

Significant Elements of Islamic Capital Market

Chaibou Issoufou¹

¹Universiti Kuala Lumpur (UniKL) Business School (UBiS), Department of Economics and Law

Abstract

There is no doubting the importance of the Islamic capital market particularly its elements. These elements are crucial for boosting the economy of a country and providing funds for a project. The development of any country is based on its capital market elements which are trading in the market. This paper examines and explores the nature of Islamic capital elements such as Islamic Real Estate Investment Trust, Islamic Unit Trust as well as Sukuk. The paper elaborates the significance of Sukuk in the contemporary era and Shari'ah issues on Sukuk. The study adopts a qualitative research methodology in which the researcher analyses principles of Islamic jurisprudence on the issues pertaining to elements of Islamic capital market. The study finds that not all companies are eligible to invest elements of Islamic capital market such as non-halal companies are not eligible to invest Islamic capital elements. Thus, for a company to be eligible to invest such elements, its activities must be halal or must attain certain benchmarks as determined by the Malaysian Shari'ah Advisory Committee of the Securities Commission. The study also discovers that Sukuk is the most significant element in the market and many Sukuk structures need enhancement to conform with the principles and regulations of Islamic law.

Keywords: Islamic law, Islamic capital market, Elements of Islamic capital market, Sukuk.

1. Introduction

The Islamic capital market plays a paramount role in the development of economy of a country because it deals with stocks market elements and *Sukuk*, which cannot be easily ignored by anyone due to their importance in economic growth and commercial transactions in contemporary development [1]. Today, the growth of the economy of any Muslim country can be based on its Islamic capital market that would work as a parallel market to the conventional capital market for Muslim capital seekers and capital providers who want to invest and transact in a market that is free from any prohibited elements [2]. The Islamic capital market is a market which is free from any element of usury, gambling and uncertainty. This is unlike the conventional capital market which operates based on the above prohibited elements as well as other activities which are considered illegal in Islam.

Islamic capital market is a market where shares, stocks and derivatives are sold and purchased without contradicting the principles of Islamic law of commercial transactions. It plays a crucial role in providing capital for a project, or investment. In respect of this, a lot of development has taken place in Muslim and non-Muslim countries. The most important element of this market is *Sukuk*, which represents the holder's ownership over an asset that is offered for investment. This is because *Sukuk* investment is a milestone for the provision of capital for long-term investment that conforms with the principles of Islamic law. Islamic law is a comprehensive law suitable for anytime and anywhere. In addition, many Muslim countries rely on the products of the Islamic capital market, such as Islamic Real Estate Investment Trust, Islamic Unit Trust, and Islamic Exchange Traded Funds and *Sukuk* investment. Unlike conventional capital market in which the wealthy will manipulate or exploit the poor and this will affect the economy, not only at the individual level,

but also at the social level. This contravenes with the principles of Islamic law regarding wealth which is to make wealth circulates among the people through various instruments which are in conformity with the principles of Islamic law, such as investing in the Islamic capital market which is free of illegal activities.

Furthermore, the objective of investment in Islamic law is not simply to make the financial products look similar to that of conventional financial instruments, but rather it is to evolve innovative types of assets that are in conformity with Islamic law principles. Therefore, the investment of Islamic capital market elements should not be considered a replacement for the conventional capital market elements which are based on *riba* because they are only contractual debt obligations with no existence of real asset during the conclusion of the contract. In light of that, the present study focuses and elaborates on the above mentioned issues, which have not been well elaborated by previous researchers. Given that *Sukuk* investment has become the main method for redemption or increasing the capital of any investment and financing any project, the study also highlights the main differences between investment of *Sukuk* and bonds as regards to Islamic law and conventional law. This research is therefore undertaken in order to highlight the importance of Islamic capital market elements particularly the above-mentioned elements.

In the perspective of Islamic law, wealth belongs to Allah, and human beings are accountable for any transaction that may be carried out by them. Investment is encouraged by Islam, but this is not absolute. A person should invest his wealth in such a way that it does not contravene the principles of Islamic law. He should invest his assets in a way that provides opportunity for others to work and benefit the society. Islam has forbidden usury (*riba*) and similar illegal activities because they hold back the economy and limit wealth circulation among the wealthy. Hence, this study investigates the practice of the Islamic capital market elements. The challenge of the Islamic capital market in the

contemporary financial sector is to have an Islamically permissible elements to promote its capital market development anywhere in the world. Based on the basic understanding of the Islamic capital market, it is worthwhile taking a look at some of the key issues relating to elements under an Islamic capital market system. This study consists of literature review, research methodology follows by elements of Islamic capital market, significant of *Sukuk* in Islamic capital market and *Shari'ah* issue on *Sukuk* in Islamic capital, findings, conclusion and suggestion.

