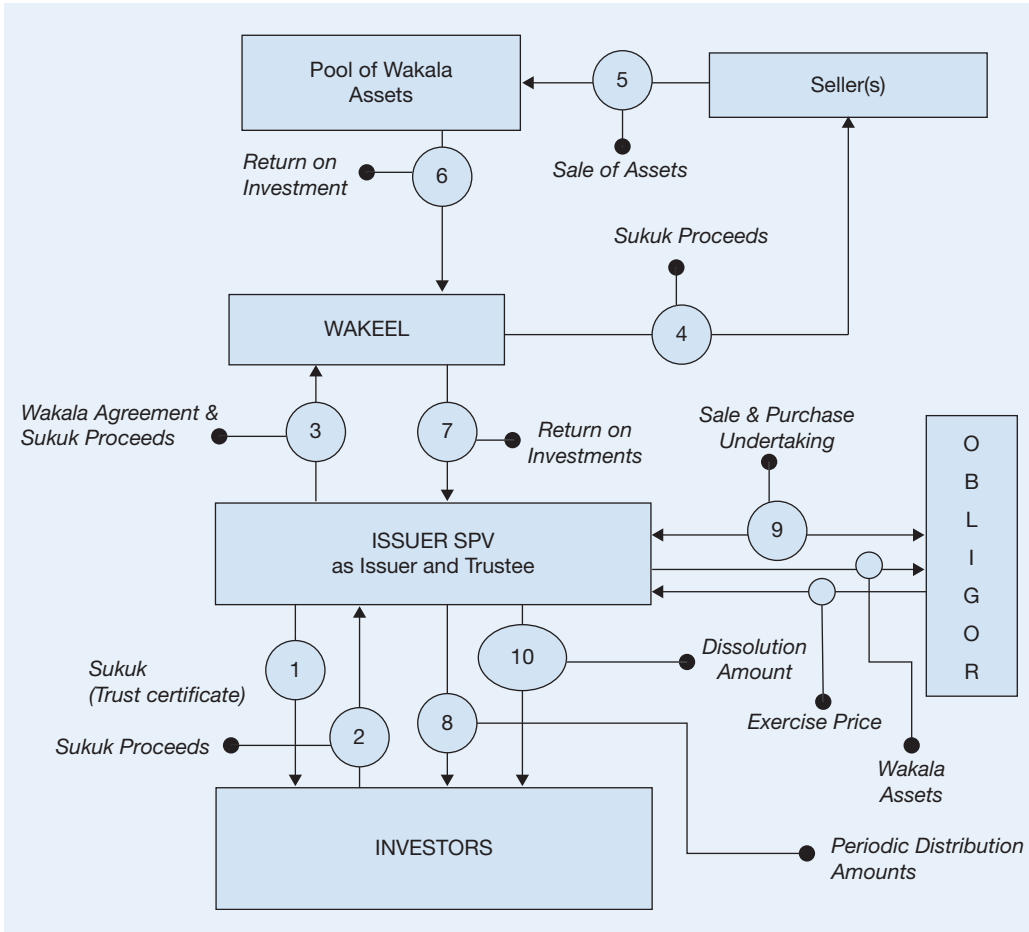
Country	Kingdom of Saudi Arabia (KSA)
Sukuk name	Dar Al Arkan Sukuk Wakalah
Trustee	Dar Al Arkan International Sukuk Company
Originator (obligor) name	Dar Al Arkan International Sukuk Company II
Principal activities of originator	Developers of real estate in KSA
Date of issue	February 11, 2010
Issue size	US$450 million
Tenor (years)	5 years
Listing status	Listed in London Stock Exchange
Rating	Ba2/BB by Moody's and S&P
Profit/coupon	10.75 percent per annum
Profit/coupon payment frequency	Annual basis
Purpose of issue	Sukuk proceeds will be invested in a portfolio of Ijarah agreements and Murabahah agreements entered into worth restricted subsidiaries of Dar Al Arkan company.

The General Structure of *Sukuk al-Wakala*

The following 10 explanations of the structure are offered by DIFC:

1. Issuer SPV issues the sukuk, which represent an undivided ownership interest in, inter alia, the wakala assets. They also represent a right of the investors against the Issuer SPV to payments of the Periodic Distribution Amounts and Dissolution Amounts.
2. The Investors subscribe for the sukuk in return for a fixed principal amount (the sukuk proceeds) payable to the Issuer SPV.
3. The Issuer SPV, in its capacity as principal, enters into a wakala agreement with the wakeel pursuant to which the wakeel agrees to invest the sukuk proceeds, on behalf of the Issuer SPV, in a pool or portfolio of investments

FIGURE 5.14 Sukuk al-Wakala Structure



Source: Sukuk Guidebook, DIFC and Clifford Chance (2009), 58.

(the wakala assets), selected by the wakeel, in accordance with specified criteria.

4. The sukuk proceeds will be used by the wakeel to purchase the selected wakala assets from one or more sellers.
5. The wakala assets will be held and managed by the wakeel, on behalf of the Issuer SPV, for the duration of the sukuk in order to generate an expected profit to be agreed upon by the principal. The wakala assets will constitute part of the trust assets held by the Issuer SPV (in its capacity as trustee) on behalf of the investors.
6. The wakala assets will generate a profit return, which will be held by the wakeel on behalf of the Issuer SPV.
7. The profit return will be used to fund the Periodic Distribution Amounts payable by the Issuer SPV to the Investors. Any profit in excess of the Periodic Distribution Amounts will be paid to the wakeel as an incentive fee. It is possible that the wakala assets may generate a return that is less than the Periodic Distribution Amounts. One possible mechanism used in the past, to ensure that there are sufficient funds to make up any shortfall between the income generated by the wakala assets and the Periodic Distribution Amounts due to Investors, is for the Obligor to agree (under the purchase undertaking) to purchase a certain portion of the wakala assets at regular intervals for an Exercise Price equal to the Periodic Distribution Amounts. However, following the AAOIFI Statement, the general view among Shari'a scholars is that it is not permissible for an Obligor to agree to purchase wakala assets for fixed or variable amounts (calculated by reference to a formula), as this would be akin to a guarantee of profit. This mechanism would only be acceptable under AAOIFI standards if the Seller and the Obligor were different entities (see "Key Features of the Underlying Structure").
8. The Periodic Distribution Amounts will be paid to the investors on the relevant periodic distribution dates. The Periodic Distribution Amounts will either be a fixed or variable amount calculated in accordance with a fixed formula (e.g., based upon LIBOR).
9. Upon:
   a. The maturity date or upon the occurrence of an event of default, the Issuer SPV, in its capacity as trustee will exercise its option under the Purchase Undertaking to require the Obligor to purchase the wakala assets at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.
   b. The exercise of an optional call (if applicable) or the occurrence of a tax event, the Obligor will exercise its option under the Sale Undertaking to buy the wakala assets from the Issuer SPV, in its capacity as Trustee, at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.

10. Upon the occurrence of one of the events described in (9) above, the Issuer SPV, in its capacity as Trustee, will pay the Dissolution Amount to investors using the Exercise Price received from investors and redeem the sukuk, upon which the trust will be dissolved. (DIFC 2009, pp. 59–60)

Documents Required for Sukuk al-Wakal Structure[25]

1. Document	:	Wakala Agreement
Parties	:	Originator (Wakeel) and Trustee (Principal)
Purpose(s)	:	**a.** For the Originator, it sets out the eligibility criteria for the assets to be selected by the wakeel. **b.** For the Trustee, sets out the terms and conditions of the wakala including fees for the wakeel.
2. Document	:	Asset Buying Agreement
Parties	:	Originator (Wakeel) and Seller (Commodity/Financial assets supplier)
Purpose(s)	:	On behalf of the Trustee/Investors, the wakeel will purchase the assets from seller that meet the terms of eligibility criteria.
3. Document	:	Sale and Purchase Undertaking (Wa'd)
Parties	:	Originator (Obligor) and Trustee (on behalf of investors)
Purpose(s)	:	**a.** For the Originator, it allows originator to buy back the Wakala Assets at maturity. **b.** For the Trustee, it allows them to sell the Wakala Assets back to the Originator if an event of default occurs or at maturity, in return for which the Originator is required to pay all outstanding amounts (through an Exercise Price) so that the Trustee can pay the Investors.

Key Features of Sukuk al-Wakala Structure

1. The principal amount from underlying financial assets should never be used to service coupon payments under the sukuk.
2. The clients to whom the financial assets (sukuk assets) are related should be informed about the sale of those financial assets to the Investors. The Originator is only a wakeel and acting on behalf of the Trustee/Investors.
3. Sometimes it is necessary to use the custodian to ensure that the sukuk assets are properly segregated from the other financial assets of the Originator.

Chapter Summary

- Sukuk is certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or in the ownership of the assets of particular projects or

special investment activity; however, this is true after the receipt of the value of the Sukuk, the closing of the subscription and employment of funds received for the purpose for which the Sukuk were issued.

- Sukuk has some similarities and differences from bonds and shares.
- Based on the ownership and sale status of the underlying assets, sukuk can be classified into two, namely asset-backed sukuk and asset-based sukuk.
- The AAOIFI Financial Accounting Standard No. 17 (AAOIFI FAS 17) classifies Islamic bonds (sukuk) into at least five types namely leased-based sukuk (e.g., sukuk Ijarah), partnership-based sukuk (e.g., sukuk Mudharaba and sukuk Musharakah), sale-based sukuk (e.g., sukuk Murabaha, sukuk Istisna, and sukuk Salam), hybrid sukuk (e.g., sukuk al-Istithmar), and other types of sukuk (e.g., sukuk Wakalah).
- Some sukuk can be traded in secondary markets some cannot.

Sukuk Type	Tradability
Sukuk murabaha	Acceptable before sale of goods/commodity to the end buyer. Once the goods are sold then trading is only accepted at par value.
Sukuk salam	Not acceptable except at par value.
Sukuk istisna'a	Acceptable if funds are converted into assets and before sale to party ordering the project.
Sukuk mudarabah, musharakah, and wakalah	Acceptable after commencement of activity for which the funds were raised.

Chapter Questions

1. What are the differences between sukuk, bonds, and shares?
2. Distinguish between asset-based and asset-backed sukuk.
3. What are the steps involved in issuing sukuk al-ijarah?
4. Explain the structure of sukuk al-wakalah.
5. Can sukuk al-murabaha be traded in secondary markets? Explain your answer.

Notes

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2. Ibid., 43.
3. Udovitch (1970), 86, in Adam and Thomas (2004), 43.
4. Mushanaf Ibnu Abu Syaibah, VI: 294, Bab Fi bai'i shakkak ar-Razqi. No. 21477–21478.
5. Dubai International Financial Centre (DIFC), ***Sukuk Guidebook***, November 2009, 9.

6. The establishment of the first Islamic equity unit trust fund, Arab Malaysian Tabung Ittikal (Bursa Malaysia in Islamic Capital Market).
7. The Guthrie Sukuk based on Ijarah concept worth US$150 million.
8. Dubai International Financial Centre (DIFC), ***Sukuk Guidebook***, November 2009, 10.
9. Available at: www.failaka.com/downloads/Usmani_SukukApplications.pdf.
10. Zawya Sukuk Monitor, 2009; Moody's Investors Service, January 2009.
11. The rental amount may vary based on a certain benchmarks agreed upon by both parties. For further discussion, please read Shariah Parameter Reference 2 (SPR 2): Ijarah Contract by Bank Negara Malaysia, 2009.
12. DIFC: ***Sukuk Guidebook***, 17.
13. A hadith in which the Prophet (pbuh) narrates sayings, with Allah (swt) as the speaker.
14. This hadith qudsi was narrated on the authority of Abu Hurayrah (mAbpwh) by Abu Dawud and Al-Hakim, who validated its chain of narration.
15. For more discussion on this matter, please read ***Al-Fiqh al-Islami wa-Adillatuh***, written by Dr. Wahbah al-Zuhayli, chapter: ***Al-Sharikat***.
16. DIFC: ***Sukuk Guidebook***, 25.
17. For example, the right to live in a house.
18. For more discussion on this matter, please read ***Al-Fiqh al-Islami wa-Adillatuh***, written by Dr. Wahbah al-Zuhayli, chapter: ***Silent Partnership*** (***Mudarabah***).
19. April edition, 2007.
20. DIFC and Clifford Chance: ***Sukuk Guidebook***, 32.
21. Ibid., 38.
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CHAPTER

6

Shariah-Compliant Equity

Learning outcomes

At the end of this chapter, you should be able to:

1. Distinguish between conventional and Shariah-compliant equity securities.
2. Explain the screening process of Shariah-compliant equity securities.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

Equity securities, commonly known as shares or stocks, are representing an ownership interest in a corporation or financial assets. However, owning shares in a business does not mean that the shareholder has direct control over the daily business activities; it only entitles the possessor to an equal distribution in any profits, if any are declared in the form of dividends. The two main types of equity securities are common stock and preferred stock. The main difference between these two forms of equity securities lies in the degree to which they contribute to any distribution of earnings and the priority given during the distribution of earnings (Fabozzi et al., 2012; Madura, 2010). In details, preferred stockholders are entitled to a fixed dividend that they receive before common stockholders may receive their dividends (see Table 6.1). Among the benefits of preferred stockholders are:

- Preferred stockholders dividends are fixed, so they do not participate in increases or decreases in the company's profits as common stockholders do.
- Although debt holders are the highest priority if the company is bankrupt and liquidated, the preferred stockholders have a higher priority than common stockholders.
- Dividends of preferred stockholders have to be paid before the company pays for common stockholders.

TABLE 6.1 Overview of Securities Equity

	Items	Definition
Types of equity securities	Common stock	An ownership interest in a corporation without any direct control toward the company's daily business activities.
	Preferred stock	Similar with common stock, however, preferred stockholders are entitled to a fixed dividend that they receive before common stockholders may receive their dividend.
Sources of return for common stockholders	Dividend	Distributions made by the corporation to its owners that represent a return on their investment.
	Positive changes in stock price	A situation in which the price at a future date exceeds the purchase price.
Types of orders in common stock market (trading mechanics)	Market order	An order to be executed at the best price available in the market.
	Conditional order	An order to be executed only when the desired situation arises in the market.

Equity securities resemble bond coupons with interest payments, though they are legally shares and are subject to the same tax treatment. However, there are some situations in which the company misses the payment of the preferred stockholders' dividend. In this regard, preferred stock is divided into two:

1. Cumulative preference stocks.
2. Noncumulative preference stocks.

Due to the global financial crises, some companies may not be able to maintain their performance and end with failure to pay dividends to their stockholders during one particular year. Cumulative preference stocks will accumulate any dividend that is not paid when due. Any unpaid dividend will be added to the amount payable the following year and no dividends can be paid toward ordinary stockholders until the entire backlog of unpaid dividends on cumulative preference stockholders is resolved. However, for the noncumulative stockholders, they must forgo dividend payments when the company misses a dividend payment.

The value of one company's common stock determines its market capitalisation (Fabozzi et al., 2012; Madura, 2010). It is because the total value of one company's common stock, which is equal to the price per share multiplied by the number of common stock shares outstanding, is referred to as market capitalisation. Now, what about the potential return that will be obtained by the common stockholders? For common stock investors, there are at least two potential sources to obtain the return:

1. Dividend payments.
2. Positive changes in the price of the common stock sold.

Dividend is a distribution made by the company to its shareholders that represent a return on their investment. While it is typically in the form of cash, some companies may add these distributions using additional shares or stock. To meet shareholders' expectations, increases in dividends are viewed favorably and are associated with increases in the company's stock price. On the other hand, decreases in dividends are viewed unfavorably and definitely will lower the company's stock price.

The change in the company's stock price determines whether the shareholders will gain or lose (Fabozzi et al., 2012; Madura, 2010). Logically, when the stock price at a future date exceeds the purchase price, then there is a capital gain. Otherwise, when the stock prices at a future date below the purchase price, then there is a capital loss.

When an investor wants to buy or sell a share of common stock, the price and terms under which the order is to be executed must be communicated clearly to a broker. There are two types of trading mechanics in common stock markets:

1. Market order.
2. Conditional order.

Market order is the simplest type, which is available in the common stock market. It is an order to be executed at the best price available in the market. However, the price-adverse move may take place between the time the investor places the order and the time of the order is executed. This is one of the disadvantages of market order.

Another trading mechanism is the conditional order, which will only execute the order if the limit price or a better price can be obtained. There are at least two types of conditional orders:

1. Limit order: designates a price threshold for the execution of the trade.
2. Stop order: specifies that the order is not to be executed until the market moves to a designated price, at which it becomes a market order.

And now you have learned at least three key points from this discussion before proceeding to the next discussion. First, you now know what are so-called equity securities. Second, you know what is the fundamental element that distinguishes between common stocks and preferred stocks. Last but not least are the two potential sources of return from investing in common stock.

The Structure of Equity Markets

By issuing stock in exchange for cash in a primary market, a firm is called a "go public" firm. There are at least two main factors that distinguish a "go public" from a "closed" firm:

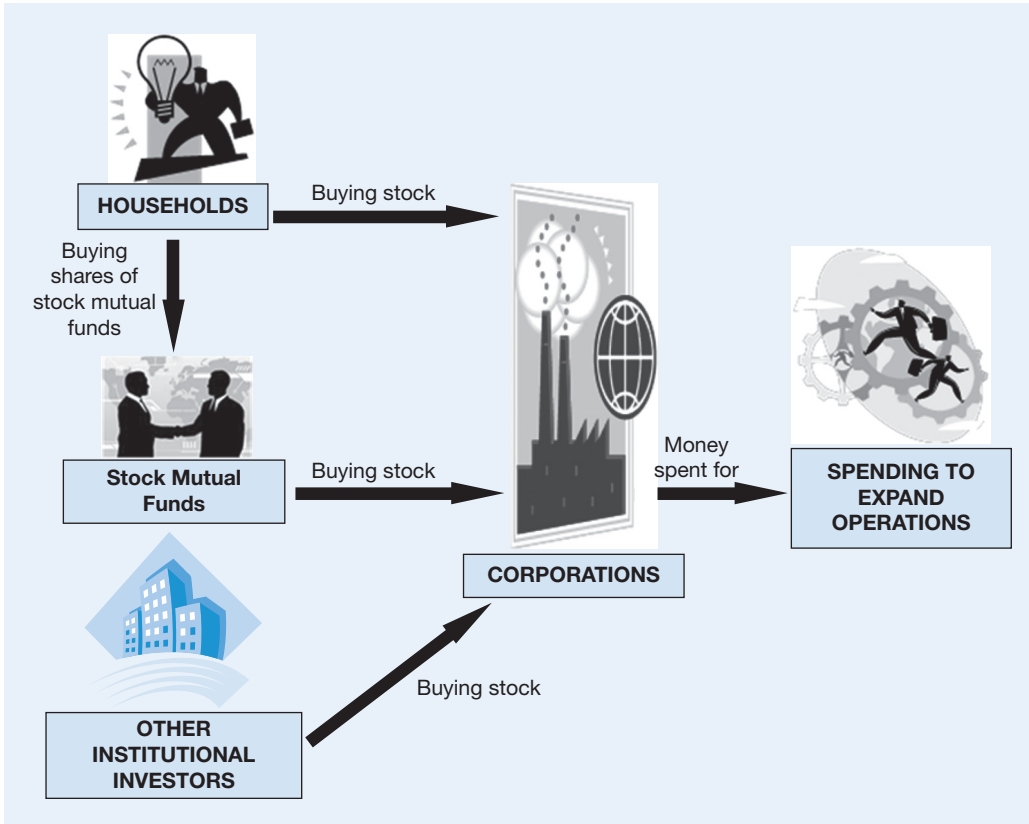
1. Ownership structure of the firm is different due to increasing number of owners.
2. Capital structure of the firm is also different due to increasing amounts in equity investment that later on allow them to either pay off some debts or expand operations, or both.

Similar with debt securities, common stock is issued by firms in the primary market to obtain funds, particularly long-term funds. However, instead of being a creditor as in debt securities, a stock buyer becomes a part owner of the firm. Therefore, the increases and decreases in stock value of the firm are the risks that should be taken by the stock owner.

As shown in Figure 6.1, the means by which stock markets facilitate the flow of funds are similar to other financial markets by linking the surplus units or those with excess funds with deficit units of those who need funds. Technically, firms issue stock in primary markets to collect funds to cover their expenses and expand their operations and thus will support economic growth. The buyers for the stocks issued by those firms are individual investors as well as other firms or institutional investors. While institutional investors like pension funds and insurance companies invest directly by buying the stocks, individual investors may directly buy the stocks from stock markets or invest in shares of stock mutual funds so the managers of these funds use the proceeds to invest in stocks.

In comparison with individual investors, institutional investors hold larger amounts of stock. Therefore, their collective sales and purchases of stocks will significantly affect the stock

FIGURE 6.1 Structure of Stock Markets



prices in the market. This will affect the reaction of the firm toward all the advice and complaints given by their investors. Definitely, institutional investors are given priority by the firm, which responds to their advice and complaints in order to keep them as investors. On the other hand, institutional investors are also willing to spend time to ensure that the firm will perform excellently because they hold millions of shares of the firm and do not want it to fail.

Most of the institutional investors are financial institutions like commercial banks, finance companies, and insurance and pension funds (see Table 6.2). They buy stocks of a firm as an investment to get better returns. However, sometimes they sell their own stock as a means of raising funds.

Shariah-Compliant Equity Securities

The Islamic Capital Market is getting more and more famous in the world of finance nowadays, particularly after the financial turmoil of the 1997 and 1998 era and the 2007 to 2008 global economic crisis. In the case of Malaysia, the majority of the counters on Bursa Malaysia

TABLE 6.2 Financial Institutions as Participant in Stock Markets

Type of Financial Institutions	Participation in Stock Markets	
	Issuing Stock	Buying Stock
1. Commercial banks	To boost their capital base	Manage trust funds that usually contain stocks.
2. Insurance companies	To boost their capital base	Invest a large proportion of their premiums in the stock market.
3. Saving banks	—	Invest in stocks for their investment portfolios.
4. Pension funds	—	Invest a large proportion of pension funds in stocks for their investment portfolios.
5. Finance companies	To boost their capital base	—
6. Securities firms	New issues of stocks To boost their capital base	Offering advice to those who want to acquire stocks. Execute buy-sale transactions of stocks.
7. Stock mutual funds	To attract individual investors To boost their capital base	Use the proceeds from selling shares to individual investors to invest in stocks.

today are Shariah-compliant, and thus people are increasingly interested to find out more about these counters. Based on the report provided by the Shariah Advisory Council of the Securities Commission of Malaysia, by November 2010 around 88 percent of shares traded in the Malaysian capital market were Shariah compliant. This makes Malaysia the biggest capital market with Shariah-compliant equity in the world.

Shariah-compliant securities are the securities of companies whose activities conform to the Shariah principles. It is the Shariah Advisory Council (SAC) that releases the decision of whether securities traded in capital markets are Shariah compliant. In classifying these securities, the SAC received input and support from the Securities Commission (SC). In order to provide that information, the SC will gather information on the companies from various sources, such as company annual financial reports, company responses to survey forms, and through inquiries made to the respective companies' managements. The SC, via the SAC, continues to monitor the activities of all companies listed on Bursa Malaysia to determine their status from the Shariah perspective (see Figure 6.2).

To accomplish its heavy tasks, the SAC has applied standard criteria in focusing on the activities of the companies listed on Bursa Malaysia. Subject to certain conditions, companies whose activities are not found to be contrary to the Shariah principles will be classified as Shariah-compliant securities. On the other hand, companies will be classified as Shariah–non-compliant securities if they are involved in any of the following core activities:[1]

- Financial services based on riba (interest).
- Gambling and gaming.

- Manufacture or sale of nonhalal products or related products.
- Conventional insurance.
- Entertainment activities that are nonpermissible according to Shariah.
- Manufacture or sale of tobacco-based products or related products.
- Stockbroking or share trading in Shariah noncompliant securities.
- Other activities deemed nonpermissible according to Shariah.

One may question the status of a company that has interest income and invested in Shariah–non-compliant securities, such as, can it be endorsed as a Shariah-compliant equity? The answer is, it depends on the proportion of such incomes. For companies with activities comprising both permissible and nonpermissible elements, the SAC considers two additional criteria:

1. The company must be perceived well by the people.
2. The core activities of the company are very important and should bring maslahah (benefit for general) to the people and the nonpermissible elements must be very small in proportion and very difficult to be avoided.

With regard to the tolerable level of mixed contributions from permissible and nonpermissible activities upon turnover and profit before tax of a company, the SAC has set the benchmarks, which are:

The 5-percent benchmark. This benchmark is applied to assess the level of mixed contributions from the activities that are clearly prohibited such as riba (interest-based companies like conventional banks), gambling, liquor, and pork.

The 10-percent benchmark. This benchmark is applied to assess the level of mixed contributions from the activities that involve the element of "umum balwa," which is a prohibited element affecting most people and difficult to avoid. For instance, the contribution came from the interest income of fixed deposits in conventional banks. This also applies to tobacco-related activities.

The 20-percent benchmark. This benchmark is applied to assess the level of contribution from mixed rental payments from Shariah–non-compliant activities such as the rental payment from a premise that involved gambling, sale of liquor, etc.

The 25-percent benchmark. This benchmark is used to assess the level of mixed contributions from the activities that are generally permissible according to Shariah and have an element of maslahah to the public, but there are other elements that may affect the Shariah status of these activities. For example, hotel and resort operations, share trading etc., as these activities may also involve other activities that are deemed nonpermissible according to the Shariah.

Every market has its own screening process and it is not necessarily the same one to another. This somehow depicts the wideness of Islam. It can be varied in branches, but it is one in three. We will talk about this matter in the next section.

Differences between Shariah and Non–Shariah-Compliant Equity Markets

Gambling, riba, and gharar are three main causes that make a transaction prohibited under Shariah law. Gharar is uncertainty about one of the objects of exchange: either amount of price to be paid for a specific commodity, or nature of commodity to be bought at a given price. A serious gharar is indistinguishable from gambling. In the absence of accurate and reliable information about what the "share" stands for, its mere purchase turns out like playing any gambling game. To avoid gharar in equity markets, the authority may apply (Tag el Din, 1996):

a. Making accessible all relevant information and financial indicators for the use of participants in the stock exchange, and
b. Participants must acquire (or somehow seek the service of) the analytical ability to carefully process such information to obtain consistent estimates for the true expected exchange values of the shares.

Market efficiency is a hypothesis that when financial markets are in equilibrium, the prices of financial instruments reflect all readily available information (Burton et al., 2003). It is also generally defined as the speed at which stocks' prices respond to changing information such that no participant can outwit the market, i.e. take an informational advantage that is not yet publicised. An efficient stock market occurs when one quickly and accurately mobilises liquid capital to where it gets the highest returns. This concept stimulates short-selling by the investors, which is forbidden in Islam due to its similarity with gambling. On the other hand, brokers have vested interest to spread exciting rumors (hot tips) among investors to encourage as much speculative trading as possible for the accounts of their clients, being motivated by the commissions they get in return (Tag el Din, 1996).

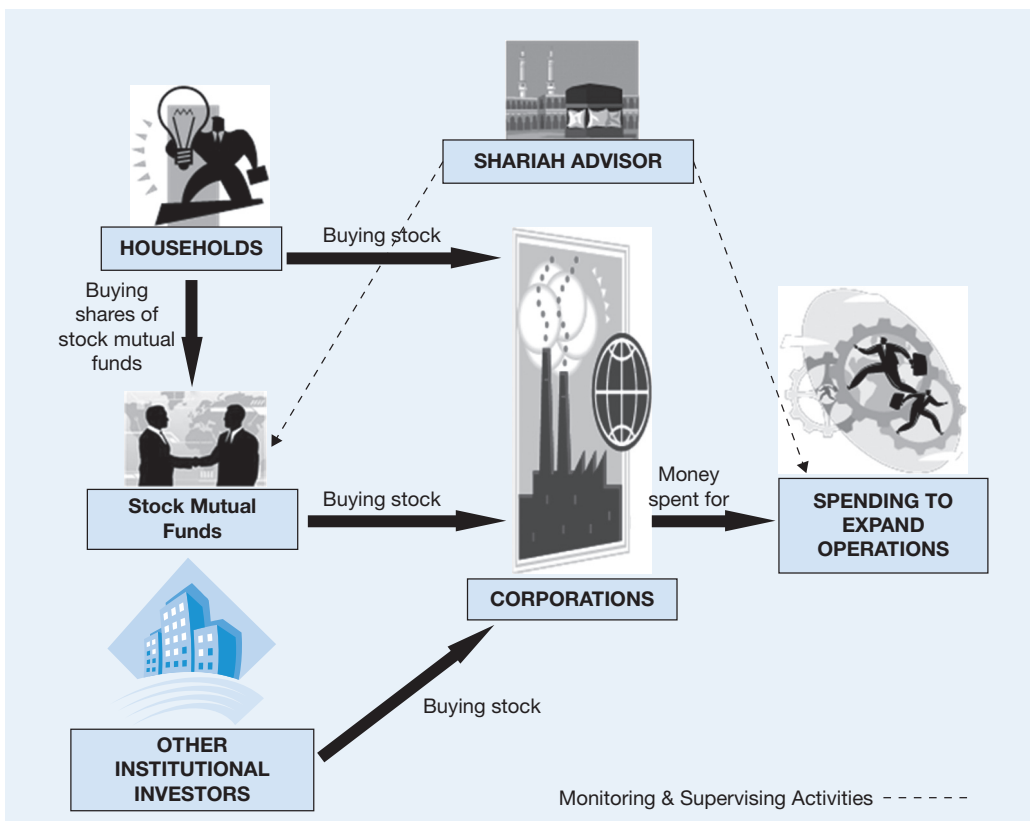
Extensive short sales' practices, therefore, account for the high circulation velocity, which characterise the conventional equity markets. It is not surprising that modern investment theory is formulated with the assumption that the rational investor is indeed a busy speculator, figuring out the optimal re-allocation of his savings between the various income earning securities in an ever changing environment. With accelerated speculative tendencies, as is the case in the present economic order, the corporate sector becomes very much like a moving train where passengers exchange seats randomly for short trips with too little concern for whoever drives. Apart from signing a proxy statement, which automatically approves of existing corporate managers, the shareholder does nothing else to distinguish him from a bondholder. In this fashion, shareholders of a given corporation no longer exercise their legal right of closely cross-checking the performance of inefficient managements, a problem that would reflect negatively on the overall productivity index of the corporate sector. (Tag el Din 1996, p. 39).

