

**Developing Islamic Capital Market Instruments**  
**by**  
**JCR-VIS Credit Rating Company Limited**  
*Luxembourg November 9, 2005*

Honorable speakers, distinguished ladies and gentlemen,  
Thank you for the opportunity to present on this very important topic of 'Developing Islamic Capital Market Instruments'. As we know, the financial system in any economy rests on the three pillars of banking, insurance and capital markets and none of these three integral elements of a financial system can get far unless a certain balance is achieved in the development of each of these pillars. The more developed segment of Islamic finance, i.e. banking is now encountering impediments which are the natural consequence of an underdeveloped capital market and takaful industry.

My paper covers some particulars about where we stand in terms of progress in Islamic capital markets, the challenges ahead and infrastructural development that took place in recent past to address these challenges. I will also make specific reference to the systems, processes and checks and balances required for growth in a financial system and to build investor confidence by reducing systemic risks.

Comparative data of conventional and Islamic markets suggests that while Islamic Finance has grown at a fast pace over the last two decades, it is still in infancy. Deposits in Islamic Financial Institutions (IFIs) amount to over 200 b USD according to latest estimates while Citigroup alone has deposits over 560 b USD. Islamic capital markets are even more limited in scope. Conventionally, debt markets are much bigger than equity markets with governments being amongst the major issuers of debt. Islamic instruments issued by Muslim sovereigns are only a few in numbers.

However, all this needs to be put in the context of the stage of economic development which Islamic economies are generally in. Growth in capital markets is driven by economic and industrial development in a country and therefore even conventional markets of Islamic countries do not have the depth and efficiency of capital markets of the developed world. The US debt market is estimated at 25 trillion dollars with a GDP of approximately 11 trillion dollars while the debt market in Malaysia, which is the leading Islamic economy in terms of conventional as well as Islamic capital market development, is approximated at USD 100b and with a GDP of 120b USD. The relationship of the size of debt markets and GDP in the US is similar to most of the developed economies, whereas most OIC countries have considerably smaller capital markets relative to GDP. Most corporations in the Islamic world are privately owned that continue to fulfill their financing needs from the primary market. Most importantly, domestic investors' takeover

capacity and savings available for investment in capital markets are not sizable enough to regularly absorb capital market instruments, either conventional or Islamic.

Given the recency of the renaissance in Islamic thought and the strength of Islamic economies, Islamic finance has made considerable progress dovetailed by some growth in Islamic capital markets. To cite the example of Malaysia again as one of stronger Islamic economies, it is interesting to note that Islamic issues comprise approximately a fourth of total debt issues in Malaysia. However, while total issues grew by 28% from 2002 to March 2005, Islamic instruments grew slightly faster with market share increasing from 23.7% to 26% over the same period. Growth in Islamic markets was primarily due to a corresponding increase in Islamic sovereign and near sovereign issues. On the other hand Islamic instruments issued by corporations have just about retained market share vis-à-vis conventional issues.

The development of Islamic capital market instruments requires dual conformity with Shariah as well as with sound market practice. While devising Islamic financial structures, it is necessary to cater for the following:

- Supervision as effected by regulators and/or rating agencies ensuring Shariah compliance from the issue of the instrument to its maturity
- Returns on the instrument commensurate with risk
- Adequate security against nominal and economic loss
- Presence of an exit mechanism

Several types of instruments have been developed for the Islamic capital markets. These cover a wide range of financing mechanisms including those for securitization. However, some of the concepts that are basic to conventional markets but pose questions in Islamic finance have still not been given adequate thought. For instance, as regards the safety measures built into a transaction through collateralization, the concept of priority of claim and security is different under Shari'a law as is commonly understood within the context of conventional law. Further, in case of legal recourse, the Sharia law tends only to provide cover against direct losses rather than complete compensation to cover economic loss. Securitization under Sharia law presents additional complexities stemming from the requirement of the transaction being a true sale and the SPV being bankruptcy remote. An indubitable transfer of legal interest in securitized assets is not easily achieved.

Despite the availability of alternatives, the extent of activity or depth in these markets needs to increase to make these capital markets efficient. Established market based benchmark yield curves for Islamic Sukuks are absent in most markets making price discovery difficult.. Nevertheless, Islamic issues are increasingly attracting the interest of issuers and investors alike. For instance in Malaysia, we have witnessed robust Islamic market instruments which have public participation and are rated as well. Two tiered Mudarabah/Mudarabah-Istisna and other combinations are being used. In Pakistan also,

both manufacturing concerns and financial institutions have issued Islamic instruments and more recently a global sukuk has also been issued. We are currently also engaged in researching an equivalent of commercial paper based on the Islamic concept of Istisna. As more issues continue to come through for varying terms and durations, the Islamic market will gradually begin to take shape.

