Challenges of Islamic Financial Market Development

By, Ijlal Alvi

Contents

• Evolution of the Islamic Finance Industry & Islamic Capital Markets
• Current State of the Islamic Capital Markets
• Sukuk Issues
• Islamic Liquidity management- Challenges and potential
• Role of infrastructure institutions specifically IIFM
• Recommendations
• Conclusion
Evolution of the Islamic Finance Industry & Islamic Capital Markets

- Islamic finance has followed in the wake of innovations in the global financial services industry
- A natural progression of the Islamic finance industry
  - competitive retail offerings
  - sophisticated corporate banking products
  - innovative project finance solutions

1970's: commercial banking
1980's: commercial banking, project finance & syndications
1990's: commercial banking, project finance & syndications, equity, Ijarah
2000's: commercial banking, project finance & syndications, Equity & Funds, Ijarah, Sukuk, structured alternative assets
2005+: commercial banking, project finance & syndications, Equity & Funds, Ijarah, Sukuk, structured alternative assets, liquidity management tools

Global Market Perspective

- US Equity Market: US$ 12.7 trillion (46% Global)
- Global Equity Market: US$ 27.0 trillion (estimate)
- Islamic Equities at 30%: US$ 8.0 trillion Potential
- Islamic Financial Assets: US$ 400 billion (UAE MOF)
- Islamic Money Market: US$ 30 – 50 billion
GCC Equities – 12 month Performance

GCC / Egypt Equity Performance (12months to Dec ‘05)

Dubai 221%
Egypt 139%
Saudi 114%
Abu Dhabi 104%
Qatar 89%
Kuwait 85%
Oman 44%
Bahrain 27%

Global Bond Issues

New Issuance Levels 2001-2004
Islamic Fund Management

* Islamic financial assets estimated at USD 400bn*
* Liquid assets estimated at USD 30-50bn **
* Islamic Fund Management c. 15% of sector liquid assets
* Access needs to be regulated and liquid capital market

(* source – UAE MOF/IMF)

![Bar chart showing estimated fund assets as of 31 December 2004](chart)

Current State of the Islamic Capital Markets

<table>
<thead>
<tr>
<th>Conventional Instrument</th>
<th>Characteristics</th>
<th>Shariah-Compliant Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>Equity holders are the owners of the firm and responsible for conducting its affairs</td>
<td>Accepted</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>A hybrid security that combines features of debt and equity</td>
<td>-</td>
</tr>
<tr>
<td>Primes and Scores</td>
<td>Equity is split into a prime component that has dividend and capital gains up to a stated price and a score component that has capital gains above this</td>
<td>-</td>
</tr>
<tr>
<td>Warrants</td>
<td>A long-term call option on a firm’s stock issued by the firm</td>
<td>-</td>
</tr>
<tr>
<td>Synthetics</td>
<td>Securities that allow combinations of assets to be obtained with low transaction costs</td>
<td>-</td>
</tr>
<tr>
<td>Acceptances</td>
<td>A written promise to pay a given sum at a pre-specified date</td>
<td>Developed, but not negotiable</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>A short-term debt security that can be easily traded</td>
<td>Developed, but not negotiable</td>
</tr>
<tr>
<td>Bonds</td>
<td>A term obligation to make a series of fixed payments. The interest rate on the debt is based on LIBOR or the T-bill rate</td>
<td>Emerging</td>
</tr>
<tr>
<td>Floating-rate Bonds</td>
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<td>Securitized loans</td>
<td>Pools of mortgages or other types of loans that are publicly traded</td>
<td>Emerging</td>
</tr>
<tr>
<td>Index-linked securities</td>
<td>Bonds where the payment is linked to an inflation index or a commodity price</td>
<td>Emerging</td>
</tr>
<tr>
<td>Convertibles</td>
<td>A bond that can be swapped for equity at a pre-specified ratio or vice versa</td>
<td>-</td>
</tr>
<tr>
<td>Swaps</td>
<td>Transactions in which different streams of income are exchanged</td>
<td>-</td>
</tr>
<tr>
<td>Options</td>
<td>The right to buy or sell a security on or before a specified date</td>
<td>-</td>
</tr>
<tr>
<td>Commodity futures</td>
<td>Contracts for the future delivery of a commodity.</td>
<td>Under development</td>
</tr>
<tr>
<td>Financial futures</td>
<td>Contracts for the future delivery of currencies, securities, or an amount of money based on an index.</td>
<td></td>
</tr>
</tbody>
</table>