The Islamic concept of market efficiency does not rely exclusively on the pure profit motive as is the case in the conventional one. The importance of a socio-ethical element in the

Islamic concept of efficiency cannot be ignored particularly in a genuine Muslim society where investment motives by funds' owners do not exclude a sense of ethical responsibility toward the attainment of social goals. Hence, the criterion of market efficiency in a genuine Islamic perspective does not rely on the speed of liquid capital's flow from less profitable projects to more profitable ones (Tag el Din 1996, p. 36).

It is always interesting to see how Islam has already pinpointed the relevant regulatory principles of any modern activities, though they have only been recognised recently in the developed world. In the case of stock markets activities, the Prophet's (p.b.u.h.) has taught that free exchange is governed by basic ethical values to guard against illegitimate external influences on the true market price—for example, najash, which means any mock interference by a third party with the intention to influence the pricing of certain goods in favor of the seller. A najash-like practice flourished openly in the American system before the Great Depression of 1929 when large profits were made out of najash practices until it was abolished by law in 1934. But before its legal abolishment, investors used to recruit large capital and expertise to organise a so-called "pool," which was used to work actively and secretly in a tactical way within the stock exchange to misguide the ignorant participants, and hence redirect the shares' price movement toward some desired target (Tag el Din 1996, p. 38).

FIGURE 6.2 Structure of Shariah-Compliant Stock Markets



There is not much difference between conventional and Islamic equity markets structure except for the existence of a Shariah advisor in Shariah-compliant equity markets. The task of a Shariah advisor is to monitor and supervise the use of money invested in two institutions, for example, stock mutual funds and firm-issued stocks. The first level is for individuals who buy stocks through stock mutual funds and need to be assured that the mutual funds are operated within Shariah-compliant mutual funds criteria and activities. The second level is for the Shariah advisor to monitor and supervise the firms' activities.

However, the main task of a Shariah advisor is to filter the list of equities to be listed in the stock markets. The screening methodology is mostly similar in every market. It differs only in a very few categories, particularly in financial screening methodology. Further details regarding screening methodology are presented in the next section.

Shariah-Compliant Stocks Screening

Stock screening is the process of reducing the universe of all possible stocks to just a few stocks that match the criteria of an investment strategy. It combines strategy, data, and screeners. Strategy is like a recipe to bake a cake, data are like ingredients, and screeners are like the tools. Stock screening is very important because it reduces the size of the problem we are trying to solve. It is simpler to analyse a few stocks rather than every possible stock.

In Shariah-compliant stocks, screening is used to segregate between the Shariah-compliant and non-Shariah-compliant stock in one particular market. This is very important because Islam forbids Haram products or activities to be supported or followed. This Shariah-compliant stocks screening is to help investors who are concerned with Islamic values to find their sweet spot in the market.

However, due to tradition and geographical differences between markets, there are differences in their screening methods. Here we will compare the screening methods of Shariah-compliant stocks between the Malaysia Securities Commission, S&P Shariah Indices, Dow Jones Islamic Index, Pakistan Meezan Islamic Fund, Global GCC Islamic Fund, and Jakarta Islamic Index.

Malaysia Securities Commission

Core Activities

The core activities of the companies should not be against Shariah principles. Therefore companies with non-Shariah-compatible core business activities are excluded. For example, companies cannot pursue riba- (interest-) based financial services, gambling, manufacture or sale of non-halal products or related products, conventional insurance, entertainment activities that are not permitted according to Shariah, manufacture or sale of tobacco-based products or related products, stockbroking or share trading in non-Shariah-approved securities, and other activities deemed nonpermissible according to Shariah.

Mixed Activities

For companies with activities comprising both permissible and nonpermissible elements, the SAC considers two additional criteria:

1. The company must be perceived as good by the people.
2. The core activities of the company are very important and should bring maslahah (benefit for general) to the people and the nonpermissible elements must be very small in proportion and very difficult to avoid.

Benchmarks of Tolerance

With regard to the tolerable level of mixed contributions from permissible and nonpermissible activities upon turnover and profit before tax of a company, the SAC has set the benchmarks, which are:

The 5-percent benchmark. This benchmark is applied to assess the level of mixed contributions from activities that are clearly prohibited, such as riba (interest-based companies like conventional banks), gambling, liquor, and pork.

The 10-percent benchmark. This benchmark is applied to assess the level of mixed contributions from activities that involve the element of "umum balwa," which is a prohibited element affecting most people and difficult to avoid. For instance, contributions from the interest income of fixed deposits in conventional banks. This also applies to tobacco-related activities.

The 20-percent benchmark. This benchmark is applied to assess the level of contribution from mixed rental payments from Shariah–non-compliant activities such as the rental payment from a premise that involved gambling, sale of liquor, and so on.

The 25-percent benchmark. This benchmark is used to assess the level of mixed contributions from activities that are generally permissible according to Shariah and have an element of maslahah to the public, but there are other elements that may affect the Shariah status of these activities. For example, activities such as hotel and resort operations, share trading, and so forth, may also involve other activities that are deemed nonpermissible according to the Shariah.

S&P Shariah Indices

Sector-Based Screens

Business activities related to the following eight elements are excluded from the S&P Shariah Indices:

1. Pork
2. Alcohol
3. Gambling

4. Financials
5. Advertising and media (newspapers are allowed, but subindustries are analysed individually)
6. Pornography
7. Tobacco
8. Trading of gold and silver as cash on a deferred basis

During the selection process, each company's audited annual report is reviewed to ensure that the company is not involved in any non-Shariah-compliant activities and thus be appropriate for investment for observant Muslims.

Accounting-Based Screens

After removing companies with business activities that go against Shariah principles, the rest of the companies are examined for compliance in financial ratios, as certain ratios may violate compliance measurements. Three areas of focus are leverage, cash, and the share of revenues derived from noncompliant activities. All of these are subject to evaluation on an ongoing basis.

Leverage Compliance

This compliance is measured as:

$$\text{Debt/market value of equity (12-month average)} < 33 \text{ percent}$$

Cash Compliance

There are compliances with reference to cash holdings. These are:

- Accounts receivables/market value of equity (12-month average) $<$ 49 percent
- (Cash + interest-bearing securities)/market value of equity (12-month average) $<$ 33 percent

Revenue Share from Non-Shariah-Compliant Activities

In certain cases, revenues from non-Shariah-compliant activities are permissible, if they comply with the following threshold:

$$\text{(Nonpermissible income other than interest income)/revenue} < 5 \text{ percent Dow Jones Islamic Index}$$

Similar to the Dow Jones Indexes, the Dow Jones Islamic Market (DJIM) Indexes measure the global universe of investable equities that have been screened for Shariah compliance. In order to be included and displayed at the DJIM Indexes, companies in the Dow Jones World Index

are screened based on quantitative criteria designed by the Dow Jones Indexes to approximate the restrictions typically imposed on Islamic-compliant investments and then the criteria relevant to the specific index.

DJIM: A World of Possibilities

The selection universe for the DJIM Indexes is the same as the universe for the Dow Jones World Index, a broad-market index that seeks to provide approximately 95 percent market coverage of 47 countries.

- A global flagship index—the Dow Jones Islamic Market Index
- Country and regional indexes covering North America, Europe, and Asia
- Global industry indexes: basic materials, consumer goods, consumer services, financials, health care, industrials, oil and gas, technology, telecommunications and utilities
- Global and regional capitalization-defined indexes
- Global and regional blue-chip "Titans" indexes
- Global emerging markets index covering the BRIC countries

Industry Screens

The first DJIM screens are intended to remove any companies with involvement in:

- Alcohol
- Pork-related products
- Conventional financial services
- Entertainment
- Tobacco
- Weapons and defense

Financial Ratio Screens

A second set of screens, based on financial ratios, is intended to remove companies based on debt and interest income levels. In this screen, all of the following should be less than 33 percent:

- Total debt divided by trailing 12-month average market capitalisation
- The sum of a company's cash and interest-bearing securities divided by trailing 12-month average market capitalisation
- Accounts receivables divided by trailing 12-month average market capitalisation

Pakistan Meezan Islamic Fund

The Shariah screening criteria for equities and other securities given by Meezan Islamic Fund in Pakistan is as follows.

Core Business Activities of the Investee Company

The basic business of the Investee Company should be halal. Accordingly, investment in shares of conventional financial institutions like banks, insurance companies, and leasing companies is rejected. In addition, companies dealing in alcohol, tobacco, pornography, and so forth are not permissible.

Mixed Business Activities of the Investee Company

If the company is involved in business activities and income that are against Shariah principles, the screening methodology of Meezan Islamic Fund consists of two conditions:

1. The total investment of the investee company in Shariah–non-compliant business should not exceed 33 percent of the total assets.
2. The income from Shariah–non-compliant investments should not exceed 5 percent of the gross revenue (net sales plus other income).

Financial Ratio Screening

Financial ratio screenings applied by Meezan Islamic Fund are:

- Debt to Total Assets: The total interest-bearing debt of the Investee Company should not exceed 45 percent of the total assets.
- Net Illiquid to Total Assets: The total illiquid assets of the Investee Company as a percentage of the total assets should be at least 10 percent.
- Net Liquid Assets to Share Price: The net liquid assets (current assets minus current liabilities) per share should be less than the market price of the share.

Global GCC Islamic Fund Screening

Global GCC Islamic Fund applies the following screens to include stocks in the GCC Islamic investable universe.

Business Activity Screening

Global GCC Islamic Fund screens out companies that derive more than 5 percent of their revenue from the following activities:

- Production and marketing of meats
- Tobacco
- Alcohol
- Gambling/Casino
- Cinemas

- Hotels
- Conventional financial institutions
- Media

Financial Ratio

Screen out companies that derive significant income from interest or companies with excessive leverage, using the following three ratios:

1. Total debt/market capitalisation may not exceed 30 percent.
2. Accounts payable/market capitalisation may not exceed 30 percent.
3. Interest income/revenue may not exceed 5 percent.

Dividend Purification

If a company derives part of its total income from interest income, Shariah investment principles state that this portion must be deducted from the dividend paid out to shareholders and given to charity.

Jakarta Islamic Index

Business Activity Screening

The first Jakarta Islamic Index screens are intended to remove any companies with involvement in:

- Alcohol
- Pork-related products
- Conventional financial services (riba/interest)
- Entertainment
- Producing and distributing moral-damaging products
- Tobacco
- Weapons and defense

Business Activity Screening

Similar to other markets, Jakarta Islamic screens out companies that derive significant income from interest or companies with excessive leverage, using the following three ratios:

1. Total debt/market capitalisation may not exceed 30 percent.
2. Accounts payable/market capitalisation may not exceed 30 percent.
3. Interest income/revenue may not exceed 5 percent.

Chapter Summary

- Equity securities, commonly known as shares or stocks, are representing an ownership interest in a corporation or financial assets.
- The value of one company's common stock determines its market capitalisation.
- For common stock investors, there are at least two potential sources to obtain the return, namely dividend payments and positive changes in the price of the common stock sold.
- Dividend is a distribution made by the company to its shareholders that represent a return on their investment.
- By issuing stock in exchange for cash in primary markets, a firm is called a "go public" firm.
- Shariah-compliant securities are the securities of companies whose activities conform to the Shariah principles. In Malaysia, it is the Shariah Advisory Council (SAC) that releases the decisions concerning which securities traded in capital markets are Shariah compliant.
- In Shariah-compliant stocks, screening is used to segregate between the Shariah-compliant and Shariah–non-compliant stock in one particular market. This is very important because Islam forbids Haram products or activities to be supported or followed.

Chapter Questions

1. Distinguish between conventional and Shariah equity securities.
2. Explain the steps involved in determining Shariah-compliant equities.
3. Briefly compare the Malaysia SC and Dow Jones Islamic Index in terms of Shariah screening and benchmark.
4. What are the benefits that companies receive if they are classified as Shariah compliant?

Note

1. See www.sc.com.my/.

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CHAPTER

7

Islamic Mutual Funds

Learning outcomes

At the end of this chapter, you should be able to:

1. Explain the concept of mutual funds and its features.
2. Describe Shariah stock screening and purification of income.
3. Understand the role of Shariah advisors in mutual funds.
4. Calculate net asset value (NAV) in Islamic mutual funds.
5. Learn how to start investing in Islamic mutual funds.
6. Learn the organisation of Islamic mutual funds.
7. Understand the examples of Islamic mutual funds.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

In a basic economics course, we learn that there are both indirect financing and direct financing methods. The former is usually in the form of institutions such as banks, with the banks receiving funds from parties that have excess funds and giving them to other parties that need money. In this case, banks act as financial intermediaries. Meanwhile, direct financing means the investors (parties that have money) make their funds available directly to the other parties that are in need of money, without any institutions to connect those two parties, and the transactions take place in the capital market.

Within the capital market, there are many methods that investors can use. They may select stocks that suit their preferences (i.e., risk and return). In this case they have to contact brokers in the brokerage firm to do what the investors want. While the ultimate decision is in the hands of the investors, the brokers with their experience may assist the investors by providing some information on the stocks that best suit the investors objectives (i.e., long-term or short-term investment).

Other than investing directly in select stocks, investors may opt to invest in mutual funds. This alternative has features that differ substantially from picking individual stocks. This chapter provides an understanding of conventional mutual funds, and is important as a foundation when we discuss Islamic mutual funds, the main theme. After the introduction, we will discuss the basic concept of closed and open-ended funds. After this, conventional mutual funds will be discussed. This is followed by explanations of the concept, process, and organisation of Islamic mutual funds. The chapter ends with a summary and conclusion.

Closed and Open-Ended Funds

For companies that want to get funding to expand their business, it may be available via issuing shares. At the time they offer shares to the public, it is called the initial public offering or IPO and it is a primary market. The shares will then be listed in a stock exchange to be traded in the secondary market. Investors who do not wish to hold the existing shares cannot sell them back to the companies that issue those shares. This is why these shares are called closed-ended funds. The capital raised by the companies is captive. This means that if the investors feel that there is another, better alternative type of investments, they can sell those shares in the market. If there are ready buyers for it, they can sell it very quickly; however, that is not the case. Sometimes the investors have to wait for a long time to find the buyers that they want.

The price that they get follows the market price, which may or may not be significantly different from net asset value (NAV) or the original price at which they bought previously. It is considered as a premium to the NAV if the market price is higher than the net asset value. Conversely, traded at a "discount" to net asset value means that the market price is lower than the NAV. For the issuer, this type of fund is suitable if the company wants to have a longer

time horizon. The issuer would not be bothered with the capital that had been raised as the investors could not redeem it from him.

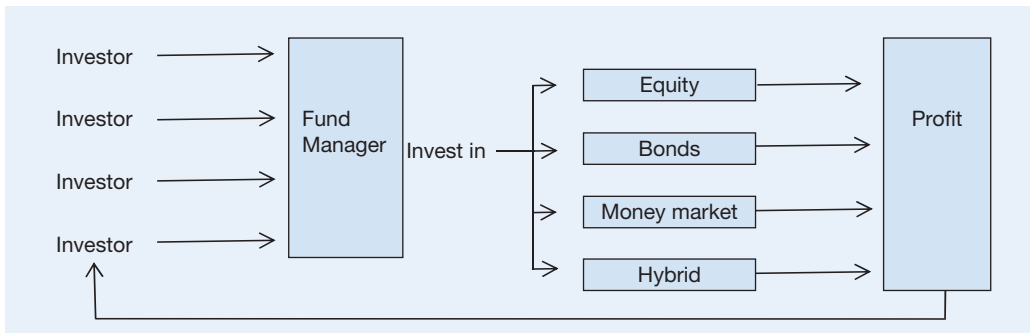
An open-ended fund is a fund that is operated by an investment company that raises money from investors and invests those funds in a collection of assets with specific objectives. This fund does not have restrictions on the amount of shares the fund issues. In the case where demand is high, shares will continue to be issued regardless of the number of investors. In this case, it always has shares available to trade. When you're about to sell or redeem the shares, you sell them back to the mutual fund. Investors exercise their own discretion as to whether to sell the shares at any time and the price fluctuates based on the performance of the individual asset. Mutual funds are a type of open-ended fund.

Conventional Mutual Funds

Instead of picking individual stocks and bonds and creating a portfolio, another alternative is to invest through a mutual fund (normally this term is used in the United States, while the term ***unit trusts*** is commonly used in the UK). Mutual funds are defined as a collection of assets, such as stocks and/or bonds, managed by investment managers or mutual fund managers to achieve certain objectives (such as income and growth) with greater efficiency. For more understanding of mutual funds, follow the process shown in Figure 7.1.

A pool of funds is contributed by a large number of investors (normally some small and some big investors/institutional investors). The funds are managed by professionals called fund managers, who act on behalf of the investors. The funds then have to follow guidelines and benchmarks in their operation. Following the request from the investors, a manager can choose to invest in equity, bonds, or hybrids. For example, in the United States, there are mutual fund stock indexes that consist of various stocks within the U.S. stock index. The guidelines for this stock can be Standard &Poor's Index (S&P index). Similarly, if those funds are invested in UK stock, then it is called a UK equity mutual fund with the benchmark of, for

FIGURE 7.1 General Scheme of the Mutual Funds



example, FTSE. Moreover, we can also invest those funds in government bonds, in the emerging market stock, or a money market instrument or hybrid (combination). As each index has a benchmark, the portfolio can be measured against the index, so that we are able to see whether the portfolio outperforms the index or not.

If the fund is allocated in equity mutual funds the manager will then pick some of the stocks that might represent the S&P index. The objective is to get the return that is not too deviate from the index. He might create a portfolio that is overweight some stocks and underweight some others, with the purpose of getting a higher return. For example, if the S&P can get a return of 11 percent, then the mutual fund manager, if he performs well, can earn a 14 percent or more return. The profit will be returned to the investors.

In order to select the appropriate types of stocks, the manager has to get the market survey and continue to review the performance of the selected candidate stocks before he finally decides. For example, companies A, B, C, and D are selected. If the company pays dividends, then it will be given to the investors. Moreover, each share price can certainly fluctuate. For example, the share price of company A increases, but B decreases. All of the share prices within the portfolio are calculated into what it is called the NAV (net asset value). It is the price of a mutual fund and is priced at the end of the day. If, for example, the NAV is $1 and on a given day the NAV increases to $1.1. (10 percent), this means that our investment, which originally is $1,000, increases to $1,100. Notice that this is on paper. The investors are actually not losing until they sell it. The job of the manager is to allocate the funds in the best portfolio to get the best return. The profit obtained will be given back to the investors. Another example can be seen in Table 7.1.

From Table 7.1, assume that the number of investors is 10 and each contributes as much as RM 1,000. The total investment is RM 10,000 (10 × RM1000). Moreover assume that the number of units is 500, so that each investor gets 50 units. After one year, the total investment increases from RM10,000 to RM 20,000. This increase is due to the performance of each share within the portfolio. If the fee for the manager is 2 percent, the total manager's fee is 2 percent × 20,000 = RM 400. Hence there is RM 19,600 left in the fund, and this is going to be the new price per unit. The NAV 2 will be 19,600/500 = 39.2.

TABLE 7.1 NAV Calculation

a. Number of Investors	10
b. Each investor contribute	1,000 Ringgit Malaysia (RM)
c. Total investment a × b	RM10,000 (10 × RM 1,000)
d. Number of units	500
e. Everyone gets (unit) → d/a	500/10 = 50 unit
f. NAV 1 (price /unit) → c/d	RM10,000/500 = 20
g. Total investment increases to	RM 20,000
h. Manager's fee 2%	RM 400 (2% × 20000)
i. NAV 2 (price/unit) → (g – h)/d	RM (g – h)/500 = 39.2

Active and Passive Management

There are two methods in the management of mutual funds, namely active and passive management. The former means that the manager makes active choices on the portfolio. For example, in the UK stock mutual funds with the benchmark of FTSE, we can actively put more weight on some stocks and underweight others. In other words, active management means taking the active position on the asset within the mutual funds portfolio in order to get the best performance.

The latter method, passive management, means replicating the performance of the index. In this case, the portfolio is designed as close as possible with the index. The ups and down of the index certainly will be followed by the mutual funds. The job of the manager is to select some stock that represents the index. This might not be easy. That is why managers have to have skill and knowledge in picking up stocks. Once the stocks are selected, the job of manager is lighter, and the work becomes an administrative task, as the monitoring of the stocks is done via computer. The benefit for the investor in the passive management style is that the manager's fee will be lower.

Advantages of Mutual Funds

There are several advantages to investing in mutual funds:

- **Diversification:** The saying "Don't put all your eggs in one basket" is good advice for investors who are creating a portfolio. Investors should not have stock with the same characteristics, such as stocks coming from only one sector (i.e., all stocks of companies that are export-oriented products with European country as the main destination). For example, if a crisis occurs in a European country, the stocks will be greatly affected and, in turn, cause losses for the investors. Hence, in order to reduce the risk, the composition of the stocks within the portfolio should be a combination of export-oriented companies with several destinations such as China, the United States, Asia, Africa, and so on. Having a portfolio with various destinations may reduce the risk, so that when a crisis occurs in one country, they still have other stock in another country, and obviously the loss in some stock will be covered by gains in others. In the context of mutual funds, the investors may diversify the portfolio for a relatively low cost.
- **Various types of mutual funds:** There are various types of mutual funds that suit Shariah-compliant needs. For instance, if our goal of investing in mutual funds is for retirement planning, then we may opt for a longer time horizon. Certainly the risk is greater, but it gives better returns. Similarly, if someone wants to make a shorter-term investment for their children's education, then a lower-risk type of investment may be chosen.
- **Daily liquidity:** One of the important aspects that have to be taken into account by the investors is the liquidity issue. A three-month time deposit has a lesser level of liquidity compared to a 12-month time deposit. The benefit of investing in mutual funds is that

transactions can occur in a relatively short period (daily). With this short period, obviously, investors have the advantage of managing their portfolio more easily to gain the maximum benefit.

- **Professional mutual funds manager:** Mutual funds are a good way to start making an investment, particularly for beginners. This is because mutual funds are overseen by managers who have skill and knowledge in selecting the best portfolio to achieve a certain objective. For beginners, it is too risky to directly pick some stocks or bonds with their limited information. The wrong combination of stocks may result in a big loss for them. The role of the manager is to act on behalf of the investors in selecting assets. This also means that managers have full authority on the use of the investors' funds in the investment. This role is substantially different from that of a stockbroker, whose role is just to assist the investor, who retains full authority on the buying and selling of stocks and/or bonds.
- **Investment in a small amount of money:** Direct investment via picking up stocks and/or bonds requires a lot of money. This kind of investment prevents small investors (investors who do not have a lot of money) from participating in investing in the capital market. However, this may not be the case in mutual funds. As the definition of mutual funds is that a pool of funds is arranged by a manager to create a portfolio, suggests that small investors can participate in the investments.
- **Convenience:** The other benefit of mutual funds is that they are convenient. This is because investors receive only one share of mutual funds, which comprises many securities (within the portfolio). Rather than tracking each individual stock performance and holding various documents, it is better to hold only one share of a mutual fund and shift the authority of the use of the funds from investors to mutual fund managers.
- **Government oversight:** The operation of mutual funds is watched closely by the government so that the investors do not need to worry about the stocks and/or bonds that have been chosen. With government oversight, obviously the risk exposure can be reduced.
- **Easy to make comparisons:** Mutual funds may invest in a group of stocks, bonds, or hybrids. This may lead to easy comparisons among those portfolios (for instance, among each of the stocks and bonds or hybrids).
- **Transparency:** The performance of each fund is disclosed by various publications as well as rating agencies.

Disadvantages of Mutual Funds

There are also several disadvantages in investing in mutual funds:

- **Fees:** There are various types of fees and expenses incurred in mutual fund transactions.[1]
- **Less predictable income:** Compared to investing in a time deposit that is predictable, investing in mutual funds is less predictable. This is because the performance of mutual funds depends on the performances of the individual stocks within the portfolio. And the

fluctuation of the price in individual stock certainly depends on the supply and demand for that stock. When stocks in mutual funds perform well, it increases the NAV and it gives profit to the investors.

- **No opportunity to adjust:** Unlike an investor directly picking up individual assets (stocks or bonds), in mutual funds selection of the assets is done by the mutual funds manager. Hence investors do not have the right to determine the composition of the mutual fund.
- In terms of categorisation based on the fees and expenses, Islamic as well as conventional mutual funds in general can be categorised into two styles: load and no load.
- **Load:** This term means "sales charges" or "commission" and can be divided into two methods:
  - **Front-end load:** This is a commission that is paid by the investors to the broker or manager at the time when shares are purchased. The amount is calculated as a percentage of the total amount that is invested and it is deducted from the investor's account.
  - **Back-end load:** As the name suggests, it is the amount that has to be paid by the investor when shares are redeemed. This amount is subject to the length of the shares that the investors are holding. The longer the investors hold the shares, the lower the commission. This structure is called contingent deferred sales charges. Similar to front-end load, the commission is deducted from the investor's account.
- **No-load:** In this type of mutual fund, there is no charge or commission based on when the shares are purchased, such as in front-end load charges, or when the shares are redeemed, such as in back-end load charges.

Fees and Expenses

Fees and expenses associated with mutual funds can be divided into:

- **Management fees:** Fees that have to be paid by the investors to the manager or institution for managing the fund's investment portfolio and administrative fees payable to the investment adviser that are included in the "other expenses."
- **Other expenses:** Other incurred expenses paid by investors are:
  - **Custody fees:** Fees charged to investors that have to be paid to banks due to holding the funds in safekeeping.
  - **Funds accounting fee:** This fee is used to compute the daily net asset value.
  - **Boards of directors' fees and expenses**.
  - **Professional service fees:** These paid fees aim to pay for legal and accounting matters incurred by the mutual funds.
  - **Shareholders communications expenses:** These fees are used for matters such as communication among the parties involved in writing financial reports, and other information.
  - **Transfer agent service fees:** These fees are used to maintain the shareholders' records and for responding to customer inquiries.

- **Securities transaction fees:** Fees related to buying and selling the securities in a portfolio. The fee has a positive correlation with trading volume. This means that if the volume is high, then the fee will increase.
- **The expense ratio:** Cost of owning the mutual funds that includes 12b-1 fees (annual fees for marketing and distribution service) plus management fees plus the other expenses, divided by the average net assets. Normally called "Total Expense Ratio" or TER.

Islamic Mutual Funds

Islam is a religion that abjures the individual not only to have a relationship with God (vertically) but to create a good relationship with other individuals socially, culturally, politically, and even financially. Islamic rules and regulations are the foundation as well as the guidelines for individuals in having transactions. A financial transaction that disobeys the Shariah or Islamic rule will certainly be prohibited. For instance, an increase of funds charged by a creditor out of the loan principal is obviously not Shariah compliant. This act is a riba transaction, which is clearly prohibited in Islam.

Muslims have attempted to follow Shariah guidelines for their financial transactions from the very beginning. An interest-free financial system was established to cater to the needs of Muslims who do not indulge in riba transactions. Mit Ghamr was believed to be the first institution in Egypt that operated on the basis of Shariah. However, the performance is not well recorded. In Southeast Asia, particularly in Malaysia, Tabung Haji was the first institution that operated an interest-free system. The objective of this nonbank institution is to assist Muslims to go on pilgrimage to Mecca. Hajj candidates need to put money in savings regularly until the full payment is made. A regular collected deposit will be used (by Tabung Haji) to finance businesses using the concept of profit-sharing. This institution has been successful in implementing Islamic financial transactions until recently. With the success of Tabung Haji, an Islamic bank was established in the early 1980s.

Today, Islamic banks in Malaysia are about to complete the third decade of their establishment. As economic problems become more complex, so do the complexity of the financial transactions. A new innovative financial product introduced by bank and nonbank institutions has been continuously developed and introduced to support the businesses in their transactions. Islamic financial innovations are not only products of financing used by businesses but also products for the investors (the parties who have excess money).

A common alternative to making investments other than putting in an Islamic investment deposit in an Islamic bank is to buy and sell Islamic stocks directly. In this case, the investors have to pick stocks by themselves and decide when to sell those stocks to gain benefit. This certainly requires a lot of time to monitor the price fluctuation of their stocks. For the investors who are very busy, this may not be a good way. This leads to the creation of another investment alternative called the Islamic mutual fund.

Basic Concept of Islamic Mutual Funds

In some aspects, Islamic mutual funds are similar to conventional mutual funds. What makes Islamic mutual funds differ from their conventional counterparts is that Islamic mutual funds have to follow Shariah rules and guidance. Shariah principles forbid practices such as riba (charging interest), al-maisir (gambling and games of chance), and al-gharar (uncertainty) and these cannot be used in any financial transactions, including in mutual funds.

In the context of Islamic mutual fund portfolios, Shariah principles play a role in terms of asset allocation (by screening), investment, and trading practices, as well as in income distribution which needs to be purified by excluding some portion of it following the Shariah scholars' opinion (Elfakhani and Hassan, 2005).

In the conventional mutual fund, there is no such thing as stock screening. There are no restrictions to invest in a certain collection of stocks. In other words, managers of the conventional mutual funds can discretionally select any stocks, bonds, or combination between the two from any type of industry. However, this is not the way that Islamic mutual funds function.

Islamic mutual funds can not operate as freely as their conventional counterparts. Screening processes mean that all assets (i.e., stocks, sukuk, or hybrid) must be screened on the basis of Shariah. A complete discussion on this issue is elaborated in other chapters of this book. Hence, a brief explanation is given in the following section.

Shariah Stock Screening

There are a number of stages in Shariah stock screening. The first stage is to examine the nature of the business of companies. This involves screening products or outputs that are manufactured by companies. If the product is in line with Shariah, then its stock can be included as an asset in the portfolio of Islamic mutual funds. Conversely, Shariah screening obviously rejects the companies that produce or serve things such as alcoholic beverages (liquor), pornography items, gambling, pork-related items, and so on, from inclusion in the Shariah stock portfolio, as these are all prohibited in Shariah.