An important aspect of capital market development is transparency and analyst coverage of issues & issuers. Credit ratings have played an important role in bond market development as third party opinions for assisting in determining an issue's price and benchmarking creditworthiness. Rating agencies have perhaps not yet allocated enough resources as is required to understand and appreciate Islamic Finance and effectively benchmark Islamic issues. The concept of default that serves as the basis underlying ratings requires re-defining, and needs to be fully understood by market players.

Rating scales need to appreciate what is of real value to investors. At JCR-VIS we believe that the loss of invested capital may be defined as the Islamic counterpart of default for profit & loss based investments. The mudarib's performance given his economic environment and the performance of his peers in delivering the maximum value to investors in such instruments will receive a higher degree of weight than such considerations normally do in conventional ratings. Islamic instruments' ratings, particularly Musharaka and Modaraba based, will tend to be more sensitive to the integrity and expertise of the modarib as an asset manager as the investor's returns and principal safety are a function of this performance and a question on integrity can have implications for the nature of obligation unto investors. This in turns means that Sharia compliance encompassing, but not limited to all principles of corporate governance will have a distinct bearing on ratings.

We believe that an Islamic Financial System requires the development of the whole infrastructure available to participants of conventional financial markets. Luckily the conventional setup provides a worthwhile learning experience in addition to serving as a benchmark for the past present and future of Islamic Finance, such that one knows what the next step should be. Further, the development of markets is not possible in isolation, rather integration with global markets is essential for future growth. In most Islamic countries, Islamic finance is limited to a provision of Islamic finance and deposit taking activities. The limited availability of Islamic insurance, advisors and arrangers for such capital market instruments, specialized audit firms, and rating agencies are all significant drawbacks in the development of a robust financial system.

Over the last 5 years several organizations have been created to give depth and ancillary support to Islamic financial markets. The Bahrain based AAOIFI has been set up to establish the accounting standards for Islamic transactions. An Islamic International Rating Agency was set up under the patronage of the BMA and IDB which is also the

agency's lead promoter. IIRA's mandate includes assigning Sharia compliance ratings. IIFM has also been set up in Bahrain for developing an active international financial market based on Shari'a rules and principles. Islamic Financial Services Board (IFSB) of course has in a very short while taken a major step to facilitate regulatory standards for a bank's capital requirement, which is integral to the safety of financial systems.

Challenges ahead are the much talked about dearth of human resource. Islamic Finance has simply not yet attracted the best experts of finance in adequate numbers. The scarcity of training institutions tells us that the problem may persist for some time yet. This perhaps is the most urgent of all steps required to be taken.

With their emphasis on asset backed transactions, growth of Islamic financial instruments can be supplemented by an active commodities market. Most Islamic countries however do not have well developed commodity exchanges.

Amendments are required in the taxation framework in most jurisdictions. The unique feature of transference of ownership in the underlying asset in Islamic Finance inadvertently triggers taxes adding to the cost of the product.

Legal mechanisms are required to cater for bankruptcy, security enforcement and financial restructuring. Complications also arise from the lack of predictability of court decisions as legal precedents may not be binding for later decisions.

Perhaps one of the most complicating issues for international capital markets and also hampering domestic growth are the variations in Sharia interpretation. Such disagreement can seriously reduce acceptability in financial markets. Singularity of opinion on Sharia related matters is possible and necessary for further development.

At JCR-VIS we believe that rating agencies in collaboration with research houses and capital markets' advisors can assist in developing structures that serve the specific needs of the issuers and that can be rated and listed. As earlier mentioned rating agencies need to spend efforts in recognizing the risk bearing aspects of Islamic finance in the light of Islamic investors' needs.

Regardless of the impediments, it is clear that Islamic finance has global acceptance as the standard of fairness and equitability. Of late, financial institutions outside the Muslim world have also made significant forays in promoting Islamic finance. There is also no reason why Islamic finance will not appeal to non-Muslims as a viable alternative to conventional finance. The Islamic Bank of Britain is the first full-fledged Islamic bank that recently opened doors in Britain and plans to extend its network across the country.

In the short-term the collection, organization and dissemination of data can be of immense value to research activities required. The catalyst to this growth will be macroeconomic stability and industrial development in Muslim countries. It is just a matter of time before the market, which is so fragmented now, comes together as a whole, with a steady stream of old and new instruments and covering an increasing range of investor preferences.