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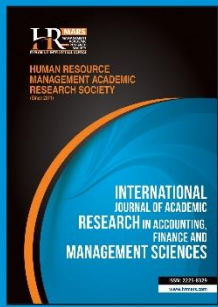
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Principles of Islamic Capital Market

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Abstract

This chapter aims at reviewing the basic concepts and principles of Islamic Capital Market (ICM). Hence, issues related to the ICM such as its components, norms and ethics of transaction, Sukuk structuring, stock selection criteria, regulatory and legal framework and challenges facing ICM were discussed. The method adopted is essentially literature review, as such the chapter is conceptual in nature. It was concluded that the ICM is rapidly growing and there is a huge potentials waiting to be exploited in the market. Finally, it was recommended that the ICM of the countries that adopted the Islamic finance should be enhanced by developing innovative products strictly in conformity with the provisions of Shari'ah.

Keywords: Islamic Capital Market, Islamic Financial System, Sukuk and Shari'ah

Introduction

As an important component of Islamic Financial System (IFS), Islamic Capital Market (ICM) has witnessed a tremendous growth in the recent years. This is however not surprising given the progress posted by IFS in general terms. Basically, Islamic equity and Sukuk together made up the commodities being traded in the ICM. In the fulfillment of its *raison d'être* (i.e. intermediation role) of transferring funds from surplus to deficit unit of the economy, ICM play a critical role in that regard (Ahmad et al., 2012). Hence, ICM is essential in ensuring efficient mobilization and allocation of funds and their optimal utilization (Ali, 2008; Obaidullah, 2005). The continuous growth of ICM is as a result of its ability to support the global financial system more especially after the recent failure of the conventional financial system which led to a general crisis. The potentialities of the IFS attract a keen interest and optimism from the general public, academicians, practitioners, professionals, Muslims and non-Muslims towards the system (ISRA, 2011). For instance, Standard & Poor's ratings organization holds that the potential market for Islamic financial institutions is about US\$4 trillion; hence, the opportunities for Islamic financial services are tremendous (Al-Bashir & Al-Amine, 2008). This optimism from the various stakeholders on the IFS makes them to confidently believe that it is more robust and provides a better option for the deep-rooted conventional financial system (ISRA, 2011). This explains the reason for the continuous development of IFS and ICM particularly Sukuk across continents in Muslim and non-Muslim countries (Jobst et al., 2008). Similarly, it has been opined that Sukuk market is one of the areas of ICM that continuous to catch the attention of stakeholders globally (Al-Bashir & Al-

Amine, 2008). Presently, the global Sukuk issuance stands at US\$61.2 billion as at the half of 2013 (IIBF, 2013).

It has been estimated that the assets of Islamic Financial Institutions (IFIs) is well over one trillion US Dollars controlled by more than five hundred and fifty IFIs worldwide (ISRA, 2011). Furthermore, the size of the Islamic financial market is estimated to be somewhere around US\$230 billion with an impressive growing rate of between 12% and 15% annually (Sadeghi, 2008). It is believed that ICM is the fastest growing sector within the broader IFS (Ali, 2008).

Similarly, being an integral component of IFS, ICM provides opportunities for long-term investments and risk-sharing through diversification. The enormous growth and development witnessed in ICM is basically attributed to the variety of products, infrastructures, institutions, and intermediaries available in the system (Sadeghi, 2008). To this end, this paper focuses on the principles of Islamic Capital Market.

Literature Review

In this section, a critical review of the relevant materials has been thoroughly conducted under various subheadings.

a. Components of the Islamic Capital Market

ICM is one of the two important aspects of the broader Islamic Financial Market the other branch constitutes Islamic Banking and Islamic Insurance better known as Takaful. ICM comprises of Islamic equity, Islamic bond (Sukuk) and Islamic-compliant derivatives. Under equity market Shariah compliant securities transactions such as Islamic unit trust/Mutual Funds, Islamic Real Estate Investment Trust (REIT), Islamic indices, Islamic Exchange Traded Fund or ETF and the Islamic venture capital or Private Equity are taking place. In the Sukuk market different types of Shari'ah compliant products are being structured in line with Islamic financial contracts. These include Sukuk al-Ijarah, Sukuk Bai'ithaman ajil, Sukuk al-Murabahah, Sukuk al-Istisna, Sukuk al-Musharakah, and Sukuk al-Mudharabah.