2. Review of Literature

AAOIFI (2008) argued that *Sukuk* is simply defined as certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or in the ownership of the assets of particular projects or special investment activity". Actually there are various definitions for *Sukuk*, it is also defined *Sukuk* as "documents or certificates that represent the value of the assets" (SC, 2007). This definition is brief, but can cover certificates that represent ownership over underlying asset which *Sukuk* represents. Furthermore, [3] defined *Sukuk* as certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting them to use as planned, common title to shares and rights in tangible assets, usufructs and services or equity of a given project or equity of a special investment activity.

From the aforesaid definitions of *Sukuk*, the definition of Kamil seems to be consistent with the definition of AAOIFI which appears to be a comprehensive definition for *Sukuk*. These certificates are tradable in stock market, particularly in secondary market, after the subscription is closed in the primary market.

[4] discussed role of *Sukuk* in Islamic capital market and highlighted evolution of *Sukuk* from 1990 to 2017 as well as types of *Sukuk* that were issued in that period. [5] also found out that *Sukuk* can be used as risk management instrument and discussed types of *Sukuk* and how they can be used to raise fund for a project. Securities Commission of Malaysia (2010) highlighted the importance of Islamic capital market in developing Malaysia economy and role of *Shari'ah* advisory board in screening stock market in which Islamic capital market elements are trading. In addition, [6] argued that Islamic real estate investment trust (REIT) plays a crucial role in financing and developing a *waqf* industry. MIFC (2013) maintained that Islamic real estate investment trust is an element that can be used as promise to manage wealth. The Securities Commission of Malaysia defined REIT as: "an investment vehicle proposes to invest at least 50% of its total assets in real estate, whether through direct ownership or through single purpose company whose principal asset consists of real assets" (Malaysia, 2009). Therefore, Islamic real estate investment trust is an investment company which aims to invest 50% as minimum of its total assets in real estate from the owners directly or from the company that invests its assets in the real estate investment.

Furthermore, [7] argued that an Islamic unit trust (I-UT) is a group of investment funds in which the investors can invest their securities in various types of investment according to the principles of Islamic law. The company that manages the I-UT fund is required to appoint *Shari'ah* advisers to ensure that the operation of the fund is conducted in accordance with the principles of Islamic law. This definition seems to be similar to conventional unit trust's definition (Malaysia, 2009). They differ only in terms of operation or investment as an I-UT fund should operate in accordance with the principles of Islamic law. Islamic unit trust fund is the fastest investment fund which is growing in Malaysia. Recently, there are 35 companies of unit trust fund management in Malaysia, and 28 of them are providing Islamic unit trust funds [8]. Investment in Islamic unit trust is similar to its counterpart (conventional). They differ only in terms jurisdiction; Islamic unit trust must be invested in accordance with the

principles of Islamic law [9]. Thus, Islamic unit trust has its one guideline for investment which should be followed so that Islamic unit trust will be different from conventional unit trust (SC, 2017). [10] outlined the benefit of Islamic unit trust and its evolution in Malaysia and found out that Islamic unit trust is growing rapidly compare to its counterpart. [11] maintained that Islamic unit trust is the most generally asset and elements which rapidly increasing in Islamic financial industry and suitable for Muslim who are seeking to invest in permissible (*halal*) activities. Islamic unit trust fund is an investment fund that is collected from a group of people to be invested in a large investment fund which jointly managed by trustee. The risk of investment is less because it is invested in many investments areas [12].

3. Methodology of Study

The study adopts qualitative research methodology in which data collected from books and articles from internet are used to examine and explore issues related to the study. Those books and articles discussed in general Islamic capital market elements such as Islamic Real Estate Investment Trusts (I-REITS), Islamic Unit Trust (I-UT) and *Sukuk* which is the most important element in the market. This methodology is used to analyse the principles of Islamic jurisprudence and views of Muslim jurists pertaining to the issues relating to the study and elements which are mentioned in the study. The qualitative methodology is based on exploratory and deductive research in which the findings are deducted from the results that come out from the study.

3.1. Elements of Islamic Capital Market

There are several elements used in Islamic capital market such as Islamic Real Estate Investment Trusts (I-REITS), Islamic Unit Trust (I-UT) and *Sukuk*. The details of these elements are as follows:

3.2. Islamic Real Estate Investment Trusts (I-REITs)

Islamic real estate investment trust is considered one of the most significant elements of the Islamic capital market, particularly in Malaysia. This is because it can assist the Malaysian Islamic capital market to promote its competitiveness by attracting global Muslim investors who want to invest in diversified elements of investments that are in accordance with the principles of Islamic law. Thus, the Malaysian *Shari'ah* Advisory Committee of Securities Commission has issued rules, principles and guidelines for Islamic REITs to be structured and invested according to the rules, principles and guidelines that are required for the investment of Islamic REITs in accordance with the principles of Islamic law (Malaysia, 2009 & (SC, 2017)).