Second, other than the use of the product as the basis of the screening criteria, Shariah screening also requires the companies not deal with riba. An example are companies that deal with conventional banks. This means that companies that put their excess funds in the form of deposits in conventional banks may gain interest, and therefore a share of this company may or may not be included in the asset portfolio of an Islamic mutual fund. The basis is on the portion of the interest obtained. If the interest portion is less than a certain rate, then its share can be included in the mutual funds. Conversely, if the interest portion is more than the allowable rate (guidelines), then certainly, the share will be rejected. With regard to the rate used for the benchmark, it is solely dependent on the Shariah advisor within the

mutual fund company. Of course, each Shariah advisor may have a different view as to what the best rate is to be used for the guideline.

Besides shares used as assets in Islamic mutual funds, other assets also have to comply with Shariah values. Hence assets, such as corporate bonds and treasury bonds, that adopt an interest system have to be excluded from the Islamic mutual funds portfolio unless they are sukuk (Islamic bonds) that are Shariah compliant.

Purification of Income

Purification of income means identifying, cleansing, and purifying the contaminated income by distributing it to charity. It is common that any companies (company that produce goods that are Shariah compliant) may put their excess funds in the form of interest-based bonds or time deposits in a conventional bank. As a consequence, there is certainly interest income earned for the companies. These nonhalal earnings are obviously contaminating the total earning by the companies. What do Shariah rules say about this particular issue? There are two ways to deal with this case. First, to be included in a Shariah-compliant stock that later can be put into mutual funds, the company must shift their excess funds from previously depositing their fund in the conventional bank as well as buy interest-based bonds to deposit their funds in Islamic banks and buy Islamic bonds or sukuk. Alternatively, if the companies do not want to shift their funds, those interest incomes must be given away as charity and not be used for their own benefit.

For the latter, it is important to note that the purification is only applicable if the noncompliant income is below a certain percentage of the total revenue (for example, 5 percent; the percentage differs from one Shariah advisor to another). If the portion of the nonhalal income exceeds 5 percent, then the stock is categorised as a noncompliant stock and it cannot be included in the Islamic mutual fund portfolio.

Purification can be done in two ways: **dividend purification** and **haram income purification**. The former is calculated by dividing the nonhalal income (in this case interest income obtained from bonds and conventional time deposit) by total income and then multiplied by the received dividend. The obtained value should be given to charity. The numerical examples on the dividend and haram income that have to be purified are as follows.

Example: Numerical example for dividend purification

Total interest income from conventional time deposit: $1,000
Total revenue: $100,000
Total profit (revenue – expenses): $30,000
Total received dividend: $10,000

Based on this data, the interest income portion is 1 percent (total interest income from conventional time deposit is $1,000 and total revenue is $100,000). This means that the contaminated element in this stock can be purified, as the portion is less 5 percent. Otherwise, it is categorised as a non-Shariah-compliant stock that cannot be included in the

Islamic mutual fund. Eventually, the amount that has to be given as charity is $100(1 percent × $10,000 = total received dividend).

Example: Numerical example for haram income purification

Total interest income from conventional time deposit: $1,000
Number of shares that is issued at the end of the period: 1,000 shares
Number of shares held: 50 shares

From the data given here, the nonhalal component that has to be given as charity is $1,000/1,000 shares = $1; therefore, $1 is multiplied by 50 (number of shares held). Hence, the total nonhalal component is $50.

The amount of the haram income purification is arrived at by dividing the nonhalal income (including interest income) by the number of shares that are issued at the end of the period and is multiplied by the number of shares held.

Types of Islamic Mutual Funds

Islamic mutual funds can be categorised into four types, which are based on the principal investments:

1. Islamic money market funds
2. Sukuk or fixed income funds
3. Islamic stock or equity funds
4. Islamic hybrid funds

Each of these funds is explained below:

- **Islamic money market funds:** This Islamic mutual fund invests in Islamic money-market instruments. It offers fixed income securities and a very short time to maturity with a high credit quality. Money market funds are used as a substitute for the saving accounts. Examples of this are the Islamic Treasury bill or other short-term securities issued by the corporation.
- **Sukuk funds:** These Islamic mutual funds invest in Islamic fixed-income securities, such as sukuk. The sukuk can be categorised into several types based on the issuer of the sukuk. For instance, government sukuk issued by the government, municipal sukuk issued by municipalities, and corporate sukuk, which is issued by corporations. Other than based on the issuer, sukuk funds can also be based on the maturity of the sukuk such as short, intermediate, and long term. Moreover, it can also be based on whether it is issued domestically or if it is foreign sukuk.
- **Islamic stock or equity funds:** This type of Islamic mutual fund invests in common stocks, both domestic or foreign stocks. Certainly the stocks have to be Shariah compliant

in order to be considered as an asset in the Islamic mutual fund portfolio. There exist two classifications on these stock funds: (1)based on the market capitalisation and (2)based on the investment style, such as growth stock or value stock.

Market capitalisation or market cap is the value of the company's stock. It is equal to the number of shares outstanding multiplied by the market price of a certain stock. Within the market capitalisation itself, it can be categorised into four categories:

1. Micro capitalisation
2. Small capitalisation
3. Mid capitalisation
4. Large capitalisation

This categorisation may differ from one country to another. For example, in the United States, stock can be included in the large cap if its market capitalisation is more than $10 billion. This type of stock is mainly offered by big companies or blue chip companies, and the price of each share is very high.

Small and micro cap stocks have market capitalisation that is below $2 billion and $300 million respectively. Small cap as well as micro cap consists of the companies that are emerging. The risks involved are greater than those of mid cap.

Based on the investment style, stocks can be categorised into growth and value stocks. The former seeks to invest in stocks of fast-growing companies. It means that it is the stock of a company where the revenue is bigger than its industry or the overall market. This company normally pays little or no dividends and prefers to use income other than bank loans to finance the business.

The latter (value stock) seeks to invest in stocks that are cheaply priced. This is a stock that tends to trade at a lower price relative to its fundamentals, which are shown by dividends, earnings, sales, and so forth, and thus considered undervalued by investors.

In order to identify whether a stock is categorised as growth or value stock, it can be identified from the value of price to book ratio. If a stock has a low price to book ratio, then it is classified as value stock. Conversely, if another stock has a high price to book ratio, then it is categorised as a growth stock.

Another categorisation of this Islamic stock fund is based on whether the stock is coming from the domestic market or international market. Certainly, the later has additional risk exposure than the former as it has to consider the country where the stock is issued. Moreover, exchange rate has to be taken into account by the manager. The other category is based on the sector. This type of mutual fund will invest in a particular sector, for instance, manufacturing, agriculture, transportation, and so forth.

- **Islamic hybrid funds:** This is a type of Islamic mutual fund that combines both sukuk Islamic stocks and Islamic money market funds. The purpose is to provide both income and capital appreciation while preventing excessive risk. Another purpose is to provide investors with a single mutual fund that combines both growth and income objectives. This diversification ensures that the funds perform well in the downturns of the stock market, hence protecting against a big loss. However, this fund normally performs less than any other stock fund during the bull market.

The Role of the Shariah Advisory Board in Islamic Mutual Funds

Unlike conventional mutual funds, in which the assets such as stocks or bonds do not need to be screened, in Islamic mutual funds, this screening process on the basis of Shariah rules has to be done. This is why the role of Shariah advisors is very important in the mutual fund. In order to help the job done by the manager, the advisors should provide criteria used as a guideline to determine whether certain assets, that is, stocks, are Shariah compliant or not. Moreover, the advisors also oversee the management of the trading in order to ensure that speculation and gambling are absent.

The Shariah board normally consists of prominent Islamic legal scholars coming from a Shariah background, and well versed in transactions and business activities. Generally the responsibilities of the Shariah board are:

1. Creating Shariah-compliant investment guidelines. As different Shariah advisors may have different schools of thought, the Shariah decision on the guidelines may also be different among them.
2. Monitoring and evaluating the funds activities to ensure Shariah compliance. An example of this is an assurance that the manager avoided activities that are deemed to be non-compliant with Shariah (such as gambling, speculation, and so forth.)
3. Selecting the appropriate charities in the case of purifications. Once the nonhalal revenue has been identified and calculated, it is then the job of the Shariah advisor to determine the use of that portion. The advisor may suggest an appropriate charitable institution to receive the funds.
4. Assisting and supervising the funds management on the issue of the development of Islam. As the stakeholders of the Islamic mutual funds are not necessarily Muslim, another job of the Shariah advisor is to ensure that the Muslim ummah get the greatest benefit of Islamic mutual funds. For example, buying stocks from companies that are owned by Muslims, buying government sukuk from Islamic countries, and so forth.
5. Proposing zakat. The other role of the Shariah advisor is to propose zakat on the Islamic mutual funds transaction. (Elfakhani and Hassan, 2005)

Calculating NAV in Islamic Mutual Funds

Net Asset Value is defined as current market value of funds minus the fund's liabilities (sometimes it is defined as "net asset"). This amount will then be divided by the number of funds outstanding. This value must be computed daily every time the stock exchange market is open.

Investors pay the mutual fund assets in terms of units. For example, an investor pays RM10 per unit. This price is called par value or face value. The price changes every day, which

is why it is called marked to market. Assume there are two investors, Yusuf and Ahmad. Both of them invest RM10,000 and RM90,000 respectively. The total would be RM100,000 with a price per unit of RM10. Yusuf is entitled to get 1,000 units and Ahmad gets 9,000 units. As the NAV is a total amount over total outstanding share (unit), with the information above, the NAV would be RM100,000/10,000, which is equal to RM10.

With the total of RM100,000, assume that the fund manager allocates those funds in two equity funds: Islamic Mutual Funds A and B (see Table 7.2). For instance, he spends 100 units of Fund A at RM500 each (the total would be RM50,000), and he spends 100 units of Fund B at RM400 (the total would be RM40,000), and he keeps the remaining RM10,000.

Assume that on the next day, the equity stocks within IMFs A and B increase to 20 percent and assume there is no management fee. So Table7.2 changes to Table 7.3.

This new NAV of 11.8/unit means that the asset value of Yusuf and Ahmad increases from 10 to 11.8. See Table 7.4.

Remember that the stock prices (within the mutual funds) have gone up 20 percent (for both IMF A and B) but the increase in the NAV is only 18 percent. Why? It is because the

TABLE 7.2 Islamic Mutual Funds A and B (before price increase)

Name of Stock	Number of Unit	Price	Value
Islamic Mutual Fund A (IMF A)	100	500	50,000
Islamic Mutual Fund B (IMF B)	100	400	40,000
Remaining cash			10,000
Total			100,000

TABLE 7.3 Islamic Mutual Fund A and B (after price increase)

Name of Stock	Number of Units	Price	Value
Islamic Mutual Fund A (IMF A)	100	600	60,000
Islamic Mutual Fund B (IMF B)	100	480	48,000
Remaining cash			10,000
Total			118,000
Number of units			10,000
NAV per unit			118,000/10,000=11.8

TABLE 7.4 Islamic Mutual Funds A and B (after price increase)

	Number of Units	New NAV	Value	Initial Investment
Yusuf	1,000	11.8	11,800	10,000
Ahmad	9,000	11.8	106,200	90,000

manager keeps some portion of the fund that is not being invested. Retaining cash is important for the withdrawal of the investors.

Normally NAV prices are announced at 9 P.M. every day. Today's price can be bought until 3 P.M., but after that the price can no longer be used. We should use tomorrow's price. The new investors who are interested in buying this unit can only buy at the new NAV (11.8); they could not buy at the price where Yusuf and Ahmad bought.

Organisation of Islamic Mutual Funds

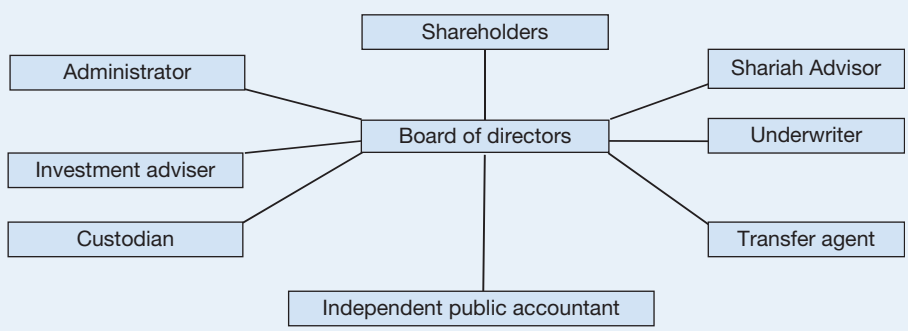
The general organisational structure of the Islamic mutual fund institution is shown in Figure 7.2. There are nine entities within the institution. Those are:

1. Shareholders
2. Sharia advisor
3. Underwriter
4. Board of directors
5. Transfer agent
6. Independent public accountant
7. Custodian
8. Sponsor/Investment advisor
9. Administrator

The role of each entity is explained as follows:

1. Shareholders: Similar to other companies, shareholders in the organisation that offers Islamic mutual funds have specific voting rights, for example, a vote to elect directors at

FIGURE 7.2 Organisation Structure of Islamic Mutual Funds



the meetings. Other matters that involve the role of shareholders are on the management fees or fund's investment objectives or fundamental policies, which cannot be changed unless the majority of shareholders vote to approve any changes.

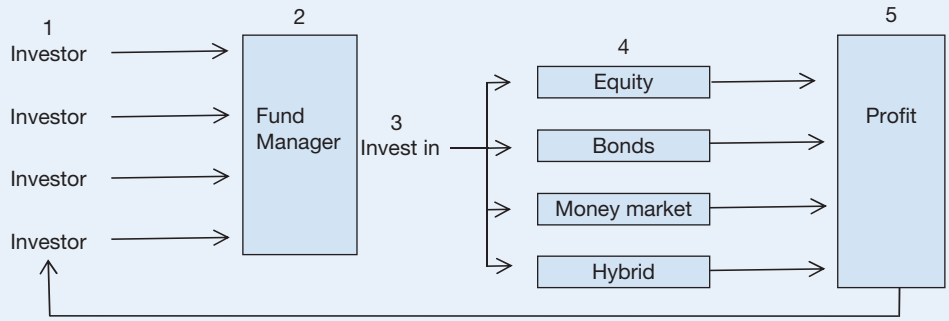
2. Investment adviser: This role is important as the adviser gives advice in directing the funds to the fund manager. The investment advisers select the employees, which include the investment professionals who work on behalf of the funds' shareholders. The job is to select which securities to buy and sell in the Islamic mutual funds' portfolio, and decisions have to be consistent with the funds' objectives and policies. Moreover, other than managing the portfolio, the investment adviser also provides service with regard to the administration for that fund (back office services).
3. Administrators: This administrator handles the administrative matters that are not done by the investment adviser. An example of this would be fund accounting services, data processing, bookkeeping, internal audits, and other reports.
4. Principal underwriters: Principal underwriters are also called the fund's distributors. In this case investors buy and redeem fund shares either directly or indirectly via the fund's distributor. The role is subject to strict rules governing how they offer and sell securities to investors.
5. Transfer agents: The agents that maintain the records of shareholder accounts, compute and distribute dividends and capital gains, prepare the shareholders' account statements, and are responsible for other shareholder notices.
6. Auditors: The job of the auditor is to certify the fund's financial statements.
7. Custodian: All funds are required to maintain strict custody of fund assets that are separate from the assets of the adviser. The domestic securities should be held by the domestic custodian, while foreign securities are required to be maintained in the foreign bank or securities depository.
8. Shariah advisors: This entity is important to ensure that all securities are Shariah compliant, and furthermore it oversees the practice and management of the Islamic mutual funds. This is to prevent impermissible activities such as gambling.

The Process of Investing in Islamic Mutual Funds

Figure 7.3 shows the process of investing in Islamic mutual funds.

1. Islamic mutual investors come to the IMF institution and meet the fund managers.
2. The investors discuss the objective of their financial investment. There are many examples of financial goals. Some of them are planning their retirement, for their children's educations, capital for their children to start up their own business after they graduate, and so forth.
3. It is important for the fund manager to get to know the period of time chosen by the investors so that later the manager can suggest some of the Islamic mutual funds portfolios with given risks. If the period is short, then the manager should opt for the type of

FIGURE 7.3 Process of Investing in Islamic Mutual Funds



investments that offer lower risks, for example, if someone is getting married in the next two years, he has to choose the type of mutual funds that offers a lower risk so by his wedding day, he has not lost his money. Conversely, if the purpose is for retirement planning (assume the retirement age is 60) and the investor's current age is 30, then the manager has plenty of time. The more time, the more options for investment we have. Unlike short time periods when chosen instruments have to involve less risk, in a longer time frame the risk is tolerable.

4. Once we identify the objective of the financial investment as well as the available period, we then move to the next step, that is, choosing the investment options. Several types of mutual funds are available, such as Islamic equity funds, sukuk funds, Islamic money market funds, and Islamic hybrid funds. If the objective is for retirement planning (long term), then the fund manager with his skill and knowledge shall select a more risky investment by selecting equity funds that are expected to provide a better return.

   If the investor would like to have short-term investments then the fund manager may opt for Islamic Treasury bills. This is because it is highly unlikely that the government will default on its payment. Given the low risk, the return cannot be expected to be as high as that of other assets, such as Islamic stocks.
5. Regularly, the profit gained from the investment will be given to the investors, who may choose to add this to the initial capital to continue their investment in Islamic mutual funds.

Example: Amana Income Funds[2]

Investment Objective: Current income and preservation of capital that is consistent with Islamic principles. Current income is its primary objective.

Strategies: The fund invests in common stock both domestic and foreign. Investment decisions have to follow Islamic principles. In terms of the composition portfolio within the income funds, it diversified its investments across industries and companies and

generally follows a value investment style. Notice that value stocks are cheaply priced. In other words, it is the stock for which the price is below the book value. The fund purchases only dividend-paying companies, which are expected to have more stable stock prices and tend to be larger companies.

Principal Risks of Investing: The performance of the income fund depends on the performance of the individual stocks within the portfolio. The rises and falls in the income fund is following the increase and decrease of the stock's price. Hence, it is possible that investing in Islamic mutual funds can create loss in value, but this is the risk that the investors must face. However, this is an important role of the Islamic mutual funds manager: to select the stocks with appropriate risk and return.

There is a possibility that this income fund invests in securities that are not traded in the United States. The risks of doing that have to be seriously taken into account, such as (1) foreign political and economic instability; (2) adverse movements in foreign exchange rates; (3) currency devaluation; (4) the imposition or tightening of exchange controls or other limitations on repatriation of foreign capital; and (5) changes in foreign governmental attitudes towards private investment, including potential nationalisation, increased taxation, or confiscation of assets.

Example: Amana Growth Funds[3]

Investment Objective: The primary objective of the growth fund is long-term capital growth.

Principal Investment Strategies: The growth fund invests only in common stocks, including foreign stocks. Investment decisions are made in accordance with Islamic principles. The fund favors companies expected to grow earnings and stock prices faster than the economy, and that tend to be smaller and less-seasoned companies.

Principal Risks of Investing: Smaller and less-seasoned companies that may be in the growth fund have a greater risk of price volatility. Growth stocks, which can be priced on future expectations rather than current results, may decline substantially when expectations are not met or when general market conditions weaken.

Islamic Ethical Investment and Ethical Investment

Normally, nonfinancial factors such as social group and environment do not figure prominently in the design of mutual funds. However, there is an increasing trend that uses these nonfinancial factors as a determinant factor in the mutual fund, which has been called a socially responsible investment or ethical investment in recent years (Ganzi, 1998).

Prindl and Prodham (1994) have defined the ethical investment as the exercise of ethical and social criteria in the selection and management of an investment portfolio, generally consisting of company shares (stocks). It differs substantially with the common

investment decision making found in finance textbooks, which focus only on the financial return, in the form of dividends and capital gains and risk. The definition of an ethical fund is that it is a fund that excludes one or more firm groups from their portfolio for nonfinancial reasons. Factors considered in the ethical investment are the nature of the company's goods or services and the business location, as well as how the funds are conducted (or the manner in which the fund conducts its affairs).

Whether this ethical investment is viable or not is a long-debated issue. Proponents of ethical investments are of the opinion that using the screening process of both financial aspects and ethical criteria makes positive contributions socially and economically. The screening process is important to ensure that the ethical investors in their investment are consistent with their faith, values, norms, and so forth.

Another proponent argues that firms that pass the screening process enjoy a stronger financial position and more profits than firms that are rejected due to the screening processes. For example, firms that are concerned about their effects on the environment are less likely to encounter environmental fines and lawsuits. Likewise, firms that are fully responsive to product quality are equally unlikely to be subjected to product liability suits and costly settlements.

Another factor that is considered in the ethical investment is good corporate citizenship. A company may create firm loyalty among customers and therefore increase its sales. This good corporate citizenship can also be extended to employees of the firm. Good employee relations mean that the firm is able to attract and retain good workers. Loyal employees will benefit the firm by increasing its productivity, which means higher profitability.

However, the existence of ethical investment raises some criticisms. Opponents argue that the screening process incurs costs, which influence the investment performance so that the unscreened assets may outperform the screened ones.

Moreover, the screening process tends to reject the large firms, which are less volatile, and hence the return is stable. As a result, the remaining assets (stocks) that pass the screening process tend to be smaller and more volatile. In term of diversification, the portfolio may not be well diversified, due to the screening process.

The basic feature of Islamic finance is that it promotes the real sectors through various ways that are Shariah compliant, specifically Al Quran and Sunnah. The Quran is not merely moral teachings but also offers guidance in all aspects of life, including socioeconomic behavior. Examples were offered by the Prophet Muhammad. He was a successful businessman with high integrity and honesty. Moreover, his teachings regulate family behaviors and inheritance, and the use of public and private goods.

In the case of Islamic ethical investment, the funds are directed toward low debt, nonfinancial, and social-ethical investment. In the current modern era, some of the features have aspects in common with other ethical investing such as green investing, faith investing and socially responsible investing.

The main different features between Islamic and other ethical investments, beside excluding certain sectors (such as companies that produce alcoholic beverages, gambling, and so forth), is that Islamic funds do not deal with the fixed income market and the interest payment.

Chapter Questions

1. Describe the process of purification of income from the Shariah perspective.
2. Suppose that the financial report of a Shariah-compliant stock in a company is as follows:
   a. Total interest income from conventional time deposit: $1,800
   b. Total revenue: $360,000
   c. Total income (revenue − expenses): $30,000
   d. Total received dividend: $20,000

   This company asks you to be the Shariah advisor and requests you to calculate the amount that has to be given to charity as an attempt to purify the stock. How do you respond?
3. Briefly explain the types of Islamic mutual funds.
4. Describe the role of the Shariah Advisory Board in an Islamic mutual fund.
5. Assume that the total number of outstanding shares (units) is 10,000.

Mutual Fund	Number of Units	Price	Value
Islamic Mutual Fund A (IMF A)	140	400	
Islamic Mutual Fund B (IMF B)	180	300	
Total			

Question:

a. Calculate the NAV.
b. If the price of IMF A and IMF B increases to 450 and 400 respectively, calculate the new NAV.

Notes

1. See the detailed list in the "Fees and Expenses" section of this chapter.
2. Taken from Amanah income fund prospectus.
3. Taken from Amanah income fund prospectus.

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CHAPTER

8

Islamic Real Estate Investment Trusts (I-REITs)

Learning outcomes

At the end of this chapter, you should be able to:

1. Distinguish the differences between conventional and Shariah-compliant REITs.
2. Explain the Islamic REITs structure.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

A real estate investment trust (REIT) is a special type of mutual fund. Like other mutual funds, REITs allow small investors to participate with a low minimum investment. However, whereas other mutual funds invest only in financial instruments, REITs also invest in real estate and/or mortgages. Therefore, it is a vehicle that mobilises funds from the unit holders comprising individuals and companies for investment in real estate. Income generated by REITs come from rents on real property and/or interest payments on mortgages and will be passed through to shareholders.

REITs are eligible to be sold on stock exchanges so investors can easily buy and sell them at any time. Other than supply and demand law, the share value of REITs is also influenced by their composition, which is determined by the portfolio manager. Investors will monitor whether or not the portfolio manager has the expertise required for real estate investment and industry. Therefore, although the REIT's performance was good, the share value can be low due to the small number of investors who want to invest in it.

REITs normally are classified as equity REITs, mortgage REITs, and hybrid REITs. Equity REITs are REITs that invest directly in properties, whereas mortgage REITs invest in mortgage and construction loans. Hybrid REITs combine equity and mortgage REITs, which means they invest in properties and mortgage. As property values and rents tend to increase along with inflation, investors use equity REITs to hedge against inflation. REITs are expected to give the investors high returns if they are invested in potential high-growth properties. Asian countries like Malaysia and Singapore are attracting substantial interest from cross-border real estate investors from the United States and European countries. Figure 8.1 explains the main determinants that raise the demand for real properties in Asian countries.

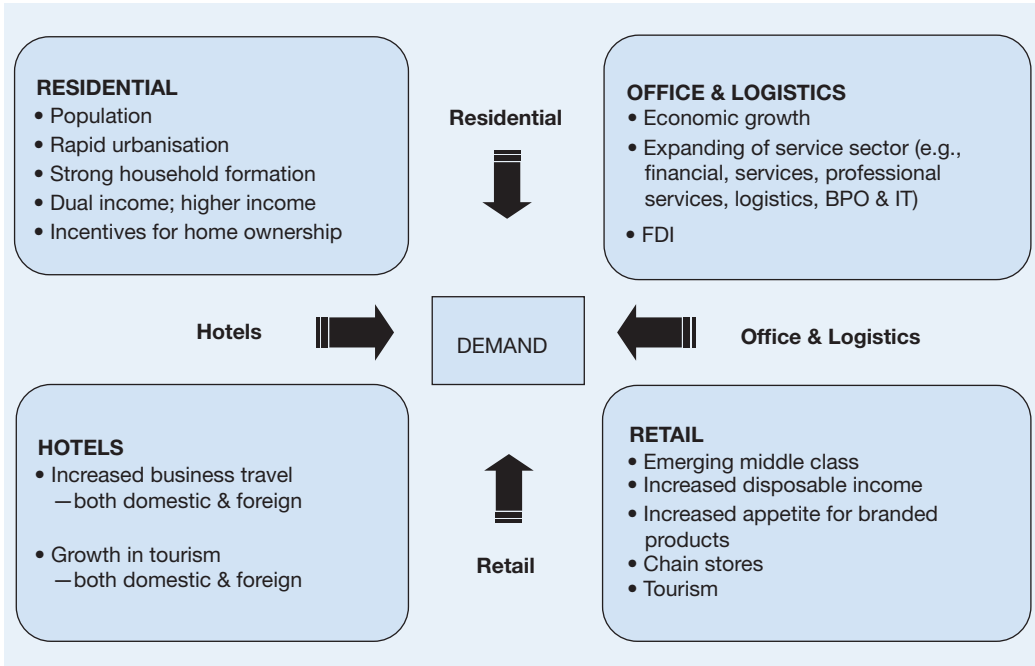
Large population growth and rapid urbanisation require development of residential areas and units in most Asian countries. In Malaysia, for example, 72 percent of the total population lives in urban areas and the rate of urbanisation is 2.4 percent per year while the rate of urbanisation for China is 2.3 percent per year and 47 percent of the total population lives in urban areas. This situation has triggered real estate investors to invest their money in building residences for the people and gaining profit from rental or property values. Other factors that influence the demand for real estate development are economic growth, increases in the number of tourists, hotels, and so forth.

In the global REIT market, as reported in Table 8.1, Asian REITs account for 10.6 percent of all global REITs with Japan and Singapore as the largest market capitalisation, both 6.66 percent and 2.26 percent, respectively. Meanwhile, American, European, Oceanian, and African markets account for 54.32 percent, 20.47 percent, 14.23 percent, and 0.35 percent, respectively.

Investing money in REITs will give investors many advantages. These advantages include the following:

1. **Taxes**
   - Tax benefits in taxable jurisdictions
   - Tax free jurisdictions shall attract foreign investors

FIGURE 8.1 Determinants of the Demand for Real Properties in China and India



Source: PricewaterhouseCoopers (2008).

2. **Liquidity**
   - REITs are a liquid asset that can be sold quickly to raise cash or take advantage of other investment opportunities.
   - REITs allow institutional funds to make incremental investments in unpredictable real estate when new investment funds are received.
3. **Diversification**
   - Diversification based on types of properties, tenants, and locations.
   - Using REITs, common investors can diversify their holdings between various geographic areas and property specialisations in listed real estate investments.
4. **Hedging**
   - Low correlation to interest rates.
   - Better inflation hedge.
5. **Profit**
   - High cash dividends relative to the market.
   - REITs can typically distribute more than 90 percent of net cash flow.
   - Income is underpinned by legally enforceable lease agreements.
   - Since REITs have a lower correlation to equities than many other asset classes, it provides portfolio stability for those with an active asset allocation strategy.