It should be noted that the securities being traded on the capital market are so traded on either primary or secondary platform. Initial offering of securities are done in the primary market. Put differently, issuing organizations raised funds from initial subscribers of bonds or shares in this market through what is known as initial public offer (IPO). On the other hand, secondary market deals with transaction of securities that are already in existence. The secondary market does not provide fund to the first issuer but rather it allows securities to change hands and provide liquidity for security holders. It has been argued that enhancing an efficient secondary market continuous to be problematic considering the fact that only a few Islamic financial instruments are eligible for transaction in the secondary market (ISRA, 2011).

b. Norms and Ethics of ICM

There are certain norms and ethics in IFS which should also be applied in the conduct of ICM. Every transaction in the ICM should be guided by the norms of Islamic ethics as prescribed by the Islamic legal system or the Shari'ah. In order words, every transaction should be in tandem with the Islamic principles (Alhabshi, 1994; Wilson, 1997). The provisions of the Sharia'ah are derivable from the holy Qur'an and Hadiths of the holy Prophet. While Islamic transactions are generally free and fair, this freedom is however not an unlimited one but constrained by the provisions of Shari'ah which include prohibition of usury (riba), deception (gharar), alcohol (khamr) and gambling (maysir) among others (Dusuki & Abozaid,

2008; Obaidullah, 2005). So, the freedom obtainable within the framework of IFS is not the same with its counterpart in the conventional system of financial transaction. Similarly, there is provision for fairness in the ICM transactions and the like of which is not obtainable in the other system. For instance, the players are protected against misrepresentation, unbalanced information, and an unequal bargaining power (Obaidullah, 2005). However, all the restrictions and constraints imposed by Shari'ah is meant to protect all the parties involved in transaction and to provide a level playing ground for the market participants as well (Dusuki, 2010).

The justice and fairness is vital for the sustenance of the IFS and ICM in particular. Hence, all the participants in the ICM are adequately protected and are given their befitting rights and obligations (ISRA, 2011). With this the operations of the market will be smooth and free from human tendency of cheating. The foregoing indicate that for any product to be developed in the ICM such a product should be a Shari'ah-compliant and should pass certain ethical requirements as highlighted earlier on (Al-Bashir & Al-Amine, 2008).

2.3. Islamic Equity

Similar to the conventional equity is the Islamic equity which constitutes partnership by sharing both loss and return. Thus, the holder of the equity can enjoy dividends if profits are made and the issuing organization decides to disburse part of it (ISRA, 2011). Furthermore, capital gain could be realized when the shares are sold at a premium price. It should be noted here that the securities of a company can only be negotiated if some of its assets are in the form of illiquid. However, if large percentage of assets is liquid they can only be disposed of at par value and not negotiable.

Islamic equity-based contracts are usually structured based on Mudarabah and Musharakah which should comply with the norms and ethics of Islamic contracts. Part of the ethics relevant here is that the business must be a permissible one or halal (Wilson, 1997). Thus, Shari'ah-compliant equity includes the equity of a company whose core line of business is wholly halal. However, companies that have mixed income from both Shari'ah compliant and non-Shari'ah compliant operations should be subjected to a screening process.

It has been argued that operating a corporation totally in line with Shari'ah requirements might not be feasible. Hence, if the main line of business is halal, an insignificant proportion of non-halal element will not invalidate the equity of such company (ISRA, 2011). To this end therefore, a Shari'ah stock selection criteria have been established to determine the benchmark of the non-compliant element.

2.4. Stock Selection Criteria

The fact that sometimes a company's operations in one way or the other delve into non-permissible elements, regulatory authorities came up with a number of screening criteria. These authorities include, Dow Jones Islamic Index, Meezan Islamic Fund Criteria, Kuala Lumpur Stock Exchange Shari'ah Index in the United States, Pakistan and Malaysia respectively. In Malaysia, the suitability of stock is determined by Shari'ah Advisory Council of the Malaysian Securities Commission. These authorities establish clear guidelines for investors to differentiate between permissible and non-permissible investment and this subsequently helps in deciding where to invest and otherwise (AbdulRahman et al., 2010; Derigs & Marzban, 2008; Wilson, 1997).

The screening of equity in line with the Shari'ah provisions are done in two difference ways i.e. qualitative and quantitative screening both of which must satisfy the requirements

established by Shari'ah advisory committee. This committee supervises and ensures that the all the equity to be listed on the ICM are actually Shari'ah compliant.

Qualitative screening or the sector screening involves the invalidation of stocks of companies whose primary activities are in the non-permissible sectors. These include dealing with interest-based finance, conventional insurance, casino and gambling, tobacco retailing or manufacturing, non-permissible foods/drinks such as pork and alcohol among others (ISRA, 2011). On the other hand, if the main operation of a company is not in the foregoing prohibited activities but rather they only constitute an insignificant percentage then the following criteria will be applied to determine the permissibility of such company's stock. For instance, the income contribution of clearly prohibited operations such as riba, non-permissible food/drinks, casino and gambling must not be in excess of 5 percent.