In terms of investment and profit gaining, I-REITs are flexible and profitable elements that attract investors. This is because in the subscription of the units of I-REITs, there is no additional requirement that investors should fulfil to subscribe. The rate of risk is diversified by having many properties which are located in different areas, because the value of the asset in one area may rise and fall in another area. The unit holders of I-REITs receive a high dividend derived from the investment. This is because the dividend that is distributed to the unit holders of I-REITs is not subject to income tax. I-REITs can provide stable profit for the investors due to its conformity with the principles of Islamic law. I-REITs are considered as a safer and more attractive element of investment because it can generate stable and sustainable proceeds through rental and capital appreciation, which can be used to pay regular dividend to the investors (Financial Centre, 2009).

3.3. Islamic Unit Trust (I-UT)

Islamic unit trust (I-UT) fund management is similar to conventional unit trust fund management. The only difference being that the I-UT fund must invest in accordance with the principles and guidelines of Islamic law. The activities of the company that invests the I-UT fund should also be in conformity with the principles of Islamic law. This is because, it is not allowed for an I-UT fund to be operated by a company whose economic activities are not carried out in conformity with the principles of Islamic law (Trust Fund, 2018). For this reason, it is compulsory on investors or any person who is engaging in dealing or marketing and distribution of unit trust funds to observe the principles and guidelines that the Securities Commission of Malaysia has issued, such as guidelines on marketing and distribution of Unit Trust Funds; guidelines on Unit Trust Advertisements and Promotional Materials; guidelines on online Transactions and online activities in Relation to Unit Trusts (Commission, 2009 & SC, 2017). These guidelines must be observed in the transactions of both I-UT and conventional funds. Thus, there are no specific guidelines for an I-UT fund to be invested, except that an I-UT must be invested in accordance with the principles of Islamic law. I-UTs are structured based on partnership and profit-sharing concepts, such as *Musharakah* and *Mudharabah*. The investors and fund managers share the risks and profit. Profit of unit trust funds cannot be derived from prohibited activities, such as cinemas or alcohol [13].

3.4. Significance of *Sukuk* in Islamic Capital Market

The significant of *Sukuk* is that it is regarded as one of the best ways to finance enterprise that cannot be financed by an individual. The benefit of the *Sukuk* is that it provides an ideal means for investors who seek to deploy streams of capital and require at the same time the ability to liquidate their financial situation with ease whenever the need arises. This is because it is expected that a secondary market for the trading of *Sukuk* will develop. Thus, whenever investors require cash from their investments, it will be possible for them to sell their *Sukuk* and receive their value from their original investment, plus earnings in cash if the enterprise is profitable. *Sukuk* represents an excellent way of offering liquidity for banks and Islamic financial institutions, because when they need to dispose of excess liquidity, they may purchase their *Sukuk* and when they need to obtain liquidity, they may sell their *Sukuk* into the secondary market. *Sukuk* is a means of distribution of wealth equitably because all investors benefit from the true profits deriving from the investment in equal shares. In this way, wealth may circulate on a broad scale and not only concentrate in the hands of the wealthy [14]. It can be observed that the most important element of Islamic capital market is *Sukuk*, so to differentiate between *Sukuk* transaction and conventional bonds transaction, *Sukuk* transaction must be done in accordance with the principles of Islamic law.

3.5. Shari 'Ah Issues on *Sukuk* in Islamic Capital

According to the AAOIFI *Shari 'ah* Board many *Sukuk* structures are not in compliance with the principles of Islamic law, so as a result of this, they issued the main following recommendations: "First, tradable *Sukuk* must represent ownership for *Sukuk* holders with all the rights and obligations that accompany ownership in real assets. whether tangible or usufructs or services that may be possessed and disposed of legally and in accordance with the Islamic law. The manager of *Sukuk* issuance must establish the transfer of ownership of such assets in its books and must not retain them as its own assets. Second, it is impermissible for tradable *Sukuk* to represent revenue streams or debt except in the case of a trading or financial entity that is selling all of its assets. Third, it is impermissible for the manager of *Sukuk* regardless of

whether the manager acts as an investment manager or a partner or an investment agent to undertake to offer loans to *Sukuk* holders when the actual earnings fall short of expected earnings. Four, it is impermissible for the investment manager, partner or investment agent to agree to purchase assets from *Sukuk* holders or from whoever represents them for a nominal value of those assets at the time the *Sukuk* is extinguished at the end of their tenures" (AAOIFI, 2008).