TABLE 8.1 Global REIT Market Report, 2007

Listing Country	Number of Companies	Market Cap > £1bn	Sector Market Cap (£mill)	% of Global Listed Real Estate Equity Mkt	% of Global REIT Mkt	% of Local Listed Real Estate Mkt
FAR EAST	100	11	44,130	4.03%	10.55%	
FAR EAST DEVELOPED	63	11	41,670	3.81%	9.96%	
Japan	41	7	27,901	2.55%	6.67%	23.87%
Singapore	16	3	9,438	0.86%	2.26%	19.85%
Hong Kong	6	1	4,330	0.40%	1.03%	2.91%
FAR EAST EMERGING	37	0	2,460	0.22%	0.59%	
Taiwan	7	0	909	0.08%	0.22%	15.09%
Malaysia	13	0	702	0.06%	0.17%	8.26%
South Korea	10	0	520	0.05%	0.12%	93.49%
Thailand	7	0	328	0.03%	0.08%	8.14%
AMERICAS	217	58	227,294	20.77%	54.32%	
AMERICAS DEVELOPED	217	58	227,294	20.77%	54.32%	
United States	184	54	213,161	19.48%	50.94%	82.22%
Canada	33	4	14,133	1.29%	3.38%	38.24%
EUROPE	99	19	85,666	7.83%	20.47%	
EUROPE DEVELOPED	67	19	84,194	7.69%	20.12%	
United Kingdom	14	7	35,457	3.24%	8.47%	47.28%
France	30	7	31,058	2.84%	7.42%	69.14%
Netherlands	9	4	14,109	1.29%	3.37%	75.69%
Belgium	14	1	3,569	0.33%	0.85%	82.11%
EUROPE EMERGING	32	0	1,472	0.13%	0.35%	
Turkey	11	0	940	0.09%	0.22%	99.18%
Greece	2	0	373	0.03%	0.09%	17.22%
Bulgaria	19	0	159	0.01%	0.04%	92.33%
OCEANIA	69	13	59,934	5.48%	14.32%	
OCEANIA DEVELOPED	69	13	59,934	5.48%	14.32%	
Australia	61	13	58,385	5.34%	13.95%	84.88%
New Zealand	8	0	1,549	0.14%	0.37%	91.23%
AFRICA	5	0	1,444	0.13%	0.35%	
AFRICA EMERGING	5	0	1,444	0.13%	0.35%	
South Africa	5	0	1,444	0.13%	0.35%	26.60%
GLOBAL REIT	490	101	418,468	38.24%	100%	
GLOBAL DEVELOPED	416	101	413,092	37.75%	98.72%	
GLOBAL EMERGING	74	0	5,376	0.49%	1.28%	

Source: AME Capital/Bloomberg (2007).

FIGURE 8.2 REIT Structure

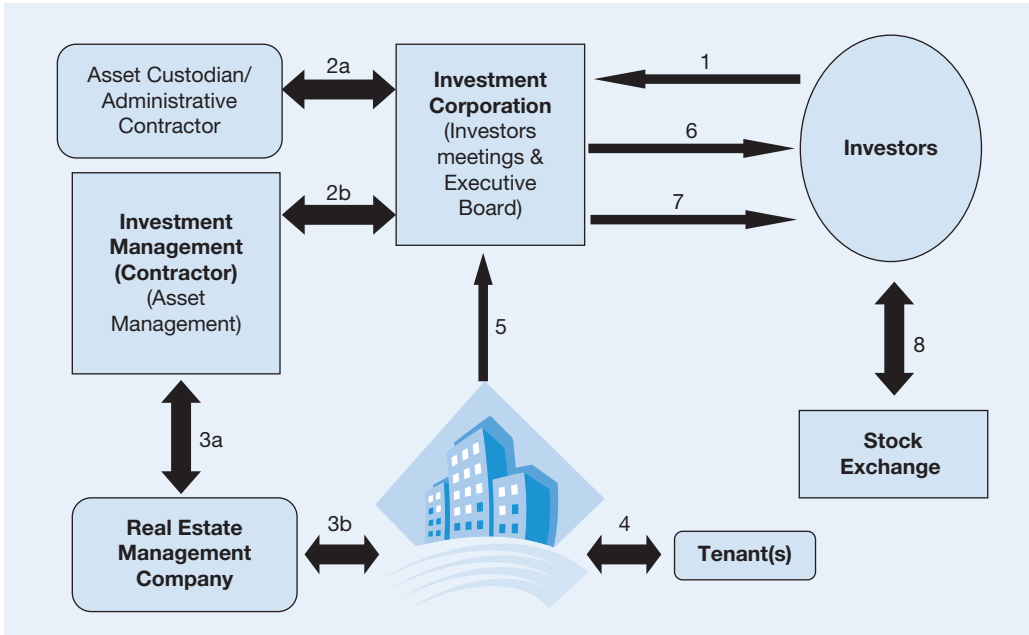


Figure 8.2 depicts the structure of the REIT—the diagram shows the following:

1. Investors buy the REITs via Investment Corporation.
2. (a) The investment corporation works together with asset custodian and (b) asset management contractor to get a good REIT portfolio.
3. (a) Investment manager will choose the real estate company with the best portfolio performance and (b) potential locations and tenants.
4. Rental payment from the tenant(s).
5. Ownership will be transferred to the equity REITs investors via Investment Corporation.
6. Investment certificates are given to the investors.
7. Dividends will be given periodically to the investors.
8. If they want, investors can trade their REITs certificates to the stock exchange.

Islamic Real Estate Investment Trusts (I-REITs)

There is no universal definition of an Islamic REIT (I-REIT), although all definitions have to comply with the requirements of Shariah. Following the I-REITs guidelines released by the Securities Commission of Malaysia in November 2005, an Islamic or Shariah-compliant REIT

is a collective investment scheme in real estate, in which tenants operate permissible activities according to Shariah. As the first country to establish Islamic REITs (I-REITs), Malaysia put all its efforts into ensuring full compliance of I-REITs transactions with Shariah tenets. In order to do that, every single transaction on property for I-REITs has to be examined by the Shariah Advisory Council of the Malaysian Securities Commission.

The Islamic REITs were developed to provide unit holders with a stable distribution per unit with the potential for sustainable long-term growth of such distributions. This will be done by optimising the performance and enhancing the overall quality of a large and geographically diversified portfolio of Shariah-compliant real estate assets through various permissible investments and business strategies.

Shariah-Permissible Investments for I-REITs

As explained before, equity REITs invest in and own properties and mortgage REITs loan money for mortgages to owners of real estate, or invest in (purchase) existing mortgages. Thus, the REITs area of investments is very broad and promising to offer a good income. REITs investments include physical land and man-made items attached to the land, private companies whose principal assets comprise real estate, and so forth.

Islamic REITs Shariah-permissible investments are also similar to conventional REITs. However, some restrictions are related with nonpermissible activities. The Malaysian Securities Commission through its Shariah Advisory Council has released the guidelines that should be followed in order for a REIT investment to be declared a Shariah-compliant REIT. The main tasks of the Shariah Advisory Council are to review, monitor, and approve or disapprove investments by Islamic REITs in order to ensure that they are Shariah compliant.

The criteria outlined by the securities commission in their guidelines on Islamic REITs are:

- Rental of real estate by Islamic REITs for business purposes.
- Investments, deposits, and financing for Islamic REITs.
- Takaful scheme to insure real estate. A conventional insurance scheme is only allowed if the takaful scheme is unable to provide the insurance coverage desired.
- Forward sales or purchases of currency for risk management and Islamic financial institution under the concept of wa'ad (only one party is obligated to fulfill his promise/responsibility). Participation in conventional forward sales or purchases of currency is permitted if the Islamic REITs deal with conventional financial institutions.

Rental of real estate is permissible, except when the property is used by the tenant(s) for nonpermissible activities such as:

- Financial services based on riba (interest).
- Gambling or gaming.

- Conventional insurance.
- Entertainment activities that are not allowed by Shariah law.
- Manufacturing or sale of tobacco-based products or related products.
- Stock broking or share trading in Shariah–non-compliant securities.
- Hotels and resorts.
- Other activities that are not permitted by Shariah law.

An Islamic REIT is permitted to own (purchase) real estate in which the tenant(s) conduct mixed activities that are both permissible and nonpermissible, according to the Syariah. However, based on the guidelines from the Malaysian Securities Commission, the Islamic REIT fund manager must perform some additional compliance assessments before acquiring real estate that has a tenant(s) who operates mixed activities.

First Case: Mixed Activities

According to the guidelines for mixed activities in Islamic REITs, an Islamic REIT must obtain the total rental from nonpermissible activities from the property that it wants to acquire, and subsequently compare the total rental from nonpermissible activities to the total turnover of the Islamic REIT (latest financial year). This is to find the percentage of rental from nonpermissible activities. The percentage amount will be referred to the 20 percent benchmark, as determined by the Shariah Advisory Council of the Securities Commission for the criteria on rental from nonpermissible activities. In the event that the percentage exceeds the benchmark, the Shariah adviser shall advise the Islamic REIT fund manager not to invest in the said real estate.

For example, if the total rental from nonpermissible activities is RM205,000 and the total turnover of the Islamic REIT for that financial year is RM1,000,000, then the percentage of rental from nonpermissible activities is 20.5 percent, which exceeds the 20 percent benchmark that has been determined by the Shariah Advisory Council. In this situation, the Shariah adviser shall advise the Islamic REIT fund manager not to invest in the said real estate.

Second Case: Rental of Nonpermissible Activities

One might have a question on one specific condition—for example, if an Islamic REIT owns real estate that is vacant and plans to rent it out to a new tenant(s) that will operate a mixed-income from the Islamic REIT. Assume that it is a supermarket that will sell halal-goods and alcoholic beverages. Every month, this supermarket will pay RM5,000 to the Islamic REIT. How does the Shariah adviser distinguish the rental that is considered as nonpermissible from the total rental paid by the supermarket?

In this situation, following the guidelines provided by the Malaysian Securities Commission, the calculation for the rental of nonpermissible activities from a tenant(s) operating mixed activities can be based on the ratio of area occupied by nonpermissible activities to the total area occupied. The percentage will be used as the basis for determining the ratio of rental of nonpermissible activities to total rent paid by the tenant(s).

For example, in a supermarket, if the total area rented out is 1,000 square feet and the area allocated for the sale of alcoholic beverages is 100 square feet, then the ratio of area used for the sale of alcoholic beverages is 10 percent. Therefore, the rental from nonpermissible activities (sale of alcoholic beverages) is 10 percent of the total rental paid by the supermarket, that is RM500 a month (10 percent × RM5,000). In addition, for activities that do not involve the use of space, such as services-based activities like packaging of goods that are non-permissible, the calculation method will be based on the ijtihad of the Shariah advisor of the Islamic REIT.

The prohibited income cannot be distributed to the investors but must instead be donated to charity. In some situations, the fund managers allow the investors some discretion in deciding the recipient organization of those charity funds. However, there is no consensus among Shariah scholars in the way of implementing the purification or the standard available from AAOIFI. Instead, the way to compute purification is provided by some institutions:

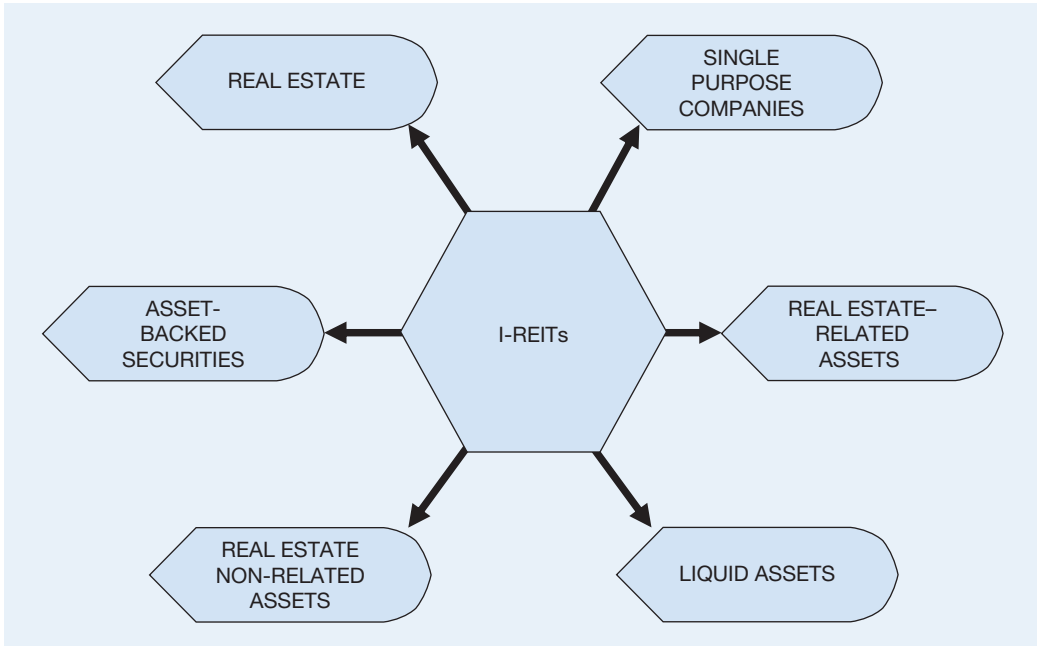
- AAOIFI
  - First step: determine the proportion of prohibited income → (Total prohibited income: number of shares)
  - Second step: Determine the quantum of prohibited income → (Number of shares owned × proportion of prohibited income)
- FTSE GII
  - 5 percent of the dividend received should be taken out and given to charity.
- S&P SI
  - Estimating tainted dividend → Div × (Nonpermissible revenue: revenue).

As depicted in Figure 8.3, based on the Islamic REITs' guidelines of the Malaysian securities commission, Shariah-permissible investments for Islamic REITs are divided into six broad categories:

1. **Real Estate Investments:** Physical land and man-made items attached to the land.
2. **Single-Purpose Companies Investments:** Private companies whose principal assets comprise real estate.
3. **Real Estate-Related Assets Investments:** Units of other I-REITs, Shariah-compliant securities of property companies, and Islamic securities issued by property companies.
4. **Liquid Assets Investments:** Shariah-compliant securities of nonproperty companies.
5. **Real Estate Nonrelated Assets Investments:** Cash, deposits, or other instruments convertible into cash within seven days (or following the Shariah guidelines on this issue).
6. **Asset-Backed Securities:** Sukuk issued from securitisation of transactions.

In an Islamic REIT, there is a registered deed (legal instrument) to the regulator (securities commission) that governs the three partite relationships between the unit-trust manager, the trustee, and the unit holders. The trust deed is a legally binding agreement

FIGURE 8.3 Shariah-Permissible Investment for Islamic REIT



between the manager, trustee, and unit holders. The agreement usually clearly spells out how the unit trust scheme is to be administered. The contents usually include:

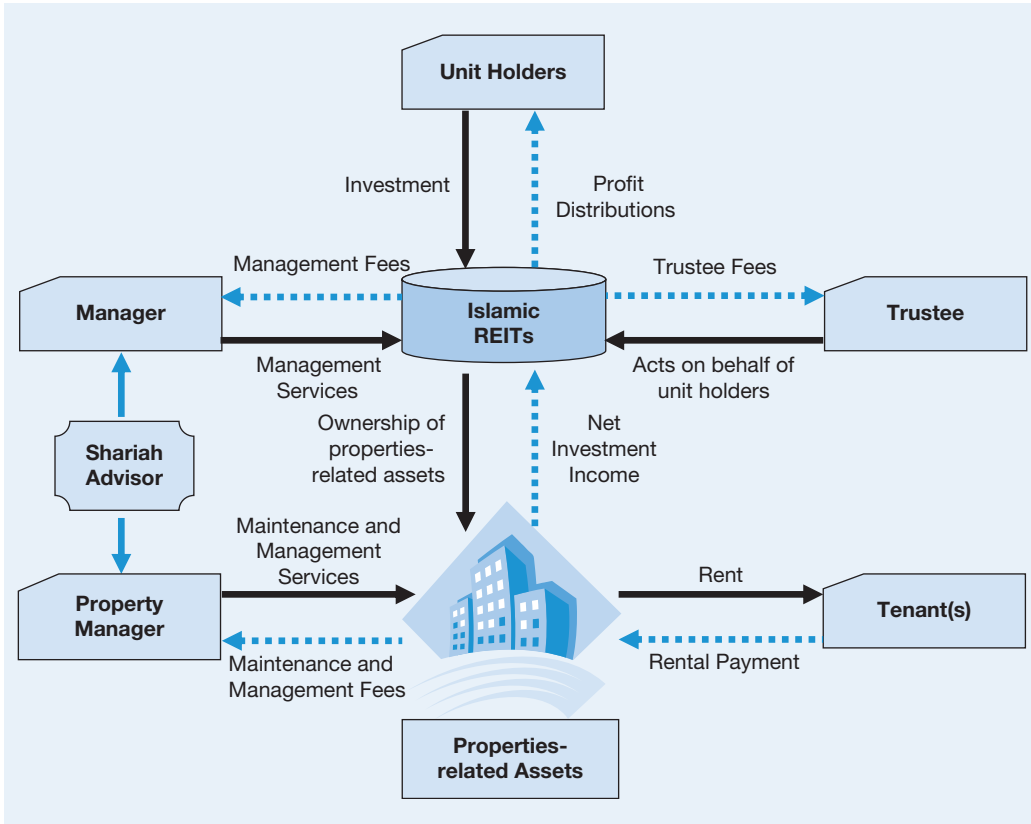
- Valuing and pricing of units.
- Keeping of proper accounts and records.
- Collection and distribution of income.
- Rights of unit holders.
- Duties and responsibilities of the manager.
- Duties and responsibilities of the trustees.
- Protection of unit holders' interest.

I-REITs Structure

The very significant difference between the conventional and Islamic REIT structure is the existence of the Shariah advisor (see Figure 8.4). The roles of the Shariah advisor are:

- Establish Shariah guidelines for the fund manager.
- Monitor fund operations so as to ensure Shariah compliance.
- Make updates to Shariah guidelines when necessary.
- Devise capital gains and dividend cleansing procedures.
- Provide assurances to investors that their investments are managed in compliance with Shariah.

FIGURE 8.4 Islamic REIT Structure



A Shariah advisory team works together with the management, which has normal tasks, such as managing the properties effectively, maintaining net property income, raising the profile of properties, acquiring property assets with good yield and growth potential both locally and abroad that meet the manager's investment criteria, and employing optimum capital structure in return for a fee (ujrah). However, based on the I-REITs guidelines by the securities commission, as mentioned before, the manager of an Islamic REIT must also ensure that all forms of investment, deposit, and financing instruments comply with Sharia principles. In addition, an Islamic REIT has to use Islamic insurance to insure its property. However, when Islamic insurance is unavailable to cover the scheme developed by the management, conventional insurance is acceptable. As a risk management effort, an Islamic REIT is also encouraged to participate in forward sales or purchases of currency with Islamic financial institutions. However, if the Islamic REIT deals with conventional financial institutions, it is permitted to participate in the conventional forward sales or purchases of currency.

In the wakalah model of Islamic REIT, unit holders appoint a trustee to serve as a custodian for all the assets of the Shariah-compliant REITs. On behalf of the unit holders, trustees appoint the Management Company to invest funds in properties. Both the trustee and

Management Company earn fees for their services. All these agreements are incorporated and should be written clearly in the deeds of Shariah-compliant REITs. As a consequence, under the wakala-based Islamic REIT structure, the fees consist of:

- Management fee.
- Maintenance and management fees.
- Trustee fee.
- Shariah advisor member fee.
- Fund expenses.

Following the implementation of a wakala contract in Islamic REIT, unit holders are facing some risks that later on justify their right to gain profit (al-ghurm bil-ghunm). The risks faced are:

- Original investment is not guaranteed.
- Income may rise or fall.
- May not receive any income at all.

The risk of not getting any income at all is due to the unit holders promise to pay the fees for management, maintenance and management, trustee, Shariah advisors, and other expenses. To overcome this problem, the alternative model of Islamic REIT is the mudharabah model, which uses the profit-sharing concept and not the fees concept. The mudharabah contract is applied only between trustees on behalf of unit holders. Meanwhile, trustees and unit holders still use the wakala contract, which declares that the trustee (as wakeel) acts on behalf of unit holders.

Case Study: Al-'Aqar KPJ REIT[1]

The Al-'Aqar KPJ REIT is the first Shariah-compliant REIT listed on the stock exchange in the world. This Islamic REIT is sponsored by the KPJ Group, whose principal activity is investing in Shariah-compliant properties with the primary objective of providing unit holders with stable distribution and potential for sustainable long-term growth of such distribution and capital appreciation. The Al-'Aqar KPJ REIT has obtained many achievements, such as the world's first listed Islamic REIT, Asia's first healthcare REIT, the first listed Islamic REIT under the new Malaysian Securities Commission "Guidelines for Islamic REITs," and a benchmark for the development of Islamic REITs in Malaysia, as well as in the region.

The Al-'Aqar KPJ REIT was issued in July 2006 and listed in Bursa Malaysia in August 2006, after Am Investment Bank, as the advisor, managing underwriter, and placement agent of the REIT received approval from the SC for the establishment and listing of Al-'Aqar KPJ REIT on the Main Board of Bursa Malaysia Securities. As shown in Table 8.2, the Al-'Aqar REIT comprises six hospitals (Johor Specialist Hospital, Puteri Specialist Hospital, Ampang

TABLE 8.2 Identified Asset of Al-Aqar Islamic REIT*

Hospitals	Location	Gross Floor Area	Appraised Value* (RM)
Ampang Puteri Specialist Hospital	Selangor	423,675 sq ft	128,800,000 (US$73.30 million)
Damansara Specialist Hospital	Selangor	445,131 sq ft	107,500,000 (US$31.13 million)
Johor Specialist Hospital	Johor	269,571 sq ft	75,300,000 (US$21.80 million)
Ipoh Specialist Hospital	Perak	215,762 sq ft	69,000,000 (US$19.98 million)
Puteri Specialist Hospital	Johor	131,033 sq ft	39,000,000 (US$11.29 million)
Selangor Specialist Hospital	Selangor	209,455 sq ft	61,400,000 (US$17.78 million)

*Valuation between September and December 2005.

TABLE 8.3 Dividend Per Unit

	Financial Year December 31			
	2006	2007	2008	2009
Dividend per unit (%)	7.25	7.32	7.52	7.70
Dividend yield per annum (%)				
Institutional #	7.25	7.32	7.52	7.70
Retail #	7.63	7.71	7.92	8.11

Puteri Specialist Hospital, Damansara Specialist Hospital, Selangor Medical Center, and Ipoh Specialist Hospital), worth RM481 million (US$137.36 million) and is expected to yield a competitive market rate of more than 7 percent every year.

According to its prospectus, there are some key factors that can assist in meeting the expectations of Al-'Aqar REIT investors to enjoy a consistent income return (see Table 8.3):

- Stable rental income from the properties.
- A 100 percent occupancy rate.
- Minimum risk.
- Single exposure in the healthcare industry in Malaysia.
- Capital appreciation on the units purchased.

As an result, Al-'Aqar Islamic REIT was oversubscribed by 4.13 times, with more than 30,000 units being sold at the opening bell, and drew more than 5,000 investors combined between non-Muslims and foreign investors. Total units issued were 340 million units with distribution of 160 million units to KPJ Healthcare and 165 million units issued for

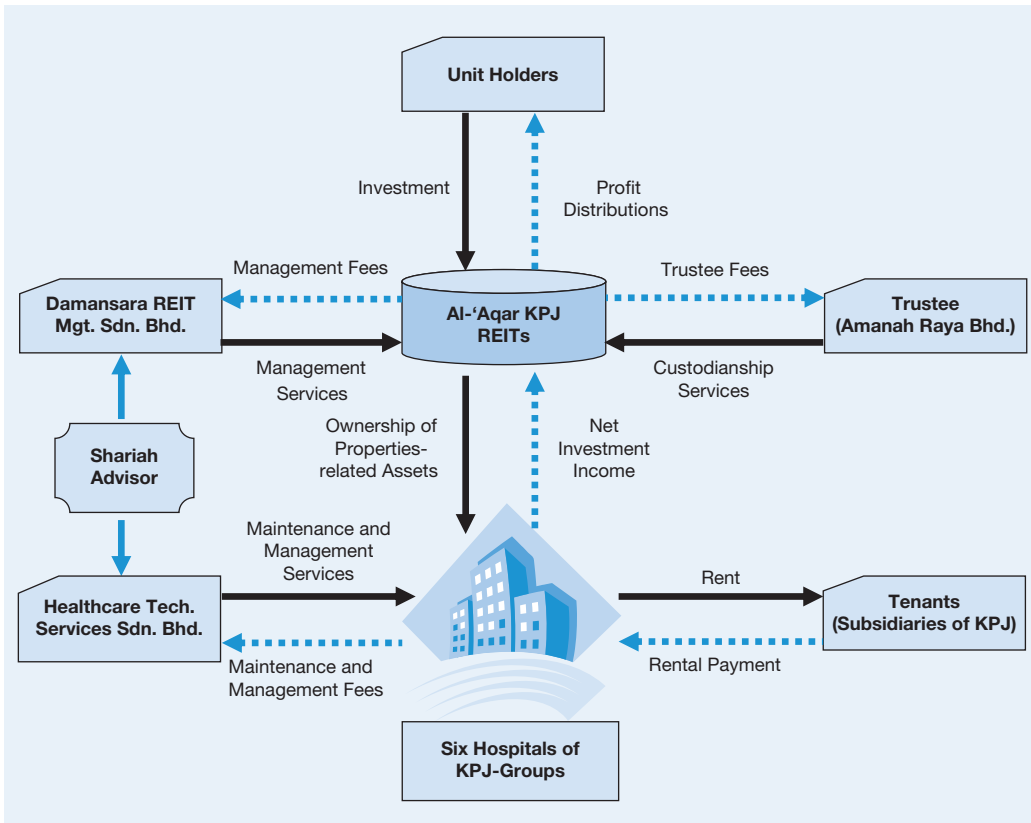
institutional investors and individual investors. Price per unit for institutional investors is US $0.27 (RM1) and for individual investors is US$0.26 (RM0.95).

The structure of the Al-'Aqar REIT is similar to the common structure of an Islamic REIT (see Figure 8.5). The trustee is Amanah Raya Bhd, who acts on behalf of the unit holders. The manager position is given to Damansara REIT Management Sdn Bhd, while the property manager position is held by Healthcare Technology Sdn Bhd. All six properties injected into the Al-'Aqar KPJ REIT are occupied by six tenants (who are subsidiaries of the KPJ Group), and the lease agreements entered into with all these tenants are long term, that is, for a lease period of 15 years. Upon listing, KPJ, as a sponsor of the Al-'Aqar KPJ REIT, as well as the holding company of the six hospital tenants, indirectly held 47.1 percent of the total units in the Al-'Aqar KPJ REIT, with a listed fund of 340 million.

The fees and expenses related with the structure of the Al-'Aqar Islamic REIT are:

- Annual management fee
- Maintenance and management fees
- Annual trustee fee

FIGURE 8.5 Al-'Aqar Islamic REIT Structure



- Auditors' fees
- Valuation fees
- Relevant professional fees
- Profit payments and expenses in respect to the Islamic financing facility
- Administration fees

Case Study: Al-Hadharah Bousted REIT[2]

Al-Hadharah Boustead REIT is the first Islamic plantation-based real estate investment trust (REIT) in the world. Much like conventional REITs, a plantation REIT's success will depend largely on the assets injected into the trust. However, unlike conventional REITs, whose economic success is based on the building and the rental yield, for plantation REITs, it will be the crops planted on the land. It is expected that oil palm may be the favored product because of its potential use in biodiesel production, which becomes more and more attractive after the rocketing of oil prices. Investment in plantation assets brings with it the benefits of profit sharing, which are pegged to the price of crude palm oil (CPO) and fresh fruit bunches (FFBs).

Al-Hadharah Boustead REIT launched the Prospectus and Opening of the Retail Offering and Institutional Offering on January 15, 2007, and listed on the Main Board of Bursa Malaysia Securities Berhad on February 8, 2007. Al-Hadharah Boustead REIT's principal investment strategy is to own and invest primarily in plantation assets, comprising plantation estates and mills. The primary objectives of the establishment of Al-Hadharah Boustead REIT are to provide Unit holders with stable distributions of income/yield and to achieve long-term growth in the NAV per Unit of the Fund.

Table 8.4 depicts the assets of Al-Hadharah Boustead REIT, comprising eight oil palm estates and two palm oil mills located in Peninsular Malaysia worth RM472 million (US$148 million). These assets were purchased from Boustead Properties, Boustead Plantations, and Boustead Heah Joo Seang, who collectively are the vendors in this Islamic REIT. As of December 31, 2010, the REIT comprised 10 oil palm estates and two palm oil mills in Peninsular Malaysia, covering 16,391 hectares with a market value reaching RM856 million.

The structure of Al-Hadharah Boustead REIT (see Figure 8.6) involves not only wakalah but also sale and lease-back agreements between the trustee and the vendors. The trustee, on behalf of unit holders, enters into a sale and purchase agreement with the vendors. The trustee purchases all rights, titles, interests, and benefits relating to the ownership of the plantation assets from the vendors at a predetermined agreed-on purchase consideration. Upon completion of the acquisition of the plantation assets, the trustee leased back the plantation assets to the respective vendors for agreed-on and fixed rental payments and for an agreed tenancy period.