2.5. Sukuk Market

Debt market is one of major component of the ICM, the other being the equity market. Sukuk is considered to be the most active instrument in the Islamic debt market (ISRA, 2011). Thus, Sukuk enhances the development of the activities in the ICM of proving long-term funding alternative for corporations and public sector institution through investment banking. Sukuk are the certificate representing financial obligations arising from trade and other commercial activities. According to ISRA (2011) Sukuk is considered as a contemporary financial instrument and the usage of which started since the 1st Century during the Caliphate of Umayyad. Unlike conventional bond, Sukuk are usually backed or secured by some underlying assets. Such assets, provide an in-built security to the investments (Obaidullah, 2005). Hence, under events of default by the sukuk issuer, the sukuk generally reasonably assures sukuk holders i.e. the investors, the ability to recover their investments whether in full or in part, from the liquidation of the assets.

According to Obaidullah (2005) Islamic securities can be created through either direct structuring or asset securitization. Similarly, Sukuk structures can be further categorised based on the underlying Shari'ah-compliant contracts such murabahah, salam, istisna, musharakah, mudarabah and wakalah. However, structuring of sukuk calls for creation of special purpose vehicle (SPV). A Special Purpose Vehicle (SPV) held and managed by trustees, legally will be under the control of the holders of the securities or sukuk who will acquire the asset under a true-sale arrangement (ISRA, 2011). The function of the SPV thus is to hold the assets on behalf of the investors or Sukuk-holders, by way of a trust deed created over the assets. In the following paragraphs we shall be discussing different types of sukuk structures as highlighted by (Obaidullah, 2005):

Sukuk Al-Murabahah: this type of sukuk involves direct structuring of securities on the basis of murabaha-Bai Bithaman Ajil (BBA) operations. In the first place company seeks advice from bank regarding the issue of securities, subsequently; SPV is created for the attainment of this objective. The SPV will issue securities and uses the proceeds accrued from investors to pay for the asset. Then the company as SPV's agent takes delivery of assets from the vendor and this mark the end of the agency contract. Thereafter, sale's contract take place as SPV sells and transfer the ownership of the asset to the company. It should however be noted that the payment for the asset is on deferred basis and that the profit is pre-determined based on cost-plus basis. Therefore, as the company pays on installments basis, SPV transfers the proceeds to the Sukuk investors after deducting wakala/agency fee.

However, the Shari'ah issues associated with Sukuk al-murabaha include: The cash paid by the company to SPV and eventually passes on to investors ($Nx + p$) can be predicted;

however, it is different from the conventional bond because of its asset-backed structure. Similarly, Sukuk-murabaha cannot be traded in the secondary market due to its debt nature except at face value and therefore, not liquid. Only at maturity is the yield on the instrument constitutes legitimate profit and thus, can be negotiated. This restriction of trading in the secondary market limits the attractiveness of sukuk-murabaha.

Sukuk-Al-Ijara also known as ijara certificate is considered to be the most ideal option for structuring debt securities. The process for structuring this type of security is as follows: company seeks advice from bank regarding the issue of securities; an SPV is created and issues securities to investors. Then the SPV utilizes the proceeds to purchase assets needed by the company from a vendor. As in the previous contract, the company acts as the agent of SPV and takes delivery of the assets from the vendor. Thereafter, the company takes assets from SPV on ijara and pays rentals to SPV who in turn passes on the proceeds to investors. Since the ijara instrument signifies a pro-rata ownership of asset and not an evidence of debt, it can be negotiated in the secondary market (Obaidullah, 2005). Although, the ijara rentals can be predicted, sometimes due maintenance and insurance expenses they are hardly predictable. Similarly, holders of the instrument are part-owners of the underlying asset and thus, exposed to risks associated with ownership.

Sukuk-Al-Salam: in this arrangement SPV mobilizes funds from investors and pays to vendor in lieu of a promise to deliver an item in a specified future date. The item to be delivered must be described fully. Similarly, the quantity, quality, date and place of delivery must be clearly stated. It should be noted here that all the conditions and requirements applicable to bai-salam contract apply here as well. SPV can appoint an agent to sell the item after delivery at higher price and the difference constitutes profit to the investors or sukuk holders as in the case of Bahrain government Al-salam sukuk whereby Bahrain government was appointed as an agent to market the underlying asset, aluminum (Obaidullah, 2005). Salam instrument holders are exposed to both the market risks and counter party risk. Market risk arises when the delivered item cannot be marketed at all or marketed at a lower price. On the other hand, counter party risk surface if the vendor is unable to deliver the promised item. However, market risk can be mitigated by getting a third party to make a unilateral promise to purchase the item at a predetermine price against delivery. Therefore, once the item is delivered as promised then the SPV will deliver it to the third party as promised and this type of unilateral promise is binding and enforceable by law. The Shari'ah issue in this contract is that as in the case of bai-salam, item is not allowed to be sold before delivery; it also applies here i.e. the instrument holders can only sell at maturity. Hence, salam instrument is illiquid and consequently less attractive to investors.