In view of the aforementioned recommendations, there is a need to conduct research on *Sukuk* structures in order to find proper Islamic law compliant structures. In addition, the issuer of *Sukuk* must transfer ownership of assets to *Sukuk* holders and record this transfer of ownership in its books and must not keep them as its own assets.

4. Findings

This study argues that elements of Islamic capital market play a crucial role in development of economy of a country in general and particularly waqf assets. The elements of Islamic capital market are like conventional capital market elements. They differ only in terms of operation as Islamic capital market elements should operate in accordance with the principles of Islamic law. In the market, *Sukuk* is the most significant element which plays a crucial role in providing fund for a project which an individual is not able to provide a fund for it. *Sukuk* is structured for it to be in compliance with the principles of Islamic law. The transfer of ownership must be registered in the name of the investors and not merely registration to receive right on the asset. When the subscription is closed by the issuer and the certificates are issued, that would be regarded as evidence of ownership of the underlying asset. The asset would therefore no longer belong to the issuer. In case of the insolvency of the issuer, the *Sukuk* holders can still recover their assets, but if there is damage to the asset, it is only the investors who would bear the loss according to the portion owned by them. In Islamic capital market *Sukuk* is not issued to compete conventional bonds in conventional capital market but rather to protect wealth from hand to hand and right of ownership over the underlying asset which *Sukuk* represents.

5. Conclusion and Suggestion

It is argued that in the Islamic capital market, the transaction is based on tangible assets and rights over the tangible assets, and transfer of ownership of underlying asset from issuer to investors. This is because it is impermissible in Islamic law to conduct a transaction on an assumption. The elements used in the market must be acceptable by the principles of Islamic law. It is impermissible in Islamic law for a company that conducts the investment of Islamic Real Estate or Unit Trust to carry out its activities in non-*halal* activities. Islamic capital market elements are significant elements which have specific rules and regulations which must be observed while investing. In *Sukuk* transaction, the underlying asset, which is transformed into *Sukuk* exclusively, belongs to investors who are the *Sukuk* holders. In Islamic law, *Sukuk* transaction is based on transfer of underlying asset into certificates that are traded in stock market and the ownership of these certificates is transferred from the issuer to the investors. The study suggests to future researcher to conduct empirical research to investigate and find out the practical elements of Islamic capital market.

References

- [1] Abdul Rahim Kamil. *Structuring Sukuk*, paper presented at Workshop on Detailed, (2007).
- [2] Structuring of Islamic Securities Kuala Lumpur: IBFIM

- [3] Adnan, A. A., Ghani, B. A., Zin, S. M., & Aziz, I. A. The Disciplinary Status of Islamic Consumer Behavior. *International Journal of Asian Social Science*, 7(12), 949-962, (2017).
- [4] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Statement on
- [5] *Sukuk* and its implications, <<http://www.nortonrosefulbright.com/knowledge/publications/16852/aaofii-statement-on-sukuk-and-its-implications>>
- [6] Sallam, S. Productivity and Technical Efficiency in Islamic Banks: Cross-Country Analysis. *Asian Journal of Economic Modelling*, 6(1), 1-7, (2018).
- [7] *Contemporary Instrument in Developing Waqf Assets: Potential Structure, Issues and Challenges*. Intellectual Discourse, Special Issue Copyright © IIUM Press ISSN 0128-4878 (Print); ISSN 2289-5639.
- [8] Azizi Abu Bakar. Islamic Unit Trust in Developing Countries Economy and Society, *Journal of Global* ,(2016).
- [9] Business and Social Entrepreneurship (GBSE)
- [10] Chowdhury, T. S., Habibullah, M., & Nahar, N. Risk and Return Analysis of Closed-End Mutual Fund in Bangladesh. *Journal of Accounting, Business and Finance Research*, 3(2), 83-92, (2018).
- [11] Lee, C. H., & Chou, P. I. Corporate Cash Holdings and Product Market Competition: The Effects of Stock-Based Executive Compensation. *Asian Economic and Financial Review*, 8(9), 1140-1157, (2018).
- [12] Halim, A. H. A., Shariff, A. A. M., Dahlan, N. K., Hashim, F. Y., Markom, R., Azira, T. N., & Zainudin, T. Diversified Method in Teaching and Learning Muamalat towards Sustainable Legal Education in Islamic Finance. *International Journal of Asian Social Science*, 8(6), 314-319, (2018).
- [13] Nazal, A. I. Financial Tables Reports Gaps in Jordanian Islamic Banks. *The Economics and Finance Letters*, 4(2), 9-15, (2017).