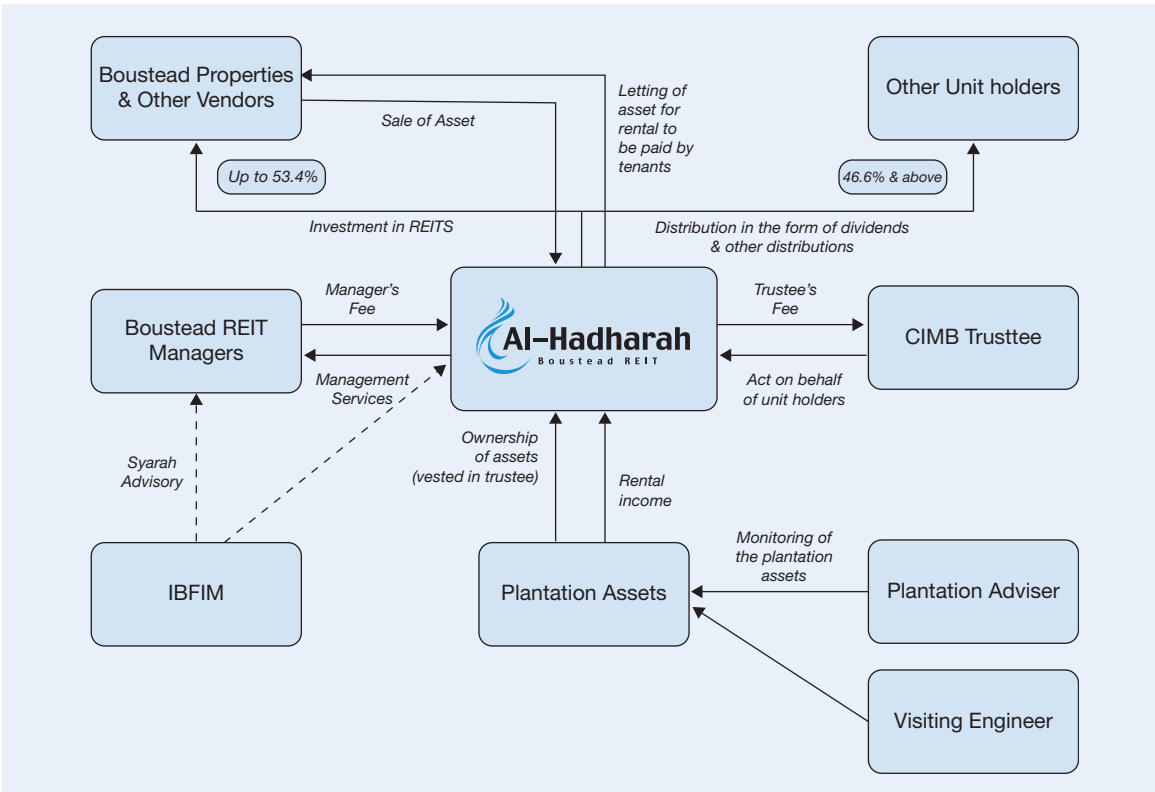
The total period is 30 years with a three-year renewable tenancy. At the end of every three years, the fixed rental will be reviewed and a new rental will be drawn up between trustees, on behalf of unit holders and the vendors as the tenants. Interestingly, the new rental will be determined based on historical crude palm oil (CPO) prices, prevailing and expected

TABLE 8.4 The Assets of Al-Hadharah Boustead REIT as of 31 December 2010

Plantation Assets as at 31 December 2010	Land Area (hectares)	Purchase Consideration (RM' 000)	Latest Market Value (RM' 000)
Bekoh Estate, Johor	1,226	33,510	49,100
Malaya Estate, Perak	922	20,770	37,400
Kulai Young Estate, Johor	803	40,850	52,800
Bukit Mertajam Estate, Kedah	2,173	96,970	112,800
Batu Pekaka Estate, Kedah	969	38,630	45,200
Chamek Estate, Johor	817	22,020	42,300
Telok Sengat Estate and Telok Sengat Palm Oil Mill, Johor	3,699	147,400	228,223
Lepan Kabu Estate and Lepan Kabu Palm Oil Mill, kelantan	2,044	71,750	87,810
Malakoff Estate, Pulau Pinang	1,397	100,500	106,000
Bebar Estate, Pahang	2,341	88,300	95,000
Total	16,391	660,700	856,633

Source: www.al-hadharahboustead.com.my.

FIGURE 8.6 Al-Hadharah Boustead Islamic REIT Structure



Source: www.al-hadharahboustead.com.my.

future CPO prices, cost of production, extraction rates, and yield per hectare. Hence, income sources for Al-Hadharah Boustead REIT include:

- **Fixed Rental:** Fixed rental payments can increase as well as decrease due to the fluctuation of CPO price in the global market. Based on the renewal of the Ijarah agreement effective from January 1, 2010, the fixed rental income for the second tenancy term is increased. In the next period, tenants will pay a cumulative fixed rental of approximately RM53.2 million to RM57.8 million per annum for the first tenancy term of three years. This will be payable on a bimonthly basis.
- **Performance-Based Profit Sharing:** In addition to a fixed rental, the unit holders may enjoy an annual profit sharing of net incremental income based on a formula pegged to CPO and fresh fruit bunch (FFB) prices. This net incremental income is determined based on the actual CPO price realised for the year, above the reference price of RM2,000 per MT for the first next three years. It will be shared on a 50:50 basis between the tenants and the unit holders.
- **Capital Gains:** Given the development potential of some of the plantation assets, especially those located in prime locations, there is a potential upside for capital gains, which will be distributed as bonus distributions.

Difference between Conventional and Islamic REITs

As mentioned previously, investing money in a REIT will give investors many advantages, such as:

- Tax benefits in taxable jurisdictions.
- Tax-free jurisdictions attract foreign investors.
- REITs are a liquid asset that can be sold quickly to raise cash or take advantage of other investment opportunities.
- REITs allow institutional funds to make incremental investments in unpredictable real estate as and when new investment funds are received.
- Diversification based on types of properties, tenants, and locations.
- Using REITs, common investors can diversify their holdings between various geographic areas and property specializations in listed real estate investments.
- Hedging.
- Low correlation to interest rates.
- Better inflation hedge.
- High cash dividends relative to the market.
- REITs typically distribute more than 90 percent of net cash flow.

TABLE 8.5 Differences between Shariah and Non-Shariah REITs

	Conventional REITs	Islamic REITs
Income from real estate	No restriction, anything is legal	Restricted to Shariah-compliant usage of real estate assets
Income from other assets (non-real-estate related assets)	No restriction, anything is legal	Restricted to Shariah-compliant investments in other assets such as sukuk
Business activities allowed in real estate	No restriction, anything is legal	Restricted to Shariah-compliant usage of real estate assets
Insurance	No restriction, anything is legal	Shariah-compliant insurance
Financing	No restriction, anything is legal	Shariah-compliant financing
Appointment of Shariah advisors	None required	Must appoint Shariah advisors

- Income is underpinned by legally enforceable lease agreements.
- Since REITs have a lower correlation to equities than many other asset classes, they provide portfolio stability for investors with an active asset allocation strategy.

However, investing money in conventional REITs will raise some issues for Muslim investors who are seeking Shariah-compliant investment structures and income. Islamic REITs have the potential to appeal to Muslim investors because:

- It is Shariah-compliant investment.
- Higher certainty of income in the form of dividends.
- An Islamic REIT will typically have multiple properties in a portfolio as well as a diversified tenant pool, which reduces reliance on a single property and tenant in the case of directly held real estate.
- It allows investors access to investment grade assets within the property market for a small initial capital outlay.
- Investors have the opportunity to invest in properties that are managed by professional management companies.

Table 8.5 shows some differences between Islamic and conventional REITs from several aspects, such as the source of income or activities allowed to generate the income, the insurance and financing involved, and also the existence of Shariah advisors.

Chapter Summary

- Equity securities, commonly known as shares or stocks, represent an ownership interest in a corporation of financial assets.
- REITs are a vehicle that mobilises funds from the unit holders—individuals and companies—for investment in real estate.

- REITs are eligible to be sold on stock exchanges so investors can easily buy and sell them at any time.
- REITs normally are classified as equity REITs, mortgage REITs, and hybrid REITs.
- Investing money in REITs will give investors many advantages, such as:
  - Tax incentives
  - Liquidity
  - Diversification
  - Hedging
  - Profit
- An Islamic or Shariah-compliant REIT (I-REITs) is a collective investment scheme in real estate, in which tenants operate permissible activities according to Shariah.
- Based on the I-REITs guidelines by the securities commission, the manager of an Islamic REIT must also ensure that all forms of investment, deposit, and financing instruments comply with Sharia principles.

Chapter Questions

1. Distinguish between conventional and Islamic REITs.
2. Explain the Islamic REITs structure.
3. What are the nonpermissible activities under the Islamic REITs guidelines?
4. Briefly explain the differences between KPJ Islamic REITs and Al-Hadharah Islamic REITs.
5. Why do investors want to invest in Islamic REITs?

Notes

1. Information retrieved from www.alaqarkpjreit.com.my.
2. Information retrieved from www.al-hadharahboustead.com.my.

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CHAPTER

9

Islamic Exchange-Traded Funds

Learning outcomes

At the end of this chapter, you should be able to:

1. Distinguish between open- and closed-end funds, as well as ETFs.
2. Identify the benefits and the risks of ETFs.
3. Describe the parties involved in managing ETFs.
4. Distinguish between conventional ETFs and Islamic-ETFs.
5. Identify the framework of stock borrowing and lending (SBL).
6. Identify the framework of the Islamic alternative of stock borrowing and lending (SBL).
7. Explain the practice of Islamic ETFs in Malaysia.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

The discussion of exchange-traded funds falls under the category of asset management firms (Fabozzi, 2009). Basically, asset management firms are firms that manage funds of business, individuals, and foundations as well as local and state governments. These firms normally are affiliated with some financial institutions such as commercial banks and investment banks, as well as insurance companies. One of the businesses of these firms is managing exchange-traded funds (ETFs).

Open- and Closed-End Funds, and Unit Trust Funds

Before discussing the ETFs, it is worthwhile to look at other similar investment alternatives such as mutual funds, unit trusts, and so forth. In addition, we will discuss in detail conventional as well as Islamic ETFs.

Open-End Funds

An open-end fund is normally called a mutual fund. It is a portfolio of securities, mostly stocks, bonds, and money-market instruments. In this case, the investor owns the pro rata share of the portfolio, which is managed by a manager who buys and sells securities. In each share of the portfolio, there is a price that is called net asset value (NAV). This important concept of NAV has to be understood by the investors. Basically, it is the market value of portfolio minus the liabilities divided by the number of shares:

$$\text{NAV} = (\text{Market value of portfolio} - \text{Liabilities})/\text{Number of shares outstanding}$$

This NAV is priced at the end of each trading day. For example: the market value of a portfolio is US$100,000 with the number of outstanding shares being 10,000. Assume no liabilities, the NAV is US$10 (US$100,000/10,000). If during the day investors made an additional investment of US$4,000 to the portfolio then the additional new number of shares is 400 (US$4,000:US$10). With the additional US$4000, the total value of the portfolio is US$104,000 and the additional increase of the share leads to the increase of total number of shares to 10,400 (10,000 + 400). The NAV is still US$10 (104,000/10,400).

Notice that the market value of the portfolio depends on the price of the stocks constituting that portfolio. Certainly, when each stock price increases, so does the market value of that portfolio. If for example, the market value for that portfolio increases double to US$200,000 (due to an increase in stock price) and the number of outstanding shares is 10,000 then the NAV will be US$20 (US$200,000/10,000) The additional US$4,000 deposited into the portfolio will add a new share of 200 (US$4,000/20). The number of outstanding shares will be 10,200. The total

value of the portfolio after the increase in the market price, as well as the additional US$4,000 deposit into the portfolio, will be US$204,000 (10,200 shares × 20).

From the example above, we are able to identify that the increase in the additional investment into the portfolio will increase the number of shares, and the price of the securities that make up the portfolio will increase the NAV. And the increase or decrease of the total value of the fund can be due to both factors (price of securities as well as the additional deposit into the portfolio).

Closed-End Funds

This fund is similar to the common stock of a corporation. This stock is issued initially by the underwriter and this is called the primary market. After this, stock will be traded in the secondary market. As an investor, he can buy from both markets. To do this, he has to contact the brokerage firm to help him arrange and administer the stock that he wants to buy. Certainly, he has to pay the brokerage fee when he makes purchases and sells stocks.

The way to calculate the NAV in closed-end funds is pretty much the same as with the open-end funds. The difference lies in the mechanism to determine the price. In closed-end funds, the price of the securities is determined by the market forces. This means that supply and demand forces will create prices for the stocks. In this case, there is a possibility that the price can be below the NAV, which is called "trading at a discount." Conversely, if the price is above the NAV, then it is "trading at a premium."

There are two different features of the open-end funds and closed-end funds. First, in the open-end funds, the number of outstanding shares varies as the sponsor may buy the existing shares or sell new shares to investors. Second, the price of the shares is always the NAV of the funds. Conversely, closed-end funds have a fixed number of shares outstanding. This is because the fund sponsor does not sell new shares or redeem shares, and furthermore the price of the stock is determined by the market.

Unit Trust

Unit trust is akin to a closed-end fund whereby the number of unit certificates is fixed. There are differences between unit trusts and mutual funds. First, in the unit trust, there is a fixed termination date which is not available in mutual funds. Second, in unit trust, investors are able to identify the securities in the portfolio and they are not concerned about whether the trustee will change the composition of the securities or not.

Exchange-Traded Funds (ETFs)

These relatively new funds were created due to some limitation on the previous investment alternative. Two criticisms can be directed against mutual funds (open-end funds), which

gained popularity during the 1980s and 1990s. First, pricing of the mutual funds is done at the end of each day or closing price. This means that the prices that occur during the day or intraday cannot be used to value the mutual funds. Second, is on the issue of taxation. In the case whereby there is a withdrawal from the shareholders, it may cause taxable realised gains for other shareholders who maintain the portfolio.

In the early 1990s, there was a new investment vehicle created that has the same feature as a mutual fund but has already accommodated its limitation. This is called Exchange-Traded Funds (ETFs). Unlike mutual funds, these ETFs can be traded like stock on the stock exchange. Moreover, although ETFs are open-end funds, they are to some extent similar to closed-end funds, for which the price can be traded at a premium or at a discount from the NAV as the price is determined by market forces (the movement of supply and demand).

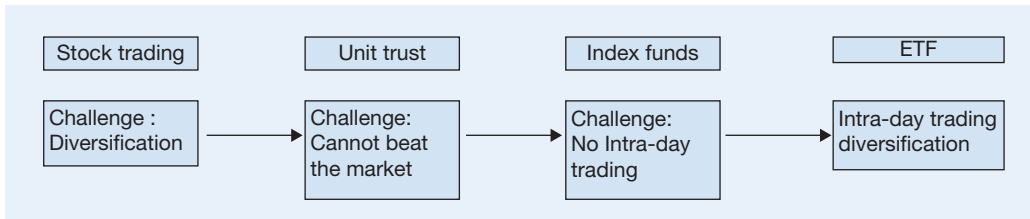
The dividend income and capital gain realised on both transacted ETFs and the mutual funds (open-end funds) may be taxable to the investor depending on the regulation of the respective countries. But there is a different treatment in the case of the redemptions: Mutual funds may have to sell the securities if the cash position is not sufficient to fund the redemptions. This leads to a capital gain or loss for those who hold their shares (Fabozzi, 2009). In the case of ETFs, portfolio securities do not have to be sold, as the redemptions are affected by an in-kind exchange of the ETF shares for a basket of the underlying portfolio. Moreover, ETFs distribute only a limited amount of realised capital gains that are taxable, and it does not distribute the cash dividend.

Why are ETFs created? These funds are relatively new in the world of capital market. The equity market started with the trading of stocks. Retail investors sometimes do not have time to pick up the stocks. To solve this problem, a collection of stock was created to mitigate the risk and these are called mutual funds. In this mutual fund, a manager manages the stocks for a pool of investors.

Although this fund is relatively diversified, it still could not beat the market return. For that reason, an index fund was created. This is the fund that tracks the index. However, both of these funds (mutual funds and index funds) are not traded, hence, ETFs were created (see Figure 9.1).

The first ETF was the Toronto Stock Exchange Index Participation (TIPs) in 1990. This fund is listed on the Toronto Stock Exchange and is designed to track the TSE 35 and afterward track the TSE 100. In the United States, the first-ever ETF was Standard & Poor's

FIGURE 9.1 Evolution of the ETFs



Source: ISRA Bulletin, April 2009.

Depository Receipts (SPDR, pronounced "spiders") which was designed to track the performance of the S&P 500 stock index. These ETFs were introduced in 1993.

Following it, ETFs are designed to track the subsectors of the S&P 500, particularly the Mid-Cap SPDRs. Other ETFs were then introduced, such as Diamonds, which track the Dow Jones Industrial Average, and QQQs, which track the Nasdaq 100 index. There were also ETFs, which track international stock indexes such as iShare MSCI, which is designed to track the Morgan Stanley Country Indexes (MSCI). iShares, which is sponsored by Barclay's Global Investors, is designed to track 42 different stock indexes.

There are many benefits in investing in ETFs, including:

- **Diversification:** As opposed to buying and selling individual stocks where the risk is higher, ETFs allow us to diversify the risk as they are portfolios of all stocks that constitute an index. Investors are given investment exposure to a specific sector, market, or whole sector.
- **Convenience:** A unit of ETF represents the underlying basket of securities. Hence, it is very convenient, as an ETF is a single transaction that has multiple investments. Moreover, holding an ETF will give immediate effective ownership in a basket of securities.
- **Low Costs:** As ETFs are index funds, they adopt passive management (fund manager does not have to choose what to buy); hence the management fees are generally cheaper than those of mutual funds which require more active management. Moreover, compared to a unit trust for which the investor has to pay the initial charges, these ETFs have no initial charges or exit fees.
- **Tradability:** ETFs adopt the characteristics of stocks with regard to tradability. As in the trading of stocks, ETFs can also be traded at any time during trading hours on the exchange. However, that is not the case with the mutual funds. In these open-end funds, trading can only be done at their daily closing net asset values (NAV).
- **Transparency:** ETFs allow the investors access to information regarding their portfolio. In contrast, traditional mutual funds usually disclose their portfolio holdings on an annual, semiannual, or quarterly basis.
- **Low Expense Ratio:** As ETFs are a basket of securities, transactions can be less frequent as compared to trading individual stock. Hence it has a low expense ratio.
- **Cheap Price:** Small investors have a chance to buy ETFs as the price is generally cheap. In Malaysia, ETFs are traded in board lots of 100 units.

The nature of ETFs and unit trusts is almost the same. In essence, both are portfolios (a collection of stocks). Hence, a unit represents an underlying basket of stocks. However, even though both are portfolios, the basis of the stocks that are selected is different. The ETF tracks on an index. Managers will use all stocks that constitute for that index. In this case, managers oversee the fund passively. However, managers in unit trust funds have to actively select which stocks they want to have in the portfolio. Hence, the manager adopts an active management. Stocks in this case simply represent an ownership in a company. Table 9.1 compares ETFs, stocks, and unit trusts.

TABLE 9.1 ETF, Stocks, and Unit Trusts

	ETFs	Stocks	Unit Trusts
Nature	Units that represent an underlying basket of stocks	Shares	Units that represent an underlying basket of stocks
Traded on exchange	√	√	X
Redemption	Purchases and sales of the funds' shares take place only in the secondary market	Purchases and sales of the shares take place in the secondary market	Redemption with the fund
Diversification	√	X	√
Price transparency	√	√	X
Traded through broker	√	√	X
Management fees	< 1%	0	1–2% for index fund
Brokerage	0.6%	0.6%	0
Sales charge	0	0	3–5%
Cash settlement	T+3	T+3	Upfront

Source: Hasan (2008).

With regard to tradability, ETFs have features similar to those of stocks. In other words, ETFs can be traded just like stock and it follows the trading hours of the stock market. However, unit trust cannot be traded. In the case of redemption, unit trust can only be redeemed with funds. But ETFs and stocks both can be purchased and sold at any time in the secondary market.

On the issue of diversification, ETFs and unit trusts have advantages. This is understood as both are portfolios of stocks. Meaning to say, it can be a collection of some stocks that have a low risk and some other stocks that have a high risk. Hence, the risk can be distributed. However, a single stock has a relatively high risk as compared to a portfolio.

The benefits of trading via ETFs and stocks is that the investors can assess the price of their assets very easily. Therefore in terms of the price transparency, these two instruments are very transparent compared to a unit trust.

There are two prices that need to be considered, namely, market price of the ETFs and the net asset value (NAV). This NAV is the actual value of the fund. In calculating this value, it is pretty much similar to the NAV in the open-end fund (mutual funds), as discussed previously. During the trading day, updated information on NAV can be obtained from the broker trading system: This is called the optimised portfolio value (IOPV), but in Europe it is normally called indicative NAV (INAV).

However, the market price is determined by supply and demand. This means that it is possible that the NAV is US$20 while the ETF unit price could be US$22 as the numbers of buyers are many. If some of the buyers expect that the market price will increase, they are more than willing to buy, although the price is above the NAV since the price six months later is much greater.

In terms of the existence of the broker, ETFs and stock trading should be administered by a broker. Investors of ETFs and stocks never meet face-to face. Rather, both have to contact their respective brokers in order to trade and they have to pay for it (called a brokerage's fee). However, in unit trusts, the broker is not available.

With regard to the incurred management fee, the lowest is trading via stock which is 0 percent while management fee for unit trusts is, at the highest, 1 percent to 2 percent (for index fund). A sales charge is only applicable for the unit trust and not for ETFs and stocks. Duration period for the cash settlement for ETFs and stocks is T+3. It means that if we buy stocks now, the deadline for the payment will be three days later.

However, investing in ETFs does not mean it is without risks. There are risks involved, such as:

- **Market Risk:** Like stocks that may be affected by economic conditions, ETFs are also exposed to the ups and downs of economic and political situations. Recall that ETFs are baskets of securities, and that the performance of the ETFs somehow depend on the performance of its component securities, which are represented in the benchmark index.
- **Tracking Error:** The performance of the ETFs may not closely track the performance of the underlying index.
- **Discount or Premium:** The exchange of the ETFs unit price may be done at a discount or premium to its NAV.

These risks can be anticipated by the investors if they have already decided on the investment objective and strategy. For instance, investors have to decide whether to buy ETFs for short-term or long-term gains. Second, by knowing the information on the index that ETFs are tracking—for example, the energy sector—then, investors can follow the movement of, for example, the world oil price. Third is the information about the performance of the company. This is necessary for investors so that they can identify several indicators, such as profitability and/or solvability of a company, which can direct or indirectly affect the index. These are examples of ways that investors can eliminate the risk.

Islamic Exchange Trade Funds (I-ETFs)

Conventional ETFs have been in place for more than 15 years. We have seen that the growth has covered various sectors, countries, and markets (Mokhtar 2009). Meanwhile, the first Islamic ETFs (I-ETFs) came into being in 2006 and was called the DJIM Turkey ETF, which was listed on the Istanbul Stock Exchange. Islamic ETFs simply mean ETFs that are Shariah-compliant. In other words, they consist of baskets of securities that meet Shariah stock screenings.

The differences of these Islamic ETFs (I-ETFs) compared to conventional ETFs are: I-ETFs track an index in which the companies are Shariah-compliant as opposed to conventional ETFs, which may track any index. Second, Islamic ETFs have to appoint Shariah advisors/committees and comply with the Shariah investment policies. Third, regular review is also done by Shariah advisors to ensure compliance with Shariah principles. Fourth, I-ETFs avoid securities lending, futures, and options as part of their operations. The securities for the I-ETFs need not be always the share/stocks: They can be sukuk or event commodities such as gold or silver (Table 9.2).

The first Islamic ETFs instrument in Asia was launched in Malaysia on January 22, 2008, and listed in Bursa Malaysia on January 31, 2008. Government at that time had pushed this ETF project forward via the coordination and participation of many stakeholders, for example, government linked investment companies(GLICs). It is called MyETF Dow Jones Islamic Market Malaysia Titans or simply MyETF-DJIM25 valued at RM840 Million. DJIM is a market capitalisation weighted and free-float-adjusted index that consists of 25 Shariah-compliant securities of companies listed on Bursa Securities.

One of the benefits of this fund is that it enables the GLICs to divest their interest in Government Linked Companies (GLCs) by selling a portion of their portfolio to the ETFs in exchange for units. Moreover, it promotes greater retail participation in the equity market. The market capitalisation of the 25 constituent companies at the time when this fund was introduced accounted for 30 percent of the Malaysian stock market. The fund information of MyETF-DJIM25 is shown in Table 9.3.

This ETF tracks the performance of a benchmark index, in this case the Dow Jones Islamic Market Malaysia Titans 25 Index. In this index, there are 25 stocks that have passed the screening criteria done by Dow Jones. This first I-ETF is managed by i-VCAP Management Sdn Bhd. I-VCAP is a holder of the Capital Market Service Licence (CMSL), which is issued by Securities Commission under the Capital Market and Services Act 2007.

TABLE 9.2 Examples of the I-ETFs commodity

Name	Commodity	Manager	Shariah-Compliant Status
New Gold	Gold	Absa Investment	March 2008/South Africa (JSE)
ETF Securities		ETF Securities	August 2008/Europe
ETFS Physical Platinum	Platinum		
ETFS Physical Palladium	Palladium		
ETFS Physical Silver	Silver		
ETFS Physical Gold	Gold		
ETFS Physical Precious Metal Basket	Mixture		

Source: ISRA Bulletin, April 2009.

TABLE 9.3 Fund Information of the MyETF-DJIM Titan 25

Name of Fund	MyETF Dow Jones Islamic Market Malaysia Titans 25 or MyETF-DJIM25
Authorised Fund Size	10 billion units
Benchmark Index	Dow Jones Islamic Market Malaysia Titans 25 Index
Investment Objective	The fund's objective is to closely correspond to the performance of the benchmark index, regardless of its performance. The fund manager attempts to achieve an absolute value of tracking error of less than 3 percent between the net asset value (NAV) of the fund and the benchmark index.
Fund Manager	*i*-VCAP Management Sdn. Bhd. (a wholly owned subsidiary of Value cap Sdn. Bhd.)
Trustee	Deutsche Trustees Malaysia Berhad
Shariah Advisor	CIMB Islamic Bank Berhad
Participating Dealers	CIMB Investment Bank Berhad and OSK Investment Bank Berhad
Index Provider	Dow Jones & Company, Inc.
Listing	Main Board of Bursa Malaysia Securities Berhad

Source: www.myetf.com.my/fund_info.asp, retrieved August 16, 2011.

The main business is the provision of investment management services. It is a wholly owned subsidiary of the state-owned fund manager of Value cap Sdn Bhd. But this company does not work alone: It is aligned with BNP Paribas Asset Management Malaysia Sdn. Bhd. as the Technical Advisor, Deutsche Trustees Malaysia Berhad as Trustee, CIMB Islamic BankBerhad as Shariah Advisor, CIMB Investment Bank Berhad, and OSK Investment Bank Berhad as Participating Dealers, and Dow Jones & Company as Index Provider to the Fund (Table 9.3).

The introduction of the I-ETFs may provide other investment alternative opportunities, boost the country's capital markets, and attract more foreign investors. Moreover, the high demand growth for Shariah-compliant investment products in Malaysia specifically and generally across the country present i-Vcap to introduce Asia's first Islamic ETF.

The launch of the MyETF was timely, as at that time there was a sharp rise in oil revenue that led Middle East investors to attempt to find a new interesting investment alternative. Moreover, when these ETFs were launched, the financial market in the developed country (United States) was still very volatile due to the subprime mortgage problem. This led to the shifting of funds to emerging markets, such as Malaysia. Hence, the future of ETFs is believed to be bright as it takes advantage of a global surplus of funds from both private and sovereign companies that are looking for places to invest. The list of the 25 Shariah-compliant securities in the DJIM Titan 25 as of February 24, 2009, is shown in Table 9.4.

From the table below, it is interesting to see that several sectors have dominated the portfolio. The share of the Plantation sector, such as Sime Darby and IOI Corp, contribute more than half of the index fund tracks. Other sectors in this index include construction, real

TABLE 9.4 Shariah-Compliant Securities (DJIM Titan 25) as of February 24, 2009

Manager's Fee (% p.a.)	Trustee Fee (% p.a.)	License Fee (% p.a.)	NAV per unit (RM)	Dow Jones Islamic Market Malaysia Titan 25 index
0.4%	0.05%	0.04%	0.592	550.05

Stock Code	Issuer	Quantity of Shares	Price as of February 24, 2009	In-Kind Creation/ Redemption 1,000,000 Units
4197	SIME DARBY BERHAD	15,500	5.65	RM87,575.00
1961	IOI CORPORATION BERHAD	22,000	3.65	RM80,960.00
6947	DIGI.COM BERHAD	1,900	21.2	RM40,280.00
2445	KUALA LUMPUR KEPONG BERHAD	3,500	9.9	RM34,650.00
3816	MISC BERHAD	7,200	8.55	RM61,560.00
5398	GAMUDA BERHAD	10,500	1.93	RM20,265.00
4065	PPB GROUP BERHAD	3,900	9.75	RM38,025.00
7164	KNM GROUP BERHAD	19,900	0.4	RM7,960.00
5052	PLUS EXPRESSWAYS BERHAD	8,400	2.88	RM24,192.00
8664	SP SETIA BERHAD	5,400	3.34	RM18,036.00
4588	UMW HOLDINGS BERHAD	3,600	5.4	RM19,440.00
6033	PETRONAS GAS BERHAD	1,700	9.75	RM16,575.00
1899	BATU KAWAN BERHAD	1,400	7.95	RM11,130.00
6888	TM INTERNATIONAL BHD	10,100	3.22	RM32,522.00
2291	ASIATIC DEVELOPMENT BERHAD	1,800	4.1	RM7,380.00
3794	LAFARGE MALAYAN CEMENT BHD	1,900	3.82	RM7,258.00
7277	DIALOG GROUP BHD	5,800	0.845	RM4,901.00
5077	MALAYSIAN BULK CARRIERS BHD	2,100	2.78	RM5,838.00
2283	ZELAN BHD	1,800	0.775	RM1,395.00
6084	STAR PUBLICATIONS (MALAYSIA)	2,100	3.06	RM6,426.00
5122	KENCANA PETROLEUM BHD	2,900	1.21	RM3,509.00
2356	SARAWAK ENERGY BHD	3,800	1.64	RM6,232.00
3867	MALAYSIAN PACIFIC INDUSTRIES	400	5.55	RM2,220.00
2887	LION DIVERSIFIED HOLDINGS	2,400	0.29	RM696.00
4863	TELEKOM MALAYSIA BHD	9,700	3.34	RM32,398.00

Source: ISRA Bulletin, April 2009.

estate, oil and gas, as well as telecommunication. With the absence of the financial sector in this index due to the screening process by Dow Jones Islamic Market, then this index was not affected by the meltdown of the United States subprime mortgage. The screening process typically deletes the banking and finance stocks as Shariah disallows interest paying activities. Furthermore, highly indebted companies will also be excluded.

The response for this stock was surprising. It received overwhelming response (over-subscribed by 31.5 million units) from both retail and institutional investors on the second day of the subscription. This shows that myETF has been perceived as another, better vehicle for investment.