Sukuk-Al-Istina: just as in the case of bai-istisna, sukuk istisna to a large extent facilitates the execution of large projects in which huge resources are required. Here the SPV who represents the sukuk holders stands as the seller or manufacturer of the asset to the buyer. Through istisna the asset will be manufactured and the SPV is saddled with the responsibility to ensure that the equipment is manufactured perhaps by subcontracts and the like. The buyer pays for the equipment on deferred basis in the form of sukuk an evidence of indebtedness with the total deferred price equals to face value. Since the need for funds is gradual then sukuk could have varied maturity periods to tally time of installments as agreed. Again, given that this sukuk structure represent an evidence of indebtedness of buyer, so, the certificates could only be marketed at face value.

Sukuk Al-Mudaraba/Muqarada this is a financial instrument for raising equity capital which represents a common ownership and avail holders shares in the project being financed.

In mudaraba arrangement, the issuer who serves as mudarib or the capital manager will invite the investors i.e. rabbul mal to invest in the sukuk (ISRA, 2011). Then the issuer invests the capital in the pre-agreed project with a projected rate of return. When the project starts yielding profit the manager will apply the pre-agreed profit-sharing ratio. However, in the case of incurring loss it will be solely absorbed by the investors as it is applicable to mudaraba contract.

Sukuk-Al-Musharaka is being operated in a similar fashion with sukuk al-mudaraba. Here both the investor and issues jointly raise the fund needed for the project. Then either the issuer or a third party could manage the project. Another option is that, the investors contribute all the required capital for the project and then appoint the issuer as the manger on the basis of agency arrangement (ISRA, 2011).

ICM Regulatory and Legal Framework

Every institution more especially those related to finance need to be regulated and monitored closely. This is necessary to safeguard the funds of investors against the failures of intermediaries and to ensure redistributive policies and avoid financial crime (Ibrahim, 2008). The regulatory objective could be achieved through the regulation of securities and financial institution and through effective corporate governance as well. The peculiarity of IFS makes both the setting standards and regulation of its operation a herculean task. This explains the reason for divergent views with respect to developing a framework for regulating and supervising the Islamic financial institutions (El Qorchi, 2005; Jobst, *et al.*, 2008).

However, there is headway because a number of international Islamic financial infrastructure institutions are making efforts for harmonizing the operations of different IFIs across the globe. The organizations include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), the Liquidity Management Center (LMC), the International Liquidity Islamic Management Corporation, General Council for Islamic Banks and Financial Institutions (GCIBAFI) and the International Islamic Rating Agency (ISRA, 2011).

Given the role being played by ICM in the economic growth and development, it is therefore necessary to shield the market with legal framework. This will ensure that nobody seize the advantage of the system loopholes to abuse it (Ibrahim, 2008). Furthermore, studies found that there is a strong association between legal protection for investors and the economic development (Ibrahim, 2008). Similarly, effective legal protection through the enforcement of legal rules has a significant effect on the size of the capital market (Ibrahim, 2008). Put differently, excellent legal rules enforcement leads to the expansion and development of the capital market and vice-versa.

Challenges Facing ICM

Given that the Islamic financial operations are subjected to peculiar rules different from the ones applicable to the conventional operations, there are a number of challenges being faced by ICM. For instance, in many cases, the Islamic capital market have had to comply with the regulatory provisions meant for the conventional system which has an entirely different underlying objective and approach (Cox, 2005; Jobst, *et al.*, 2008). Additionally, it should be noted that the relatively young ICM is operating in the same environment with its long standing conventional counterpart which have been in the arena for centuries (Cox, 2005).

Conclusion

The chapter highlighted the principles of Islamic capital market and subsequently made the following conclusions:

- That the market which is fast growing mainly due to Sukuk is having a lot of potentials that are yet to be tapped.

- That being a major component propelling the market, sukuk can be structured in many ways that are shari'ah-compliant and stand as a better alternative to the conventional bond which is contrary to the Islamic principles.

- In structuring the various products of the ICM, there are a number of ethical norms enshrined in the Islamic legal system that must be followed. For instance, while structuring sukuk, Shari'ah issues must be meticulously observed.

- The international Islamic infrastructure institutions are making unrelenting efforts in establishing standards, rules and regulations with a view to harmonize the market operations globally.

Recommendations

The point of caution is that while the Islamic standards setters can learn from the experiences of the developed capital markets, they should think twice before adopting regulations due to the obvious differences (2008). The ICM across the globe should endeavor to participate actively in the global sukuk market which is presently being led by ICM in Malaysia, Saudi Arabia, United Arab Emirate, Qatar and Turkey among others. In structuring the sukuk and other products in the ICM, all the ethical standards and Shari'ah guiding principles must be duly observed. While benchmarking and learning from the experience of the conventional bond market, rules and procedures should not be blindly adopted because the basic principles of the two markets are not the same.

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