Growing Sukuk investment opportunities

- **More issuers are seeking to tap the Sukuk market**
  - Increasing Demand for Sukuk issues among issuers from Muslim countries as well as other jurisdictions
  - Islamic financial institutions are seeking to diversify their portfolio and increase their portfolio size of tradable instruments with fixed income profile
  - *Sukuk* can be used to create Sukuk funds for retail distribution
  - Once Sukuk Fund concept become more popular demand for Sukuk issues will surge exponentially
  - Sukuk can be developed into a Money Market instrument

- **Appetite for Sukuk among Reserve Managers and non-bank financial institutions increasing**
  - Central banks, state fund managers, insurance & takaful companies, are keen to invest in Sukuk issues as seen in all the sovereign sukuk issues.
  - It is important to have tradable fixed income instruments for portfolio diversification
  - Sukuk can play a major role in the development of Islamic Inter-Bank or Short term Islamic Financial market
Sukuk - Regulatory, Legal, Shariah & Other Issues

- Lack of regulatory support from key Islamic markets
- Lack of initiative in developing a separate legal framework for sukuks vis-à-vis conventional instruments
- Lack of harmonization in existing Islamic securitization products and difference of opinions among various shariah scholars
- Substantially more documentation and legal due diligence requirement for an Islamic issue
- Limited number of qualified personnel well versed in capital market issues both from shariah and commercial perspective
- Small number of Islamic investment banks lacking capability in structuring, originating or arranging capital market transactions

Islamic Liquidity Management – Challenges

- Islamic transactions generally pass through the ownership of real assets.
- Prohibited to invest in interest-bearing instruments
- Inability to trade money as commodity
- Lack of variable tenor tradable instruments
- Insufficient generation of quality assets
- Islamic banks, reliant, mostly on balance sheet assets for liquidity management
- Sub-optimal deployment of excess liquidity
- Risk Management techniques
**Islamic Liquidity Management – Potential Role**

- The fixed income market will be a developed market for Liquidity management when
  - There are issuers with differing credit qualities and Risk profile
  - There are Sukuk with maturities ranging from short-term to long-term
  - The investor base is broadened (via diversification of Sukuk products) to facilitate participation of more investors
  - Infrastructure and IT

- **Market Makers & Brokers**
  - Well defined role of Lead arrangers
  - To provide bid-offer prices on a continuous basis
  - Role of infrastructure institutions especially IIFM, LMC
  - Need for market development bodies

**The Islamic Financial Infrastructure**

- **AAOIFI** – Accounting and Auditing Organization for Islamic Financial Institutions
- **IFSB** – International Financial Services Board
- **IIFM** – International Islamic Financial Market
- **IRTI** – Islamic Research and Training Institute
- **LMC** – Liquidity Management Centre
- **GCIBFI** – General Council for Islamic Banks and Financial Institutions
- **IIRA** – International Islamic Rating Agency

**Regulators**

- IIFM* – To establish, develop and promote Islamic Financial Market
- IIRA* – Rating IFI & Islamic Finance Instruments
- LMC* – Market Maker for Islamic secondary market instruments
- **IRTI** – To enhance market understanding of Islamic finance
- **Arbitration Centre** – To promote Islamic research and training

**Governance and Auditing Standards**

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Recommendations for Way Forward

- Establishment of a Regulatory Framework
- Skilled Human Resource
- Short term Islamic Financial Market
- Liquidity Enhancement Measures
- Product Development
- Islamic Sukuk Index
- Required infrastructure as available to conventional market
- Development of Shariah Compliant Asset Backed Securities

Recommendations for Way Forward Contd.

- Active secondary market
- Uniformity of structuring and documentation
- Financial support to research and development and educational institutions
- Diversification of financial instruments and encouraging research on product development
- Increase number of Shari’ah scholars well versed in Finance and Banking issues
- Organizing conferences and seminars focusing on secondary market issues
Conclusion

For the Islamic Finance Industry to grow, move forward and capitalize on the enormous growth potentials, there should be:

- Greater cooperation among the industry players
- Better coordination to address the issue of Shari’ah harmonization
- Urgent need for the structuring of new capital market products that are Shari’ah compliant
- Creation of International Sukuk Fund

Thank You