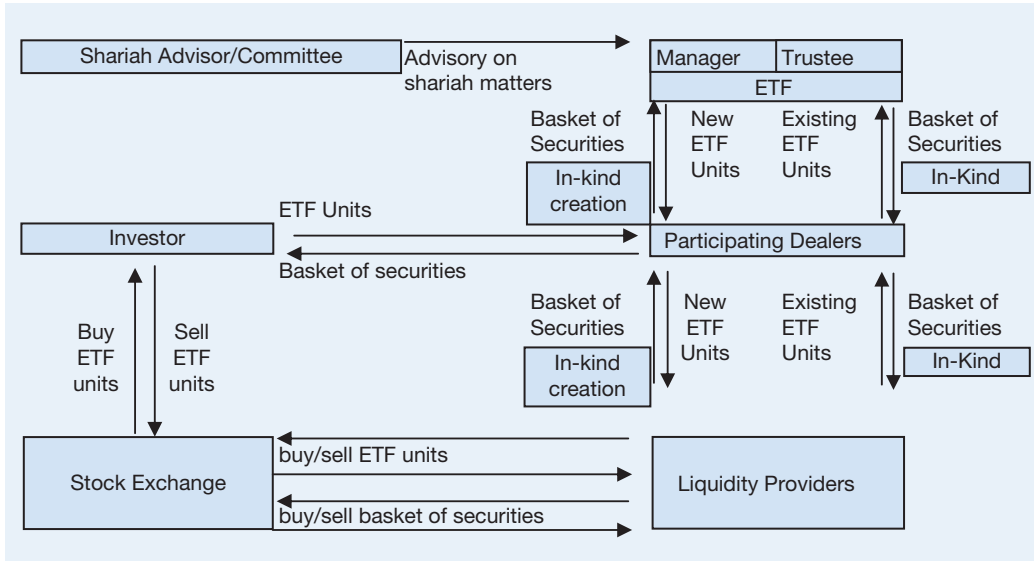
In terms of the number of entities, there are five that are most needed to run the ETF (see Figure 9.2):

1. **The Manager:** Managing the ETF so that it can be in line with the trust deed and securities laws.
2. **The Trustee:** Acts as the custodian of the asset of ETF. Moreover, ensure ETF is administered in line with the trust deed and securities laws. Furthermore, it safeguards the interests of the ETF unit holders.
3. **The Participating Dealer:** The entity that facilitates in-kind creation and redemption of the ETF units. Furthermore, they also act as the liquidity provider.
4. **The Other Liquidity Providers** (if any): Aid in providing liquidity to the ETF.
5. **The Investors:** Via brokers, they will invest in the ETF units.

There are few required steps that need to be taken in order to create the ETF unit. The first and foremost is to choose which Islamic index is going to be benchmarked. Each Islamic index will have a different set of securities and, furthermore, the screening criteria done by each Islamic index is also different. The topic of screening criteria is discussed thoroughly in another chapter in this book.

In order to create, let us say, 1 million ETF units, individuals or companies or participating dealers have to first have the perfect basket of securities within the Islamic index. In the

FIGURE 9.2 The Process of ETF



Source: **www.myetf.com.my/faq_general.asp, retrieved June 2011.**

case of MyETF-DJIM25, the perfect basket would refer to all quantities of shares of Sime Darby Berhad, which is 15,500 shares, 22,000 shares of IOI Corporation Berhad, 1,900 DIGI. COM Berhad, and so on (see Table 9.4).

The participating dealers have to deliver this perfect basket to the trustee in order to create the 1 million units of MyETF (by trustee). That is why it is called in-kind and not cash subscriptions. Hence the ETF units represent the underlying shares, as the shares are the basis of the creation of the ETFs. This unit of ETFs will be given back to the participating dealers and eventually be bought by the investors via liquidity providers (see Figure 9.2). Having owned the ETF units, the investors can then trade them via a secondary market and it will no longer be in-kind; rather, transactions will occur using cash. At the time of the redemption, the participating dealers will accumulate and deliver to the manager and trustee the specified number of ETF units. As an exchange, the participating dealer will get back the perfect basket.

With regard to the issue whereby the investors do not have a complete basket of securities, in the context of the conventional ETFs, they are still able to get the ETF unit with the help of Securities Borrowing and Lending (SBL). In this SBL, investors can borrow the perfect basket of stock and deliver. However, this way is certainly not Shariah compliant. The Islamic alternative is via Shariah-compliant replicated SBL (see Figure 9.4).

The experience of the MyETF with regard to the perfect basket of the DJIM Malaysia Titans 25 index as the basis to create the unit shows consistent commitment by the government. With the support of seven government-linked investment companies (GLICs), namely, Khazanah Nasional, Employee Provident Fund, Pension Fund, Lembaga Tabung Haji, Lembaga Tabung Angkatan Tentera, Permodalan Nasional Bhd (PNB), and Valuecap Sdn Bhd, eventually, the perfect basket can be obtained.

Each of those seven institutions provide RM120 million for the perfect basket of shares. With the seven GLICs, as many as 840 million unit ETFs can be created. Some of them were subscribed to by the GLICs and some others were also made available to the public. Specifically, each of the GLICs subscribes 100 million units as an exchange and the remaining 140 million units were sold to the public. These seven GLICs were the seeders as they buy the perfect basket to create the ETF units. However, there is a possibility that there is no seeder. Therefore, if investors want to buy 5 million ETF units, the participating dealers can buy the perfect basket in the open market.

Security Borrowing and Lending in Malaysia

At the end of 1995, the Malaysia securities market introduced the framework of stock borrowing and lending (SBL), which was followed by a guideline on regulated short selling in the following year. However, due to the Asian financial crisis in 1997, this framework was suspended, but later

reintroduced in January 2007, as recommended by the Securities Commission's Capital Market Masterplan. This SBL is important for ETFs instrument.

This framework allows investors to borrow the eligible securities for settling down a failed transaction or to cover the regulated short sell. Basically, short selling is a practice of selling a security that the seller at that point in time does not own. The seller expects that (after he sells the securities), the price will decrease and with this cheaper price, the seller will buy the securities. In this case he speculates on the movement of the price. This is normally called naked short selling. In Malaysia this type of short selling is disallowed under section 98 of the Capital Market and Services Act 2007 unless it is conducted via Regulated Short Selling (RSS) or covered short selling as set by the rules of Bursa Malaysia Securities.

In this RSS, the seller does not have the unconditional right to vest the securities in the purchaser but has executed an agreement to borrow them from other parties before the time of the sale, at the time of execution of the sale of an approved class of securities (Malaysia Islamic Capital Market, 2008).

There are five parties in SBL framework:

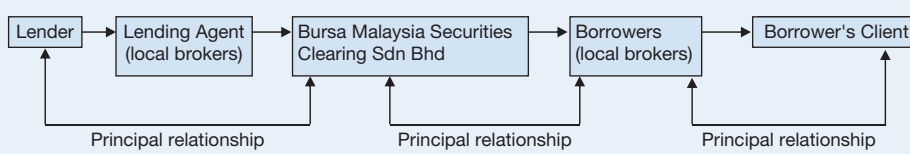
1. Lender
2. Lending agent (local brokers)
3. Central lending agency (Bursa Malaysia clearing house)
4. Borrower (local brokers)
5. Borrower's client

Figure 9.3 shows the implementation process of the SBL framework.

Here, the lender of the securities lends the shares to his local broker. Following this, the local broker gives the shares to the market, in this case Bursa Malaysia. On the other hand, the client, who needs to borrow securities to be used for short selling, has to contact his local broker. This local broker will then find the securities in the market that have been sent by the lender's local brokers.

The benefit of this process is that the borrower or the client is able to make a short sale by borrowing from another party. Hence, the risk has been significantly reduced, compared to

FIGURE 9.3 Process of the SBL Framework



Source: Malaysian Islamic Capital Market, November 2008.

the naked short selling in which the client has to find for himself the securities (the risk is high). The benefit for the lender is that he will receive the interest that has been agreed upon.

Moreover, the elements of the transaction in SBL are (Hassan, 2008):

1. The borrowing of securities for a period of time, or open ended.
2. The borrower simultaneously or previously provides the lender with collateral.
3. The lender earns a fee (or returns on the reinvestment of cash collateral) as consideration for the loan of the securities.
4. An outright disposition of the securities by the lender of the securities to the borrower.
5. The lender may recall the loaned securities at any time during the loan, after serving adequate notice.
6. At the end of the loan period, the borrower returns replacement securities to the lender that are of the same number and type as the original securities.

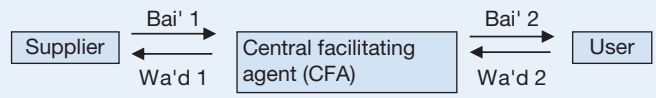
How does Islam view the short selling and the existing SBL framework conducted in Malaysia? What element of this framework needs to be adjusted in order to be Shariah compliant? Before we answer, let us take a look at the Islamic rules on buying and selling. This is important as the conventional SBL adopts the concept of buying and selling. There is a pertinent hadith with regard to this issue (buy and sell), that is "do not sell what you do not own." This hadith means that in order for the seller to be able to sell, the seller is required to have the asset at the very beginning. Therefore, it is clear that short selling activities are not allowed, as they involve the selling of shares that are not owned by the seller. This transaction falls under the category of bai' ma'dum in the Islamic fiqh as it has the element of gharar (uncertainty).[1]

However, if there is a way to reduce the uncertainty, then there is a possibility that the transaction is allowed. As regulated short selling (RSS) can only be done with the SBL arrangement in which the client (borrower) is certain that the needed stocks are available, then this significantly reduces the uncertainty. This means that the element of gharar will no longer be relevant. With regard to this, there is a fiqh ruling: "When an issue that impedes (the permissibility) is removed, then the activity that was initially forbidden becomes permissible."

In this case the impediment, which is the uncertainty (the uncertainty of the stocks that failed to be delivered), is able to be removed via RSS with an SBL arrangement, and leads the Malaysian Shariah Advisory Council to decide that RSS (with the Shariah-compliant securities) is permissible, provided that the arrangement of SBL is Shariah compliant (no interest-based transactions used in the process). While the issue of uncertainty is resolved, the next issue is how to make the SBL process Shariah compliant.

Currently, the development of the Islamic Capital Market (ICM) is very fast. With the introduction of the I-ETFs, there is a need to have an alternative to the conventional SBL in order for investors to own shares and later be able to create ETF units. Definitely, the interest component in the conventional SBL has to be removed and be replaced with the principles of bai' (buy and sell) and wa'd (promise). Let us follow Figure 9.4 for the process of the Shariah-compliant SBL.

FIGURE 9.4 Islamic Alternative of Stock Borrowing and Lending



Source: Malaysian Islamic Capital Market, November 2008.

The process is as follows:

1. In a conventional SBL, the party who lends the securities is called the Lender due to the use of the lending principle. In this Islamic alternative SBL, the party who has securities is called the Supplier, as it uses the concept of bai' (buy and sell). The Supplier sells the stock to a Central Facilitating Agent (CFA) as an outright sale. This sale is done with purchase undertaking (wa'd), which the Supplier buys from the CFA whenever the CFA sells the stocks.
2. The CFA then sells the stocks to the user again as an outright sale with wa'd 2 from the user; whenever the CFA asks for them, the user will sell the stocks to the CFA.
3. Both right and interest to recall the stock by the CFA has been stated in the rules and regulations of Shariah-compliant replicated SBL, in which the CFA sells the stocks to the supplier in the case where the supplier asks for them.
4. Similarly, the right and interest to sell the stocks by the user is embedded in the rules and regulations of Shariah-compliant replicated SBL, whereby the CFA will buy from the user whenever the user sells the stocks to the CFA.
5. These rights and interests by both supplier and user that are covered in the rules and regulations of the Shariah-compliant replicated SBL are made known to all contracting parties upfront. This is to ensure that purchase undertaking is in place.

Selling of assets, for example, shares not owned by the seller is called short selling and falls under the category of bai' ma'dum. As the delivery is not certain, then this creates the prohibited element called gharar (uncertainty). Before we continue to the Shariah-compliant RSS, let us discuss, first, the concept of bai' ma'dum (sale of unseen goods).

A resolution of the Securities Commission of the Shariah Advisory Council in Malaysia has stated that ba' ma'dum is permissible. Some opinions of past Islamic jurists, for example, Hanafi and Shafii, pronounced that the object must be existent at the time of the contract; otherwise, the contract is invalid. This was based on the prohibition by the Prophet (SAW) on the sale of an unborn baby camel and a sale of a nonexistent object. Mazhab Maliki also gives the same argument on this.

However, Hanbali Mazhab had argued that the importance was that a contract did not have the element of gharar, which is forbidden in Islam. Ibn Taimiyah and Ibnu Al Qayyim concluded that a sale is forbidden not because of the being ma'dum (unseen) during the contract, but rather because of the existence of gharar (uncertainty), which is a forbidden

element. Gharar here refers to the inability to deliver the goods regardless of whether they exist or not. For instance, assume the sale of an animal that has run loose. Both show that the good exists (in this case the animal), but the seller is unable to deliver the good. Hence, the transaction falls under the category of gharar as the seller fails to fulfill his obligation to deliver the goods.

In the context of naked short selling, there is a gharar element in the ability of the seller to deliver the good. Recall that at the time when the seller sold the goods, the seller had neither the good nor the information on the possibility that it was possible to deliver the goods. This is a clear uncertainty, which is forbidden in Islam.

With this condition, the attempt has been made to remove the gharar element in the regulated short selling (RSS). The rules and regulations of Bursa Malaysia state that any party performing RSS must fulfill one of the following criteria:

- Borrow the stock
- Be given confirmation that the status of the stock being used for short selling is obtainable or ready to be borrowed

By fulfilling one of these criteria, the gharar element has been removed. By doing so, the seller will have a high possibility that he or she will be able to deliver the goods at maturity. Hence, the element of gharar will no longer be relevant.

Shariah-compliant replicated SBL is created to replace the existing conventional SBL. The shares will be traded only after all conditions of Shariah-compliant replicated SBL have been fulfilled. With this Shariah-compliant replicated SBL, the shares become owned (not borrowed as in the conventional SBL) by the party who is performing the RSS, as the party already bought the stock. Shariah's view on this is that the ownership is transferred from the seller to the buyer once the sale is transacted/performed.

In the case in which the Shariah-compliant replicated SBL is already performed but the stock has not been delivered to the buyer who performs RSS, then it is still permissible for the buyer to sell the stock, which is still pending delivery under the qabd (transfer of possession) principle.

Shariah scholars have permitted a party to sell an item that is still pending delivery, provided that the item is not food. The thing that has to be urgently recognised is that the sale and purchase contract has been done at the beginning during the process of the Sharia compliant replicated SBL. This process is sufficient with regard to the ownership transfer. Therefore the issue of bal ma'dum and gharar element is no longer relevant as there exist conditions that have to be fulfilled (engaging with the Shariah-compliant replicated SBL) in performing the short selling.

There is another situation in which regulated short selling is permitted, that is, after receiving confirmation that the short selling stock is obtainable via Shariah-compliant replicated SBL. After short selling, the seller must complete the SBL. Again the element of gharar is eliminated in this situation; hence these activities can be classified as Shariah compliant.[2]

Islamic ETFs in Other Countries

In the United States, the first U.S.-based Islamic ETFs were launched by Javelin Investment Management.[3] By avoiding the companies that deal with alcohol and gaming, it is then similar to those of socially responsible investment funds. These funds track the Dow Jones Islamic Market (DJIM) Titans 100 index. It comprises 100 non-U.S. companies. It is traded in 18 trading currencies in 23 countries. In Canada, the first Islamic ETFs were managed by UM Financial and Jovian Capital. It tracks the performance of the S&P/TSX Shariah Index.[4] A more detailed index can be seen in Table 9.5.

In the London Stock Exchange (LSE), the first listing of the iShares FTSE 100 ETFs occurred in 2008. In LSE, some Shariah-compliant ETFs are traded in several currencies. First, iShares tracks the ETFs, which are based on the MSCI World Islamic, MSCI USA Islamic, and MSCI Emerging Markets Islamic indices. Second, db x-trackers, the ETFs arm of Deutsche Bank, offers Islamic ETFs based on the S&P Japan 500 Shariah, S&P 500 Shariah, S&P Europe 350 Shariah, and DJ Islamic Market Titans indices.[5] In India, 2007 marked an important step as a Shariah-compliant ETF, namely Shariah BeES, was launched. This index fund is based on the CNX Nifty Shariah Index.

Challenges in Promoting I-ETFs

In Southeast Asia (for example, Malaysia and Indonesia), instead of the capital market, the banking industry is considered to be a vitally important factor in each nation's economy. The

TABLE 9.5 Islamic ETFs in Several Countries

Name	Index	Manager	Launch/Listing
DJIM Turkey ETF	DJIM Turkey	Bizim Menkul	February2006/Istanbul
EasyETF DJIM Titan 100	DJIM Titan 100	BNP Paribas	February 2007/Swiss
iShares: — MSCI World Islamic — Emerging Market Islamic — USA Islamic	MSCI Islamic	Barclays (iShares)	December 2007/London
MyETF DJIM 25	DJIM Titan 25	i-VCAP Management	January 2008/Malaysia
DAIWA FTSE Shariah Japan	FTSE Japan Shariah 100	DAIWA Asset	April 2008/Singapore
Db x-trackers: — S&P 500 Shariah — S&P Europe 350 Shariah	S&P	Deutsche Bank	August 2008/London

Source: ISRA Bulletin, April 2009.

data show that, in Malaysia, the ratio of bank loans to its GDP increased steadily from about 80 percent in the 1980s to about 100 percent in the 1990s and about 125 percent in 2003 (Kassim, 2006). Similarly, in Indonesia, the banking sector continues to be the major source of domestic financing, reaching up to 80 percent of the region's investment (Miranda, 2007). The capital market as an alternative to help boost the economy is still at a premature stage.

The challenges are clear that capital markets need to be continuously promoted as an alternative for the economy to grow. The socialisation of the capital market is not only directed to the businesses in which they can issue sukuk and shares but also to the investors. If investors are not interested in making investments in the capital market and prefer to deposit their money in banks, then there will be fewer and fewer businesses participating in the capital market.

With regard to the I-ETFs, there are many things that need to be done. First and foremost is that, as I-ETFs are relatively new compared to other existing investment instruments, promotion and education should be effectively and continuously conducted. In order to convince investors that the I-ETFs are Shariah-compliant and present relatively less risk will certainly require some time. A systematic method is required in promoting this index fund.

Chapter Summary

- An exchange-traded fund (ETF) is an open-end fund or mutual fund, but to some extent it is similar to a closed-end fund, whereby the price can be traded at a premium or discount from NAV. This is because the price is determined by market forces.
- The benefits of ETFs are diversification, convenience, low costs, tradability, transparency, low expense ratio, and cheap price.
- Risks in investing in ETFs are market risk, tracking error, discount, or premium.
- Important entities to run the ETF are: Manager, Trustee, Participating Dealer, Liquidity Providers, and the investors.
- Islamic ETF is an ETF, but is Shariah compliant. The Securities Commission in Malaysia has defined Shariah-compliant stocks as stocks of companies that are not dealing with riba, gambling, manufacture of nonhalal products, manufacture of tobacco-based products, conventional insurance, entertainment, and other activities deemed nonpermissible.
- Moreover, financial ratio has also been taken into consideration for its permissibility. For example: turnover and profit before tax of nonapproved activities, portion of interest income, and dividend received from investment in nonapproved securities. If the company has fulfilled the second criteria that has been stated by the Securities Commission, then the company can go through the final scrutiny, which is the quantitative analysis, such as on the image of the company, public perception, and the importance of the company to the ummah (Islamic community), and so forth.
- There are a few differences between Islamic ETFs (I-ETFs) and conventional ETFs: First, I-ETFs track an index in which the companies are Shariah compliant as opposed to conventional ETFs, which may track any index. Second, Islamic ETFs have to appoint a

Shariah advisor/committee and comply with Shariah investment policies. Third, a regular review is also done by a Shariah advisor to ensure compliance with Shariah principles. Fourth, I-ETFs avoid securities lending, futures, and options as part of their operations.

- Evolution of the ETFs: Initially only stock trading occurred. But with lack of diversification, a unit trust is created. However unit trusts cannot beat the market. Then came index funds, but the problem is that there is no intraday trading. Finally, to accommodate the variety of the previous assets, ETFs were then created. The I-ETF fund in Malaysia is called MyETF-DJIM25. It stands for Malaysia Exchange-Traded Funds Dow Jones Islamic Market Malaysia Titans. It was introduced with a value of RM840 million.
- In 1995, the Malaysian securities market introduced the framework of stock borrowing and lending (SBL). This explains the regulated short selling. There are four parties in SBL namely, lending agent (local brokers), central lending agency (Bursa Malaysia clearing house), borrower (local brokers), and borrower's client.
- The Islamic alternative of stock borrowing and lending (SBL) is to use the principle of bai' (buy and sell) as well as wa'd (promise).

Chapter Questions

1. Distinguish between open- and closed-end funds and ETFs.
2. Briefly explain the benefits and the risks of ETFs.
3. Distinguish between conventional ETFs and Islamic-ETFs.
4. Briefly explain the framework of stock borrowing and lending (SBL).
5. Briefly explain the framework of the Islamic alternative of stock borrowing and lending (SBL).

Notes

1. This topic will be discussed later in this chapter.
2. For more discussion on this issue, see Malaysian Islamic Capital Market, Securities Commission, November 2008.
3. ***Islamic Finance News***, July 3, 2009, 3.
4. ***Islamic Finance News***, July 24, 2009, 4.
5. ***Islamic Finance News***, October 13, 2010, 20.

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CHAPTER

10

Islamic Derivatives Market

Learning outcomes

At the end of this chapter, you should be able to:

1. Understand the basic concept of derivatives and derivative markets.
2. Identify the types of players in the derivative markets.
3. Understand the concept of risk in the Islamic perspective.
4. Identify the Islamic alternative for forward, future, swap, and option contracts.
5. Understand the Islamic structure for cross-currency swaps and profit-rate swaps.
6. Understand the concept of Islamic structured products.

Fundamentals of Islamic Money and Capital Markets
By Mohd Azmi Omar, Muhamad Abduh and Raditya Sukmana

Introduction

In this modern world, in which the number of financial transactions is much greater than it was decades ago, there are also greater fluctuations in the prices of assets. The rapid movement of supply and demand for a certain product or financial asset makes the equilibrium price and quantity change very fast. This obviously affects business decisions, particularly due to the involved risk.

There are many types of risk and each company faces risk in a different way from other companies. For example, a company with almost all its assets in equity (and hence with less leverage) would not be exposed to interest-rate risk. The individual who invests in a Shariah-compliant investment may face a rate of return risk. It is a risk that is associated with overall balance-sheet exposures where mismatches arise between asset and balance from fund providers (IFSB2006). For the company that deals with international activities, they need to pay more attention on the exchange-rate risk.

For example, manufacturing companies, which have to buy imported raw materials to run their business are, of course, affected by the movement of the exchange rate. This happened during the Asian financial crisis in 1998 whereby the investors sought U.S. dollars as they did not have confidence to hold local currency. As a result, local currency fell to the lowest level ever. Due to this event, these manufacturing companies were not able to buy raw materials in the same amount as before. Therefore, they had to reduce their production and consequently fired a significant number of workers.

They might be able to reduce their exposure on the fluctuation of the exchange rate if they use a hedge instrument. Discussions on hedging, derivative securities, and the Islamic ways of hedging will be presented later in this chapter.

Before discussing the Islamic perspective on the derivative, the following section will help with our understanding of the conventional derivative instruments. Instruments that are commonly used, namely hedging with forward, future, options, and swaps, will be discussed here.

Derivative Securities in the Conventional Market

Derivatives can be explained simply as financial instruments for risk management. Examples of these derivative instruments are forward, future, options, and swaps. These tools are aimed to spread the risk among the players and, if this is achieved, all parties are better off. Other than that, derivative instruments can also be used for speculation. This derivative instrument will be used by speculators to get short-term gains. They may get a huge amount of money in a relatively short period, but they are also exposed to the high risk of losses in a short period of time.

Derivative is a zero-sum exchange between the two parties. Alan Greenspan, former Governor of Federal Reserve[1] noted that overall, derivatives are mainly a zero-sum game:

"One counterparty's market loss is the other counterparty's market gain." Therefore, derivatives are not the real transaction as there is no transfer of ownership taking place. Money only changes hands at the end of the contract. Notice that contracts that transfer the ownership and physically involve delivery of the asset are not considered as the derivative that we are discussing.

Derivative securities can also be defined as financial assets that represent claims to other financial assets (Ross, 1995). For instance, stock options (financial assets) provide the owner the right to buy or sell stocks (other financial assets). The process of creating this instrument is called financial engineering. In a normal situation whereby price is stable, financial engineering is less in demand as the risk involved is very much less. However, in the current economic and business conditions, which change very rapidly, businessmen must find ways to anticipate the fluctuations(risks). That is why, currently, the topic of financial engineering is very demanding, especially the topic of Islamic financial engineering. The reason is simply that the financial world has become more and more risky.

There are debates on the use of the derivative instrument. The advocates of the derivative argue that derivatives can distribute the risk efficiently between the participating parties. The agent becomes more productive, hence the economy as a whole will prosper. For instance, a farmer who is uncertain about the price of his commodity in the future may attempt to mitigate the risk. He can use a future contract to hedge the upcoming uncertainty. The counterparty would be the one who is willing to take risks.

Despite the common use of derivative instruments in the current uncertain business environment, many of the big names oppose the use of it. Nobel laureate M. Allais describes such a market as a "casino where gigantic games of poker are played."[2] He states explicitly that speculation on security price indices must be eliminated.

Warren Buffett, one of the world's most successful investors, graduated from Columbia University, and is in the position to oppose the use of derivatives. In the letter that he sent to the shareholders in his company, he explained that derivative instruments are "time bombs for both the parties that deal in them and the economic system." His other argument is that derivatives can exacerbate the risk at the firm's level and the market level, and that the "macro picture is dangerous and getting more so." His following view is that derivative instruments are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.[3]

A large company in the United States, General Electric, which is involved in the financial business via its subsidiary, GE Capital (GECs), expressed a view of the derivatives in their 2001 annual report. It stated that neither GE nor GECs engage in derivatives trading, derivative market-making, or other speculative activities.[4]

This discussion on the use of derivative instruments cannot be separated from the discussion of the risks that are involved. A part of the debate on the use of the derivative, one of the important things that have to be initially considered or known by the business, is the risk profile. This is important as to what extent the business faces the risk. Before choosing the instrument to mitigate the risk, the company/the firm has to be able to also recognise the future risk exposure based on their business nature.

Risk Profile

In brief, risk exposure is a plot that shows the relationship between change in the price of some goods and services and changes in the value of the firm. To illustrate, consider a big agricultural company that produces cotton. As the price of cotton might be very volatile, it is necessary to investigate the company's exposure on the fluctuation of the price of cotton, and specifically, the company's risk profile with regard to the cotton price. In order to do so, we plot a diagram that describes the changes of the value of the firm (ΔV) versus the unexpected changes in the cotton prices (ΔP).

The horizontal axis of ΔP in Figure 10.1 means the market price (in the future) minus current price. In this case, if the market price of cotton increases (assume the current price to be fixed), the value of the company will also increase, as shown by positive ΔV. It is of no surprise that the risk profile is upward sloping, as cotton is the output of that company. Hence, as the output price increases, certainly the value of the firm will also increase.

Companies face risk differently, even though they face the same product. From the example above, cottons are the output of the agricultural companies; therefore they will enjoy benefits every time the price increases. What will happen to the textile company when the price of cotton increases? Are they happy? Certainly they are not, as they use cotton as their raw material. Their value of the firm will decrease when the cotton price increases (again assume that the current price stays fixed). Conversely, they are happy when the price decreases so that the value of the firm (ΔV) increases, as shown in Figure 10.2.

Both companies (cotton producer and cotton buyer) are exposed to cotton price fluctuation, but with opposite effects. When one company enjoys benefits, the other is at a loss. However, if these companies get together, risks faced by both companies can be reduced very

FIGURE 10.1 Risk Profile for a Cotton Producer

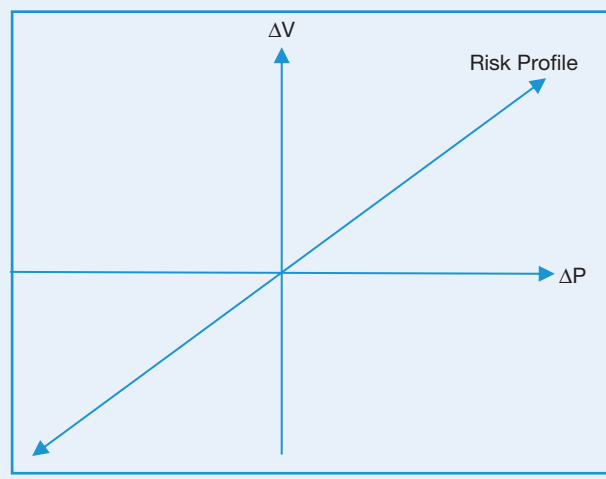
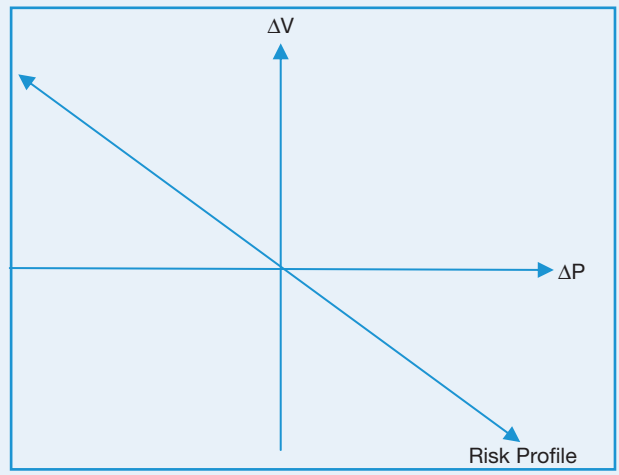


FIGURE 10.2 Risk Profile for Cotton Buyer



significantly. Both companies can make agreements that the producer has to produce a certain quantity at a certain price that will be paid by the cotton buyer. When both companies agree, they will lock in the price of cotton until the last date, as stipulated at the contract.

Main Players in the Derivatives Market

There are three broad categories among the players in the derivatives market:

1. Hedgers
2. Arbitrageurs
3. Speculators

Recall that derivatives can be used to protect against uncertainty as well as to speculate. If the objective is to mitigate against uncertainty, definitely the main players would be the hedgers. For example: an agricultural farmer may hedge against the uncertainty of the price of his product by using the hedging instrument in the derivative market, just like in the previous example. Hence, they fall under the category of hedgers.

The second category is arbitrageur. Arbitrageur uses derivatives to engage in arbitrage. Basically, arbitrage is a process of attempting to gain profit on the price differentials in the market. Arbitrageur will buy assets from the market at a low price and gain profit by selling to the other market at a high price. Moreover, arbitrage can also be done not only from the same assets with different markets, but also between product markets, for instance, between spot and

futures markets or between futures and options, or among three different markets. Arbitraging among many markets, obviously, requires a sophisticated financial engineering technique.

The last category is the speculators. As the name suggests, the job is merely on speculation. If they expect that the price of a certain asset will fall/decline shortly, they will sell it now at the current price, which is high (although he does not have the assets at this time). If his expectation comes true, he will then buy it (with a cheaper price). Therefore he makes profit from the price differential. However, if the price eventually does not decline or even increase, he will make losses.

Hedging is useful not only to create a better business plan but also reduces costs and benefits the society. This is because price discovery exists due to the existence of hedging. Price discoveries, in this context, mean a realignment of the price that is the signal of the economy and later has an important implication on the resource allocation. The role of arbitrage is to speed up the price discovery. For example: arbitrage between the markets in different countries leads to the internationalisation of product prices. This forces the less productive producers to produce more in order to stay in business. Therefore as more and more producers come into place, the price of the product becomes cheaper and benefits the customers.

Even though speculative activities create hardships, they may still create benefits. Speculative activities may increase the trading volume and this in turn results in two other benefits. First, it reduces the transactions cost as it is cheaper for hedgers to hedge. Second, it increases the liquidity.

Hedging with a Forward Contract

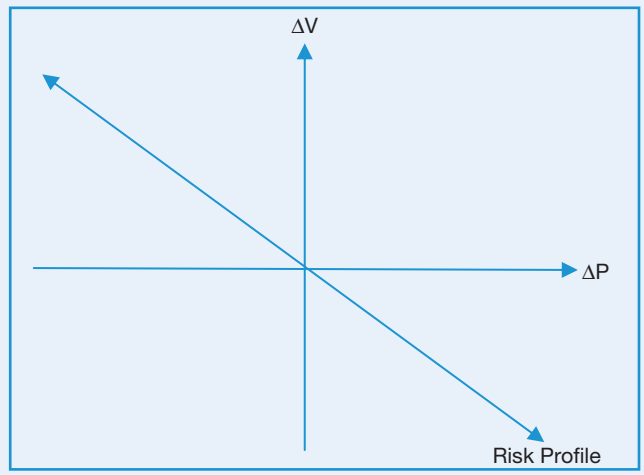
Forward contract is a legally binding agreement between two parties in which one party sells an asset or product in the future at a price agreed upon by the other party. This contract requires one party (in this case the seller) to deliver the goods to the other party (buyer of the forward contract) on a specific date in the future called the settlement date. The buyer will then have to pay the agreed-on price and take the goods.

The buyer of the forward contract will enjoy benefits if the market price, at maturity, is above the agreed-on price as he or she only has to pay with the lower price (forward price). The figure for this buyer of the forward contract is similar to the figure of the story of the cotton grower (producer) in Figure 10.1. In essence the cotton producer and the buyer of the forward contract is always expecting the price to increase in the future so that they will gain benefits.

Likewise, the seller will win if the market price is lower than the price that has been locked by both parties (buyer and seller). The risk profile of the seller is similar to the cotton buyer (see Figure 10.2) whereby both are expecting the price of cotton to go down. So forward contract is a zero sum game which means one party's win is a loss to another party.

An example of the forward contract, a state-owned enterprise (SOE) is producing goods with a price that is determined by the government (cannot be changed easily). This enterprise (manufacturing company) is using oil as the main energy to run the factory. Since oil is the input,

FIGURE 10.3 Risk Profile of State-Owned Enterprise (SOE)



then the risk profile will look like Figure 10.3.[5] It means that when oil prices increase ($\Delta P > 0$), it lowers the value of the firm. Hence, the SOE is always expecting the price of oil to go down.

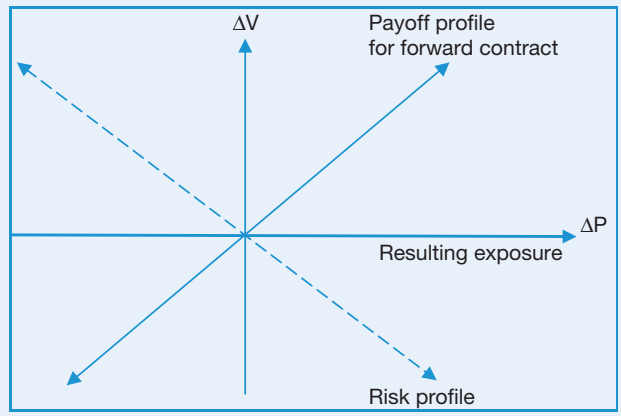
Given the fact that if the oil price increases, it leads to decreases in the value of the firm, thus the firm has to anticipate this with the use of a forward contract. Notice that the buyer of the forward contract has a risk profile like Figure 10.1. If it is combined with the risk profile of the SOE, the resulting exposure is in line with the positive horizontal line of ΔP. With this contract, the SOE will not be losing much.

Notice that with the forward contract, it means that the buyer and the seller of oil have agreed on a certain price on a certain date (settlement date), so whenever the market price (at the time of the settlement date) of oil increases more than the agreed-on price, the buyer will enjoy benefits as he only has to pay less (which is the agreed price). Hence the ultimate value of the firm is zero as the resulting exposure (coincides with the horizontal axis), while without forward contract the value of the firm (SOE), is negative (dashed line in Figure 10.4).

Hedging with Future Contracts

A future contract is basically the same as a forward contract with few differences, such as realisation. In the forward contract, the realisation of the gains or losses for the parties (buyer and seller) only occurs on the settlement date. Conversely, the realisation for the future contract is on a daily basis. For example, if we buy a future contract on a commodity such as corn, and the price of corn rises today, we will have profit and the seller will have a loss. Once the seller pays the transaction, both parties own nothing. Futures can also be referred to as standardised tradable forward contracts.

FIGURE 10.4 Hedging with a Forward Contract



The distinct feature of this contract (the daily settlement) is also called marking to market. Recall that in the forward contract, there is a possibility that one party defaulted. For example, if at the settlement date, the market price is far above the agreed-on price, this opens the possibility that the seller could not provide the goods as had been agreed on at the time when the contract is signed. Therefore the advantage of the future contract is that the risk (especially the price fluctuation) is greatly reduced.

There are two types of futures contracts, namely financial futures and commodity futures. The former refers to the use of stocks, bonds, and currencies as the underlying asset while the latter may include agricultural products such as corn, wheat, and orange juice. Precious metals such as gold and silver would also be listed as commodities futures.

In general, hedging with a futures contract is similar to planning a forward contract. The payoff profile on the futures contract can be drawn up just like the forward contract. The only difference is that in future contracts, the firm will have to maintain an account with a broker. Hence the marking to market process leads to gains or losses that will be credited or debited every day.

Hedging with Swap Contracts

Swap contract is defined as the agreement between two parties to exchange or swap with specified cash flows at specific intervals (Ross, 1995). Unlike the future/forward contracts, this contract needs a third party, called a swap dealer. The main function of the swap dealer is to make the arrangement on the swap. Notice that when we want to swap, we need to find another party which wants the opposite end of deal. In the absence of the swap dealer, the party would find it difficult (expensive and time consuming) to find another party that wants the opposite. Hence the role of the swap dealer is very important to bridge from one party to another. There are three common types of swap, namely, currency swap, interest rate swap, and commodity swap.

Currency Swap

This happens when two companies agree to exchange a certain amount of a currency to another currency on the exact date in the future. For instance, a German company (Headquarter-HQ1) has a subsidiary company (SC1) in England. This Headquarter (HQ1) plans to increase the production capacity of the SC1 by establishing a new factory. Since the currency used by SC1 is in pound sterling, HQ1 proposes to SC1 to borrow funds from the England debt market. However, this HQ1 has a good relationship with the German debt market (cheaper rate) and not with the English debt market.

At the same time, an English firm (HQ2) has its subsidiary in Germany (SC2) and HQ2 needs to expand the production capacity of the SC2. HQ2 would like to get financing from Germany but can get a cheaper price in the England debt market. Both firms are facing a similar problem: exchange rate risk. That is why HQ1 borrows money from the German debt market and sends the proceeds to its subsidiary in England. Similarly, exchange rate risk is faced by HQ2, if HQ2 borrows money from England and sends the proceeds to its SC2. Both firms can mitigate this risk by a currency swap. These two companies have to agree to exchange deutsche mark for pound sterling at the fixed rate at the exact date in the future. In practice, HQ1 will borrow money from the German debt market (where it is cheaper) and send the money to SC2. Similarly, HQ2 gets a loan from the English debt market that will be utilised by SC1. Eventually, both parties will net off the position, and each company will obtain the best rate and mitigate the currency risk.

Commodity Swap

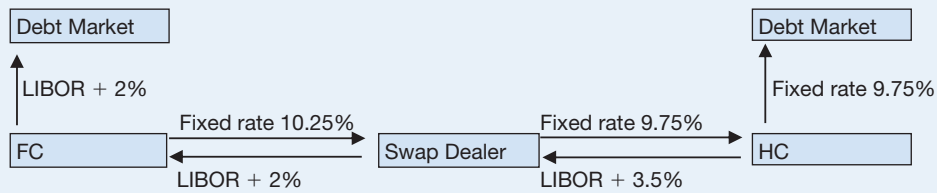
Commodity swap is an agreement on the exchange of a fixed quantity of a commodity at a specified time in the future. For example, a giant car producer wants to ensure that the operation of the factory will not be interrupted due to the lack of oil supplied (assume that oil is important to operate the equipment or machines in the factory). In order to mitigate this risk, this company (the oil user) may enter into a swap contract with the oil producer to supply the needed oil. Both can agree that the price will be the average of the prices from the past 90 days, so that the daily fluctuations of the price can be reduced.

Interest Rate Swap

Suppose there is a firm that wishes to obtain a fixed rate loan but can only get a good rate on the floating rate (the rate whereby the regular payment might be fluctuated to reflect the fluctuation on the interest rate). Another firm can easily get a good deal with a fixed rate but really needs the lowest rate, which will only be found in the floating rate. Both firms can get what they are expecting by exchanging their loan payment. This is an example of the interest rate swap. To get a better understanding, let us follow the example below on the process of an interest rate swap.

A company called "FakhriCorporation" (FC) can obtain a floating rate equal to LIBOR plus a 200 basis point[6] percent or, if it is fixed rate, it is equal to 11 percent. Another company namely, "HanifahCorporation" (HC) can easily borrow funds with a LIBOR plus 4 percent or at

FIGURE 10.5 Interest Rate Swap Process



a fixed rate of 9.75 percent. FSB wants a fixed rate loan whilst HSB desires a floating rate loan. This condition is fulfilled by an interest swap.

The first thing that FC has to do is to contact the swap dealer to agree to help FC with the interest rate swap. FC borrows money at the LIBOR plus 2 percent and the swap dealer agrees to cover the loan payments. As an exchange, FC pays the swap dealer at a fixed rate of, say 10.25 percent. Basically, swap dealers are obliged to make a payment of the LIBOR made by the FC, but receive fixed-rate payments from FC.

For the counterparty, HC borrows money at a fixed rate of 9.75 percent and has dealt with the swap dealer so that the dealer will cover all those regular fixed payments. As a consequence, HC will pay LIBOR plus 3.5 to the swap dealer. In this arrangement, the swap dealer is making floating rate payments. In other words, he has swapped a floating payment for a fixed one.

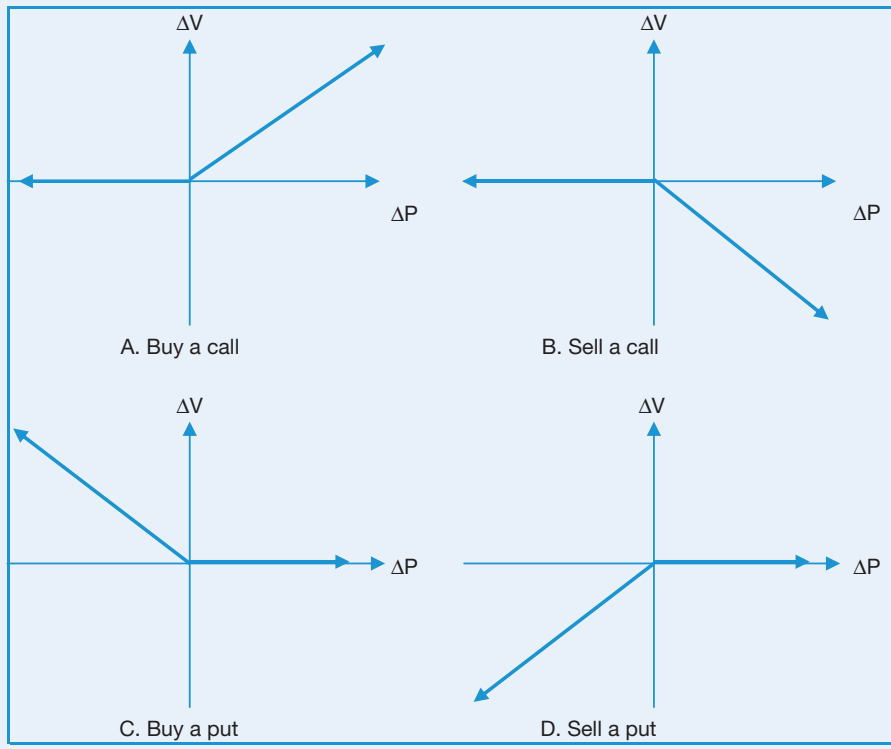
What is the net result of all these arrangements? Yes, all parties win. In essence all parties have obtained positive gains. Consider first the expectation of FC. FC wants a fixed-rate loan and finally FC has achieved it with the help of the swap dealer. And moreover, FC can get a lower fixed-rate loan. HC, which wants the floating rate, can finally get it with the lower rate. So, what about the swap dealers? Do they get profits? The answer is yes. Swap dealers receive a fixed rate (from the arrangement with FC) of 10.25 percent and pay a fixed rate (from the arrangement with HC) of 9.75 percent, hence the dealer can get the difference of 0.5 percent (10.25to 9.75 percent). Not only that, but swap dealers also profit from the floating arrangement. The dealer has to pay a floating rate plus 2 percent (from the arrangement with FC) and receive a floating rate plus 3.5 percent (from the arrangement with the HC). Figure 10.5 illustrates the process that we have just discussed.

Hedging with Option Contract

The three types of hedging discussed previously (forward contract, futures contract, and swap) oblige all parties to complete the transaction. However, there is a type of hedging contract that provides the owner with the right (not the obligation) and it is called an option. Basically an option contract is defined as an agreement that gives the owner the right, but not the obligation, to buy or sell assets at a specified future date and at a specified price.

There are two types of options, namely puts and calls. A call option is an option where the owner has the right to buy an underlying asset at a fixed price, called a strike price or an

FIGURE 10.6 Payoff Profile of Options

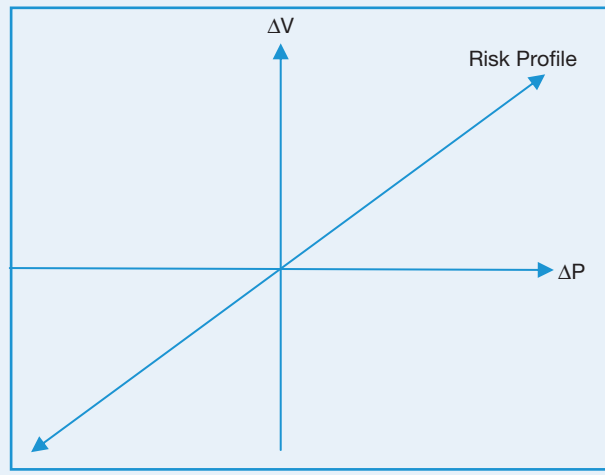


exercise price, at a specific time in the future. Meanwhile, a put option is an option that gives the owner the right to sell the underlying asset at a fixed price at a specific time in the future.

There are some distinct features of these contracts compared to forward contracts. First, as has been explained previously, a forward contract obliges all parties to complete the transaction. One party delivers the asset and receives payment while the other party has to pay and take the delivery. With this option, the transaction occurs only when the owner exercises his right. If not, then the other party would not be affected. Second, there is no money involved when the forward contract is signed. Conversely, in the option the buyer has to buy the option and this is called the option premium.

Figure 10.6 shows the payoff profile on the option. There are four possible profiles, namely buy a call, sell a call, buy a put, and sell a put. The horizontal axis is ΔP, which is the difference between the asset's value and the strike price of the option. For instance if the asset value is greater than the strike price, he (the buyer) of a call option (Part A of Figure 10.6) will exercise his right and enjoy benefits as he only has to pay the strike price (which is cheaper than the asset price). However, if the asset value is cheaper than the strike price (as shown by negative ΔP), the call option owner need not exercise his/her right and only lose the premium. In part B

FIGURE 10.7 Unhedged Risk Profile of the Cotton Grower



if the buyer exercises the call option (at the positive ΔP) then the seller will be in a loss since he has to pay the high price. As a result, the value of the firm (the seller) will be negative.

In part C, having a put option, the buyer (of a put option) can exercise his option only when the asset's value is lower than the strike price so that by selling at a high price the value of the firm increases (positive ΔP). Conversely, the seller will be in a loss if the buyer of the put option exercises the option (at the asset's value of less than the strike price). This is shown as negative ΔP.

Now, how do you use the option as an instrument for hedging? Notice that in order to hedge using the option instrument, we need to recognise first the risk profile of the company. It is important to understand the value of the firm (as shown by ΔV) when the price of the product changes. Consider the following example. Suppose the cotton grower has a risk profile like Figure 10.1 (restated in Figure 10.7).

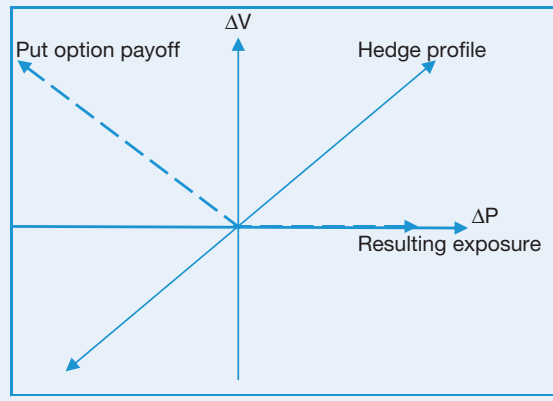
We are easily able to see that as the price of cotton increases, the value of the firm increases. However, there is also the possibility that the value of the firm will be negative. That is when the asset value is less than the strike price.

How to reduce this risk using the option? Which option should we consider in order to reduce the negative value of the firm? In order to do so, we need to check among all types of options (in Figure 10.6), and decide which one among those four types of options will increase the value of the firm in case the asset value is less than the strike price?

From Figure 10.6, we know that the option that we have to take is to buy a put. Recall that a put is the right to sell the asset. The owner will enjoy benefits if the asset value is less than the strike price, since the owner will receive a payment of strike price (which is higher than the asset value).

So, in the case whereby the asset value is greater than the strike price, the cotton grower, in the example above, is happy because he can get a higher price for his product. In this case, he does not have to exercise his put option. While if the asset value is less than the strike price,

FIGURE 10.8 The Hedged Risk Profile



he will have to exercise his put option so that he will still receive the strike price, which is higher than the asset value. So the hedge risk profile will become like that shown in Figure 10.8.

Derivative Securities in the Islamic Perspective

Before we discuss the issue of derivatives in the Islamic perspective, it is worth looking at how Islam views the issue of risk. Following it, we will discuss how derivative securities, which are Shariah compliant, can be used to mitigate the risk.

Ibn Taimiyyah has divided risk into two categories: a commercial risk and a gambling risk. A commercial risk is a risk that is commonly faced by a trader (buys goods from producers and sells them to customers). He is facing the risk that the goods cannot be sold. He is losing the price that he paid to the producer, the transportation cost from the warehouse of the producer to his shop and other prices that may incur. This kind of loss is natural for the merchant or trader. And notice that this kind of risk is associated with wealth creation activities. It is the activity in which raw material was manufactured to become a finished product and it is sold to a customer via traders. Hence this type of risk cannot be categorised as maysir (gambling) (Ryandono, 2009). Second, it is the gambling risk that can also refer to the zero sum games in which no additional wealth is being created. This type of risk is prohibited by Allah and his messenger.

Islam requires us to preserve wealth; this is one of the goals in life. If we define risk as a possibility of loss, certainly, it is not desirable. However, many good deeds are followed by a hardship. Hardship alone is not desirable. Therefore, in order for us to do a good deed, there are two things we should ensure. The first thing is to value the good deed and the second is to recognise the hardship attached to the good deed. Hence risk or hardship alone cannot determine the value.

For instance, to deliver dates that travel from Tunisia to Indonesia close to the month of Ramadhan is a good deed, because this fruit is eaten to break the fast at sunset at that time. However, there is the risk that the ship (assuming the dates are shipped via sea transportation) could be hijacked and robbed by pirates. If we based our adherence to Shariah principles solely on the hardship (in other words, the basis considers only the risk, without including the good deed), the delivery may be cancelled. This is an example of how we should not place too much importance on the hardship while doing the good deed. To conclude, the risk is lawful when it is important for value creation. However, if there is no added value, then it falls under the category of gambling. In the example of shipping goods, although the risk exists, it is balanced by the good deed (which is the delivery of dates), and hence this kind of transaction (to import dates) is lawful.

Generally, Islam allows risk with the following three conditions:[7]

1. It is inevitable: Deeds are accompanied by risks. Hence we have to be able to assess or predict the risk involved in the particular activities. Notice that risk is necessary for economic progress and wealth creation. For example: The deposit received by the Islamic bank can be channeled in two ways. The first is to provide financing to the businesses and the second is to be put in the central banks and earn fees (if it uses the instrument of jualah as has been implemented in the Bank Indonesia/Central Bank of Indonesia to all Islamic banks in Indonesia). Certainly, putting the deposit in the central bank earns zero risk, but it compensates with very low fees to the Islamic banks. However, if the banks can channel the funds to the real sector, they will face a much greater risk, such as the risk of default by the businessman. For that, the Islamic bank may earn a significant profit rate margin as compared to the fee that the Islamic bank receives from the Central Bank. Hence, risk is needed for the economy to grow.
2. It is insignificant: This focuses on the degree of risk, that is, how big or small is the involved risk while we are doing good deeds. Recall the example of the delivery of dates for Ramadan. If there is an additional number of polices to take care of the dates during the journey, then the risk of being robbed is even more insignificant. This kind of risk is allowed in Islam.
3. It is unintentional: The objective of normal activities is on value creation and not on the risk it necessitates.

As has been explained in the discussion earlier in this chapter, a derivative is a claim of the financial asset on the other financial assets. Basically there are two main reasons for investors to deal with these derivative securities: speculation and hedging. The former is done by risk-seeking investors aiming at the short-term gain in nature.

While speculation is impermissible, hedging, to some Shariah scholars, is allowed. This is because the purpose to hedge is to protect investors against a volatile market and not aim at the short-term gains. The holy Qur'an has explained this issue. Al Baqarah (219) states: "They ask you concerning wine and maysir (gambling). Say: In them is great sin as well as benefits to people, but the sins are greater than the benefit."

Maysir refers to obtaining gain without effort. An example of this is casino gambling. In this game, the gambler seeks the profit that has a low-percentage probability of occurrence. Hence it is based solely on luck. Prophet Muhammad was requested by Allah to answer that in both (intoxicants and games of chance), there is great evil, such as loss of balance and health problems (both due to drinking intoxicants), as well as cheating and deception (caused by gambling), and few worldly benefits to a few people such as material gain, temporary happiness, job opportunity. But the evils are greater than the benefits.

The value of a derivative is that it is able to mitigate the risk so that investors will be protected. However, the tools can also be used for gambling. The pertinent question is, How can we get the benefits of hedging and at the same time avoid the harm of gambling? Even now, this issue is still unresolved, although derivative transactions have already been taking place for many years.

Recall that there are four basic types of transactions: spot, deferred, salam, and forward and future. Each is described as follows:

1. ***Spot*** means that the asset or the commodity and the money are exchanged at the same time or simultaneously, which means the transaction happens at t_0.
2. A ***deferred*** transaction is a transaction in which the commodity/asset is delivered immediately (at t_0) but the payment is on the installment basis (t_1).
3. A ***salam*** transaction would require the price to be paid in full and immediately (at t_0), but the commodity will be delivered in the future.
4. Last, a ***forward and future*** transaction is a transaction in which both money and the commodity change hands in the future.

The first three transactions listed here have been approved by Shariah scholars. This means that spot, deferred, and salam transactions are valid contracts. Nevertheless, the forward and future transaction, which is similar to a conventional derivative transaction, is not permitted by Shariah scholars. This is because this future transaction can easily be used for speculative purposes.

Islamic Forward and Future Contract

The basic purpose of a forward and future contract is to mitigate the risk of the fluctuation of a price in the future. The differences between the forward and the future contracts are that the forward is over the counter (not standardised) and tailor-made between the buyer and the seller, while future trading is regulated and standardised. Hence, in the discussion of the Islamic contract, we will combine the discussion of forward and future contracts.

Salam contracts were permitted by the Maliki Schools, provided that the goods are not food or agricultural products, such as barley, dates, salt, and wheat. However, according to Ibn Taimiyyah, the contract can be traded at par.

The features of the forward and future contract that are not permitted by Shariah scholars are based on the methods of payment and delivery of the goods. Both happen in the future. In both contracts, when the contract is signed by the buyer and seller, there is no payment of price made at that point in time. They only agree on the future price at the point of contract. It is a price whereby the buyer has to pay to the seller on the settlement date (maturity date). While the buyer is obliged to pay the price, the seller also has to make a delivery of the goods. As the exchange of money and goods occurs in the future, it does not meet one of the conditions of sale. Hence, both contracts are forbidden in Shariah.

The closest Islamic instrument to the forward and future contract is the salam contract. Basically, a salam contract is a contract to buy and sell commodities in which the buyer pays the full amount at the time of the contract and receives the goods in the future. These two conditions prevent the contract from being used for speculative purposes.

For example, a trader of dates has a variety of quality dates, ranging from the lowest price to the most expensive price. This trader has made an agreement to all mosques that during Ramadan he has to supply dates. Since this is a big order, thorough preparations need to be made. Furthermore, he does not want to disappoint the mosque, particularly the people who come to mosque to break their fasts. To fulfill the contract, he can use a salam contract to buy dates from a farmer. In this contract, he is required to give the full price at the beginning of the contract to the farmer. The farmer can use the money to buy the necessary materials for dates to grow, such as seed, fertiliser, and so forth. Alternatively, the farmer can save the money but he has to find dates (by buying elsewhere, for example, from other farmers) and send the correct quantity of dates to the trader on the maturity date. This is the salam contract in essence.

Unlike a forward contract in which the money and the goods change hands in the future, in this salam contract, money changes hands at the time the salam contract is signed. The advantage of this is that the seller (which can be a farmer) can receive the money earlier. In terms of the credit risk between the forward contract and salam, it is also different. In the forward contract, either party can be defaulted at the maturity date. This means that either the buyer does have cash to pay to the seller or the seller could deliver the good as has been stipulated in the contract. Hence either party, in the forward contract, faces a credit risk.

However, in the salam contract, the only party that faces a credit risk is the buyer. This is so since, the buyer has already paid the full amount of the money up front. Hence he will face a credit risk if the seller (which is the farmer) fails to deliver the goods. So in terms of the number of parties that face risk, salam is better as the risk is only borne by the buyer, while in a forward contract both parties face risk.

Another difference is on the price. In the forward contract, both parties have to consider all the costs that might occur from the signed date to the maturity date. Examples of the costs are the spot price and the storage cost. In the case of gold being the underlying asset, both parties have to consider the storage cost of the gold until the maturity date. Conversely, in the salam contract, the price that has to be considered is the spot price minus a discount. This is because the seller has flexibility as to the range of grade or range of quality of the good that is about to be delivered.

For example, a salam contract would require the seller to deliver A-quality mangoes or, if this is not possible, then the seller has to provide B-quality mangoes. At the maturity date,

the seller has to make his best efforts to provide A-quality mangoes. Once he does so, then the remaining will be the B-quality mangoes. So the seller could not be blamed if, for example, more than 50 percent of the mangoes are B quality, provided that the seller has made his best effort.

But the flexibility given by the buyer to the seller is not free of cost for the buyer. This flexibility leads to the introduction of the term called "cheapest to deliver." This term means that the seller opts to choose the cheapest goods possible. For instance, given the range of the quality of mangoes that the seller has to deliver, the seller may attempt to choose B-quality goods, which are of lesser quality and therefore cheaper. This flexibility in the range of grades will be compensated with the discount in the initial price when the salam contract is signed.

With regard to the alternative instrument to the future contract that is Shariah-compliant, Suwailem has offered a technique termed as value-based salam. It still uses the salam contract but with slight modifications from the previous contract.

One of the problems in the salam contract is the price at maturity. The market price at the future can be higher or lower than the expected price. If the price is very much higher than the expected price, then the buyer will get benefits as he buys at a relatively cheaper price. Meanwhile, the seller will be at a loss and the high increase in price certainly wipes out the advance payment that he received from the buyer. The fluctuation in price is the main factor that emerges from the futures market. As a future contract is not acceptable in Islamic finances, it cannot be a solution to the problem. The value-based salam works as described in the following paragraphs.

The buyer of a commodity pays fully in advance for the salam contract to the seller. Assume that the agreed total price is US$10,000 for oil. In the usual salam, the quantity of the oil, such as the number of barrels to be delivered at maturity, has to be agreed upon at the time when the salam contract was signed. In this value-based salam, instead of the quantity, the value is the thing that has to be determined up front. Value is the multiplication of the unit price per barrel times the quantity or number of barrels.

For instance, both parties, the buyer and seller, have reached an agreement of the salam contract in which one of the points is that at maturity the commodity is valued at as much as US$11,000 and the buyer will have to pay only US$10,000 for the commodity (oil). At maturity, the quantity of oil barrels will depend on the oil price at that point in time. Let's say the price of oil at maturity is US$50; thus, the quantity of oil that has to be delivered would be 220 barrels (US$11,000 divided by US$50).

This kind of salam has been approved by Ibn Taymiah. The advantage of this arrangement is that the buyer is able to hedge against the price fluctuation of the future goods (in this case the buyer has already paid in advance the full amount of payment). If the price in maturity declines, then the quantity that has to be delivered will rise.

This arrangement has certainly raised some criticism, as it uses the salam contract in which all specifications, such as price, quantity, and maturity have to be agreed upon up front. There are two criticisms that can be raised of this value-based salam:

1. Quantity is not well-specified at maturity. Hence it violates the usual salam contract.
2. Essentially it is money for money, which, indirectly, is riba.

Suwailem has some responses to these two criticisms:

1. The quantity has to be identified at the beginning to avoid or eliminate the possibility of dispute. If dispute is absent, then the condition need not be observed. The value of the commodity is determined (US$ 11,000), so there will be no dispute as all variables are determined by the market.
2. With regard to the indirect way of riba, the value-based salam is not riba, either in form or substance. At maturity, the buyer receives goods and not money. This arrangement also differs from murabaha. In murabaha, banks buy spot contracts and sell to the customer with a deferred payment from the customer. In this value-based salam transaction, the bank buys a deferred product from the seller (farmer) and sells the spot contract to the buyer/customer. Essentially, murabaha and value-based salam are equivalent; the only difference is the sequence of steps.
3. Value-based salam also differs from controversial contracts, such as inah and tawarruq. In both inah and tawarruq, the commodity used can be generated without limit. It means that the same commodity can be reused many times, hence a huge debt can be created without an upper limit. Nevertheless, it is impossible for that commodity to be reused in the salam contract as well as the value-based salam contract. This is because at the time when the goods/commodities are delivered, the debt will no longer exist. Hence the commodity in this salam cannot generate debt. The instrument is self-regulated on the amount of the debt being created. This is consistent with the nature of Islamic finance in that every single instrument must have an underlying asset so that a bubble cannot automatically be created. This characteristic is unique in Islamic finance, which differs from conventional financing, in that debt can grow indefinitely, which can be more than the size of all the real economy.

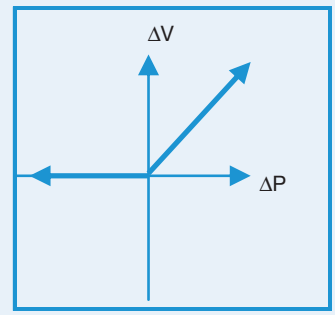
Islamic Option Contract

The Islamic instrument that is most similar to the call option is the urbun contract. As for the put option, there are two Islamic instruments that are roughly similar, namely third-party guarantee and Khiyar al-shart.

The call option gives the holder the right, not an obligation, to buy assets such as stocks, bonds, and so forth. The holder of this option will exercise the right when the market price at the future date is higher than the strike price (the agreed-upon price between the buyer and seller of the option). This means ΔP (market price minus strike price) is positive (Figure 10.9). On the contrary, if the market price is lower than the strike price (ΔP is negative), the holder will buy the asset in the market instead of exercising his right. With this, he will lose only on the premium option, which is a price that has to be paid by the buyer in order to buy the option.

This is similar to the concept of urbun in Islamic finance. Basically, urbun is an earnest money deposit whereby the buyer makes an initial deposit payment to buy an asset. In the event the buyer does not proceed with the purchase, the buyer loses the deposit. It is known since the time of the second caliph Omar ibn al Khattab 22H. However, the use of this contract

FIGURE 10.9 Buy a Call



is for the real trade transaction and is not used for speculation, that is, fixing the price to benefit from the future price movements. This contract, which is envisaged by the Hanbali School of Jurisprudence, is a sale contract whereby the buyer pays a portion of the total price immediately. This contract also gives a buyer the right to cancel the sale within a stipulated period (Archer, 2002). In the case in which the buyer chooses not to exercise his option, which also means that he prefers to buy the asset at the current market price (which is lower), then he has to forego the amount of urbun (down payment).

For example: A company (A) wants to acquire 100 cars for their rental business. The company has made an agreement to the car dealer (B) to acquire 100 cars each costing US $50,000. The company made an urbun payment of US$3,000 for each truck and the remaining payment will be settled upon delivery of the cars, which is estimated to occur in the following year.

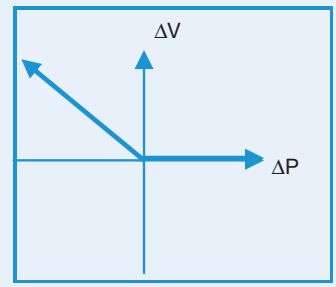
If the future market price of the cars increases by more than US$50,000, the company will enjoy financial benefit since it has locked the price at US$50,000. However, if the market price of cars at the future date is lower than the agreed-on price, then it is better for the company to forego the urbun payment and buy the cars at the prevailing market price.

The difference between a call option and urbun is that in the call option, the premium is not part of the total price of the asset. But in the urbun contract, the urbun is considered part of the total price of the asset.

For the put option, the closest Islamic instrument is the third-party guarantee and khiyar al-shart. Recall that the put option gives a holder the right, not the obligation, to sell the asset at the agreed-on price in the future. If the market price in the future is lower than the strike price, which means ΔP (market price minus strike price) is negative, then the put option holder will exercise his or her right by selling the asset at the strike price, as shown by the increase in ΔV (see Figure 10.10). Hence the holder enjoys benefit by selling the asset at the higher price. However, if the market price at the future date is higher than the strike price (ΔP positive), the buyer of the put option will not exercise it and will choose to sell in the market. He will then lose only the premium option.

In Islamic finance, the guarantee often cannot be done by the transacting parties. However, Islamic finance still allows a third party to guarantee on either one of the transacting

FIGURE 10.10 Buy a Put



parties. The third-party guarantee is compensated with a fee paid by the purchaser/buyer of an asset (item). To be Shariah-compliant, this fee cannot be a percentage of the value of the asset or contract; hence, it must be a fixed price. In the case of default, the guarantor can confiscate and sell the asset to pay the remaining obligation of the buyer to the seller.

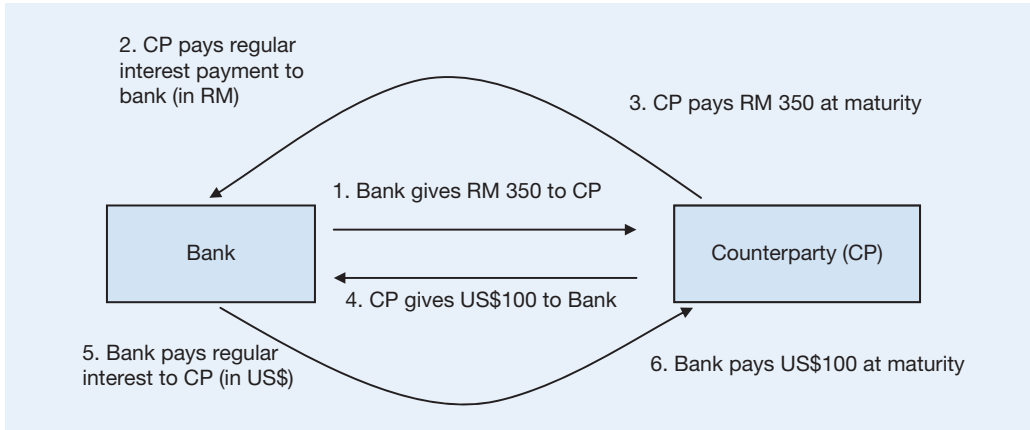
This third-party guarantee can be considered akin to the put option in the conventional sense. If during the period, the buyer decides that the asset is not as valuable as the remaining installment, then he could stop paying the installment and surrender the asset to the third party. Recall that the remaining installment can be considered as the strike price in the conventional put option. So if the asset is not as valuable as the remaining installment, it means that the asset has a value (this can also be considered as the market price in the story of the conventional put option), which is less than the remaining installment; in other words, if ΔP (market price-strike price) is negative, then the purchaser/buyer will ask the third party to sell the asset to help the seller on the buyer's remaining obligation. This decision leads to the increase in the value of the buyer (increase in ΔV).

The second Islamic instrument to the put option is khiyar al shart. It is a sales contract in which either one of the parties has the right to cancel the sale within a stipulated time period. For instance, A and B have made a sales agreement that A will sell equity stock to B. The price is negotiated and agreed upon today. This khiyar al-shart gives A the right to confirm or withdraw the contract by a certain time in the future. If the market price in the future is higher than the agreed-on price, then A may opt to withdraw the contract and sell the stock at the market price. However, if the market price is lower than the agreed-on price, A can confirm to sell the stocks to B. The difference between put options with this khiyar al-shart is that in khiyar al shart, there is no separate fee that is paid at the start of the contract.

Islamic Cross-Currency Swap

Before we discuss the structure of the Islamic cross-currency swap, let us review how the conventional cross-currency swap works. The purposes of a cross-currency swap is to hedge

FIGURE 10.11 Conventional Cross-Currency Swap Mechanism



Source: **GIFR (2010).**

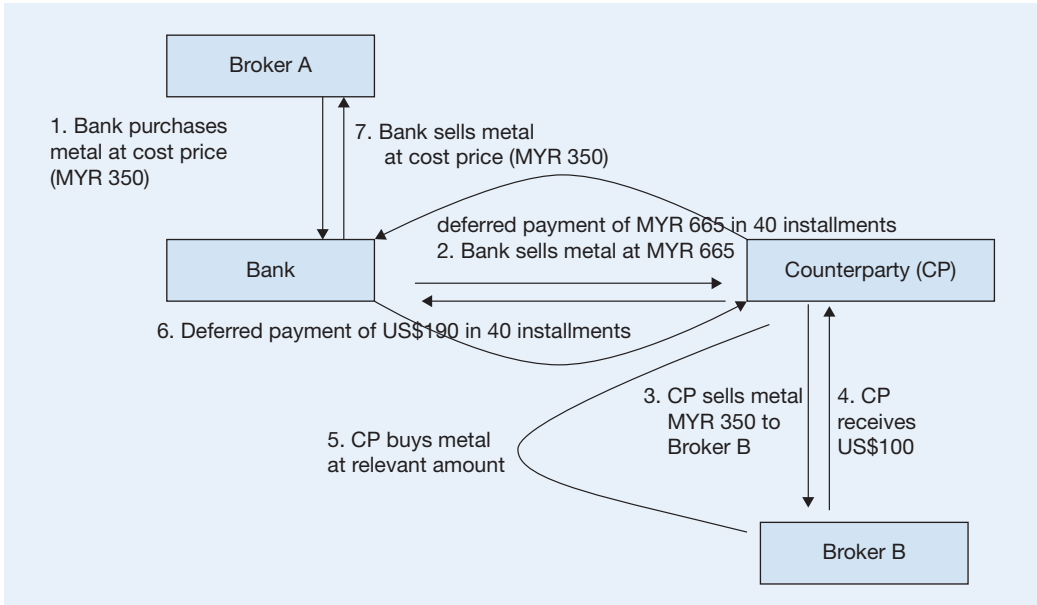
foreign exchange risk. It initiates with the exchange of the currency. For instance, a Malaysian bank requiresUS$100,000 one month from today, and in return is willing to give RM350,000. Regularly, CP will pay installments (which are the interest) to bank in RM and conversely, installment by bank to CP is in US$. At maturity, both parties pay the principal, which is equal to the money exchanged at the beginning. Hence CP pays back the RM350,000 to the bank as well as the bank pays back to CP US$100,000. Clearly, this transaction goes against Shariah, as it involves the contract of setting the exchange rate today to be delivered six months from now. Hence it is equivalent to riba, maysir, and gharar. The bank approaches CP, who is willing to undertake the transaction. In this case, CP has the US$100,000 required by the banks.

The arrangement of the Shariah-compliant cross-currency swap is by adopting the reciprocal murabaha transaction. It requires both parties to enter into a murabaha contract, which is also called primary-term murabaha as well as secondary murabaha. The assets that are commonly used for this arrangement must not be ribawi items; hence palladium and aluminum are the commodities commonly used in an Islamic cross-currency swap. The detailed process with the illustrated example is depicted in Figure 10.12 and is explained as follows:

A. Primary Murabaha

In this transaction, the bank buys the metal from broker A for as much as RM350,000 (1) in cash. Subsequently, the bank will on-sell this metal to a counterparty (CP) on deferred payment of RM665,000 in 40 installments (2). These installments are paid on pre-agreed payment dates and each installment will include a portion of the pre-agreed profit element. However, for the final installment, it includes the full payment of the cost price. Upon the receipt of the commodity, CP will then on-sell the metal at RM350,000 to broker B(3) to get cash for US$100,000 (4).

FIGURE 10.12 Islamic Cross-Currency Swap Mechanism



Source: GIFR (2010).

B. Secondary Murabaha

Under this secondary murabaha, CP buys the commodities in cash (US$) from broker B (5) and promptly on-sells these commodities with immediate delivery to bank (6). The value of this commodity should be the same with the value of the commodity in the primary murabaha. The bank then sells the metal to broker A (7) to get cash of RM350,000.

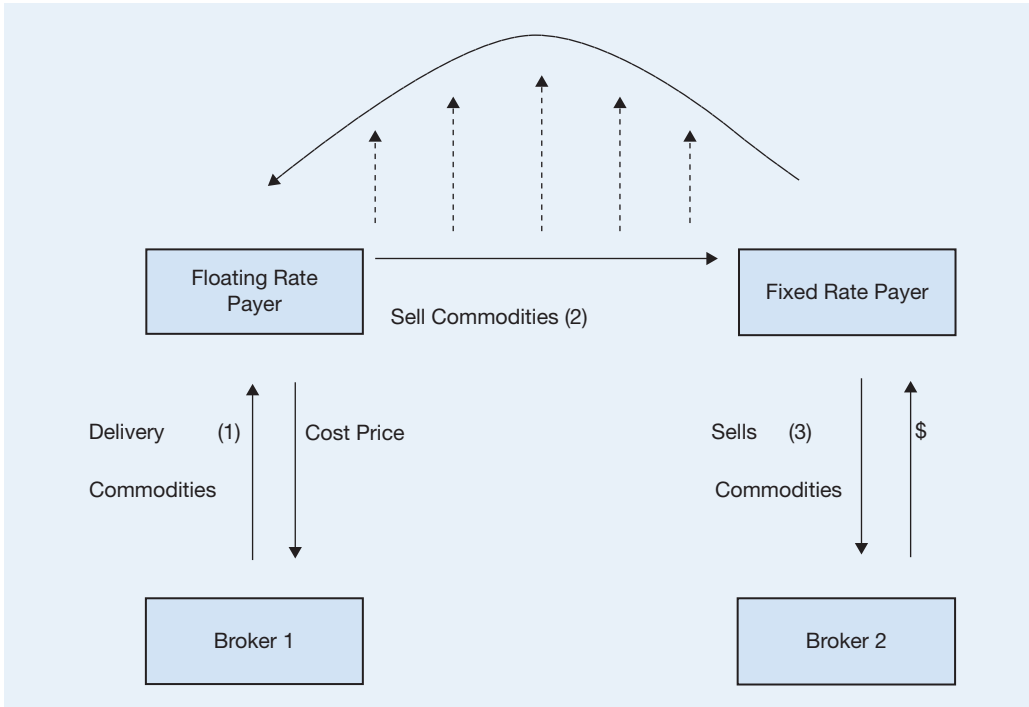
The payment by the bank is on the installment basis, using US$ currency. Similar with the installment in the primary murabaha, this installment will only include profit elements except for the final installment, which includes full payment of US$, which is equivalent to the cost price.

As a summary, the bank pays cash (to broker A) and receives installment payments from CP, both using RM. However, the bank pays installment payments in US$ to CP. Meanwhile, CP pays cash (to broker B) and receives installment payments from the bank, both using US$. However, CP pays installment payment in RM to bank.

Islamic Profit Rate Swap

An Islamic profit rate swap is the alternative to the conventional interest rate swap. This swap basically is an agreement to exchange periodic and floating payments with the use of a pre-agreed notional amount as the reference. The interest rate swap could not be accepted under Shariah.

FIGURE 10.13 Islamic Profit Rate Swap Mechanism



Source: **GIFR (2010).**

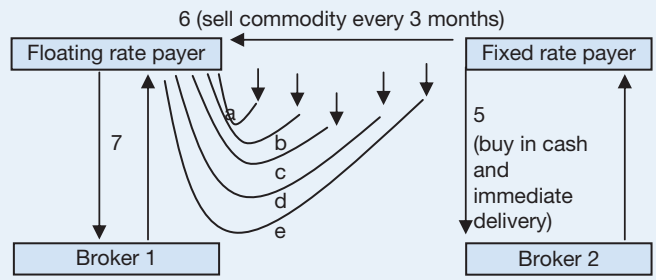
In order for this Islamic profit rate swap to be conducted, a reciprocal murabaha transaction is commonly adopted. This transaction will include the primary murabaha used to generate the fixed payments, which comprise both price and a fixed profit element (Figure 10.13) and a series of reverse murabaha which create floating leg payments whereby the cost price element for each reverse murabaha contracts is fixed but the profit element is floating (Figure 10.14). The process is as follows.

A. The Primary (Term) Murabaha

The process starts with the floating rate-payer buying commodities at cost price from broker 1 in cash (step 1). This commodity will be on sale to the swap counterparty (in this case the fixed rate-payer) on deferred payment (step 2). The value of the transacted commodities will be based on the pre-agreed cost price.

Once the fixed rate-payer receives this commodity purchased, he will then on-sell to broker 2 to obtain cash (step 3). The payment in which the fixed rate-payer pays to the floating rate-payer is on a deferred basis and it will be in a series of pre-agreed payment dates (step 4). Each installment amount will include cost price element (a percentage of total cost price), plus fixed profit portion (this is the floating rate-payer's profit for the transaction). Thus the above transaction enables the floating rate-payer to receive a fixed rate.

FIGURE 10.14 Payment Method in Primary Murabaha under the Islamic Profit Rate Swap Mechanism



Source: GIFR (2010).

B. The Series of Sequential Secondary Reverse Murabaha Contracts (SRMCs)

The structure requires a fixed rate-payer to buy commodities from broker 2 (step 5 in Figure 10.14).Then he on-sells the commodity to the floating rate-payer periodically, for instance in three months (step 6). The floating rate-payer will also on-sell to broker 1 to generate cash (step 7). The floating rate-payer will pay to the fixed rate-payer on a deferred basis by a single bullet payment which comprises the full value of the commodity purchase plus the profit, which is calculated by referring to the floating rate formula, such as KLIBOR (Kuala Lumpur Interbank Offer Rate), thereby creating the floating rate component. This process is repeated periodically in order to generate the full-cost price as in the primary-term murabahah. It should be noted that the floating profit rate must be calculated and fixed prior to the relevant SRMCs in order to minimise uncertainty, which may lead to gharar.

Islamic Structured Product

In this modern era, financial techniques have been developing very significantly. Previously, investors spent their funds in the real sector such as real estate, property, and other asset classes, such as stock, fixed income, and other instruments. Currently, the investment alternatives have been developed into sophisticated ones. For example, there is an increased interest in the index as the benchmark. While exposing the investors themselves directly into stocks will be risky, investing in an index may provide them with more manageable risks. This is one of the types of instruments called structured product (Hasan, 2007). This structure has also been discussed in the Islamic finance for its permissibility. This section attempts to provide the description of this Islamic structured product.

The definition of structured product—as stated in the guidelines on the offering of structured products, by the Securities Commission Malaysia—is any investment product that falls within the definition of "securities" under the SCA and which derives its value by reference to the

price or value of an underlying reference (c); "underlying reference" means any security, index, currency, commodity, or other assets or reference, or combination of such assets or reference (d).[8]

Basically, structured products are the investment types where there is no similarity with any other particular asset class or any other financial instrument which is standardised. Another definition is that it is a sophisticated product created and designed in such a way as to meet the specific needs of clients. This product is specific, whereby its features cannot be served by common financial instruments, and most of the time, if not at all times, it is a combination of at least two financial instruments.

One of the features of structured product is to adopt techniques such as swaps and options. The return in this investment product is tied with the performance of other assets, such as equity markets, foreign exchange markets, and others. For example: an equity-linked note would be benchmarked to the index of equity. In this case, the investors are not investing their funds in the basket of equity; rather they are buying the options of that equity. This structure allows investors to earn even more than a fixed deposit return or some other type of investment. Another advantage is that some, if not all, capital invested is protected.

The economic effects of both conventional and Islamic structured product may be similar. However, an Islamic structured product differs from a conventional structured product in terms of the mechanism and the contract used.

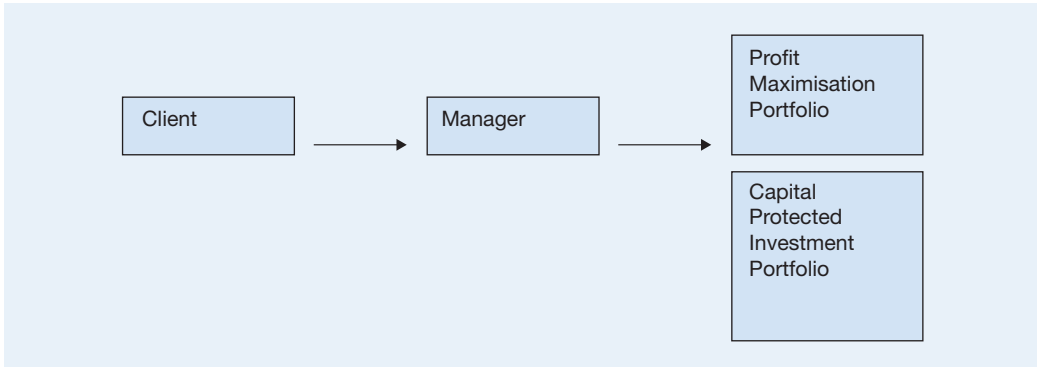
Recall that the basic legal ruling pertaining to the design of the new Islamic financial product is that the "initial legal ruling is permissible." Therefore, in order to identify whether a financial product is permissible or not, a list containing all negative values is needed. An example of this is riba (usury), maysir (gambling), and gharar (uncertainty). This list has to be observed and assurances must be made that these factors do not exist in that financial product, or otherwise it becomes invalid according to the Shariah.

Another important thing that needs consideration is on the contract used in the Islamic structured product. Each Islamic contract has its own features. If the adopted contract is a contract of sale (such as murabaha), then the features of parties (seller and buyer), object of sale, delivery, and so forth must be taken into account in that structure. Similarly, if the product makes use of ijarah, then things like rights or obligations of the lessee and lessor, fees and so forth must be clarified at the beginning. Notice that profits derived from these two contracts are different. The former is the profit derived from the purchase and sale contract while the latter is the profit derived from ijarah, called the rental fee. The fee from wakalah contract is fixed and it can be paid up front. However, this fee (which is fixed) cannot be adopted if the contract used is mudharabah. As a summary, features of each contract should correctly reflect the structuring of the Islamic product.

Figure 10.15 is the structure that is commonly adopted in the Islamic structured product. It initiates with the capital from the investor (client) that is delivered to the investment manager to be used for investment. This structure normally requires a huge amount of money; thus the clients are mostly institutional investors whose funds come from their own portfolios or banks, where the funds come from the proceeds of the products that the banks offer.

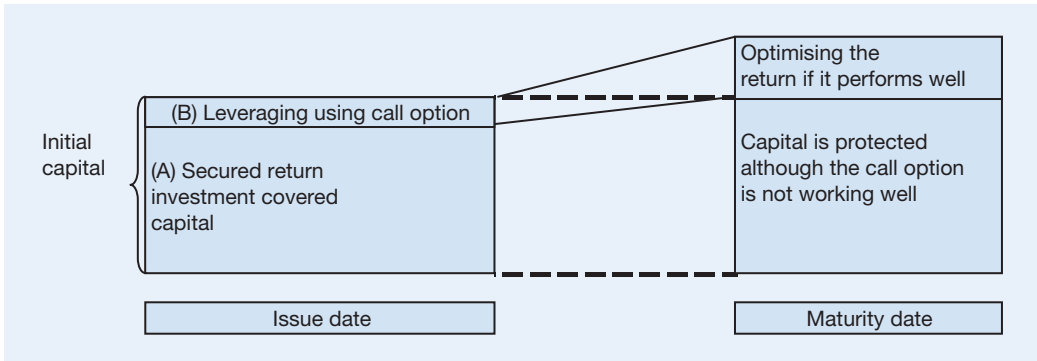
The relation of the client and the investment manager can be in many forms and it depends on the contract that they agreed on up front. If the arrangement is wakalah, then the

FIGURE 10.15 Islamic Structured Products



Source: Hasan (2007).

FIGURE 10.16 Asset Portfolio



Source: Hasan (2007).

investment manager is entitled to receive fees. Whereas if the arrangement is mudharabah, then the profit earned by both depends on the return (if any) of the business.

Figure 10.16 describes the way the portfolio is created. First, proceeds received from the clients will be divided into two parts. The bigger portion (A in Figure 10.16) of the portfolio will be used to create a relatively secured investment. This is important to ensure that the invested capital is protected even in the worst possible case, in which the remaining portion of the portfolio (B in Figure 10.16) fails to perform.

Commodity murabaha is used to ensure that the capital is protected. As far as the arrangement is concerned, the investment manager will use A to buy commodities such as metals from the London Metal Exchange (third party), whereby eventually the manager will earn profits together with the principal at the maturity date.

The other portion (B) is used to optimise the investment portfolio via any investment alternative. If B performs well, then investors will get relatively higher returns. Conversely, if it

fails to perform, then investors will lose their money but not their capital, as it is protected with the arrangement of the commodity murabaha.

There is a Shariah issue in the above-mentioned Islamic structured product. It seems that the structuring is done via more than one contract in one transaction. First, the portion of A, which is a bigger portion used to protect the capital with the adoption of the commodity murabaha, and second, the portion B, which is the investment via an Islamic option to optimise the portfolio. This raises the issue of the mixed contract in one deal.

This issue has long been debated. However, it has also been practised by Islamic banks for many years. One instance is the murabaha contract. Theoretically, murabaha would require a bank to buy in cash a specific asset that is requested by the customer. Once the ownership has been transferred to the Islamic bank, then the asset will be sold to the customer on a deferment basis. However, this ideal process in many cases creates difficulties in the real application, such as the issue of taxation and the administration process, as well as the time needed to complete the process.

As a result, Islamic banks have to find other ways to make a murabaha arrangement simpler and more efficient. This is done via additional contracts, such as al-inah and wa'd, as well as wakalah. These additional contracts are intended to simplify the process. However, this raises an issue regarding the permissibility of two or more contracts in one transaction. The opponents' view is that this practice is a backdoor to riba. In other words, they have said that this structure is a means for practising interest-based financing under an Islamic nomenclature. Hence Islamic finance is no different from its conventional counterpart (Hasan, 2007).

Nevertheless, the proponents have argued that if the arrangement is designed in such a way that it keeps within Shariah boundaries, several contracts that are taking place concurrently or in a close sequence alone will not dictate the invalidity of the whole process. As the contract is structured to be independent, the amalgamation is permissible. As a result, the opinion of the jurist is that amalgamation of contracts is allowed provided that a guideline is carefully followed.

Chapter Summary

- Sukuk is certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services, or (in the ownership of) the assets of particular projects or special investment activity; however, this is true after the receipt of the value of the sukuk, the closing of the subscription, and the employment of funds received for the purpose for which the sukuk were issued.
- Ibn Taimiyyah divided risk into two categories: commercial risk and gambling risk. The former is commonly faced by a trader, for instance: the risk of goods being unsold. The latter implies eating for nothing. It can also refer to a zero sum game whereby no additional wealth is created.
- Conditions of risk that are allowed in Islam: the inevitability that deeds will be accompanied by risks, the insignificance of risk when the risk is small, and the unintentional occurrence of risk.

- Two reasons given by investors in dealing with derivatives: speculative and hedging goals. An example of the former is short selling, whereby the investor sells stock (although he does not have that stock) at the morning session of the stock trading when the price is attractive and then buys the same stock at the afternoon session when the price is going down. Hence, he or she gains the price difference. This is certainly not Shariah-compliant. However, some Shariah scholars accept hedging as permissible when it protects investors against the volatility of the market price.
- The feature of the forward as well as the future contract that is against Shariah principles is that the contract is based on the payment of the money and the delivery of the goods that both will occur in the future. The Islamic instrument that is close to the forward and future contract is the salam contract.
- The Islamic instrument that may be used that is similar to the call option is urbun. It is basically a down payment. Meanwhile, for the put option, the Islamic instrument can use the concept of the third-party guarantee as well as khiyar al shart.
- For the conventional swap, both cross-currency swaps as well as interest-rate swaps can be replaced with the arrangement of murabaha and secondary revolving murabaha. In a conventional swap, there exists only an exchange of currency and interest while in Islam, it involves an asset. This leads to the approval of the Islamic swap.
- Structured products are the investment types for which no similarity exists with any other particular asset class or any other financial instrument that is standardised. Another definition is that it is a sophisticated product created and designed so as to meet the specific needs of a client. This product is specific, whereby its features cannot be served by a common financial instrument and most of the time, if not at all times, it is a combination of at least two financial instruments.

Chapter Questions

1. Briefly explain the mechanism of the Islamic Profit Rate Swap.
2. Briefly explain the mechanism of the Islamic Cross-Currency Swap.
3. What are the Islamic perspectives on conventional forwards?
4. What are the Islamic perspectives on conventional options?
5. What are the Islamic perspectives on conventional futures?

Notes

1. See Suwailem, 2006.
2. Ibid.
3. Ibid., 36.
4. Ibid., 36.

5. Same with Figure 10.2.
6. One basis point is equal to 0.01 percent.
7. See Suwailem 2006, 58.
8. Guidelines on the offering of the structured product by Securities Commission, 1. Revised Edition: April 27, 2007.

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