



ISLAMIC FINANCIAL SERVICES BOARD

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## **EXPOSURE DRAFT**

# ***GUIDANCE NOTE ON DEEPENING THE ISLAMIC CAPITAL MARKETS***

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***Comments on this Exposure Draft should be submitted to the IFSB  
Secretariat not later than 26 May 2022 at the email address:  
[public\\_consultation@ifsb.org](mailto:public_consultation@ifsb.org)***

## **ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, issuing exposure drafts and organising public hearings/webinars and reviews by the IFSB's Sharī'ah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues and organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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## ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
GN	Guidance Note
ICIS	Islamic collective investment scheme
ICM	Islamic capital market
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFM	International Islamic financial markets
IIFS	Institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IOSCO	International Organization of Securities Commissions
LCR	Liquidity coverage ratio
NFSR	Net stable funding ratio
SME	Small and medium-sized enterprise



## SECTION 1: BACKGROUND

### 1.1 Introduction

1. The Islamic capital market (ICM) is currently the fastest-growing segment in the Islamic financial services industry (IFSI). The ICM comprises Sharī'ah-compliant stocks, *sukūk* (Islamic bonds), Islamic collective investment schemes (ICIS) and Islamic risk management products. In many jurisdictions, ICM products and services have continued to increase and become more sophisticated, encompassing Sharī'ah-compliant product structuring, project financing, stockbroking, asset management, venture capital services and more. The ICM plays the same fundamental role as conventional capital markets; that is, it is used to raise funds in the form of securities and to provide savers with an outlet for their capital. These fundamental aims are supported by mechanisms for trading, whether on- or off-exchange, and for risk management; ICIS, for example, allow smaller investors to obtain the benefits of investment diversification with a limited scale of investment.

2. Islamic capital markets, however, need to abide by certain restrictions on how funds are raised and how instruments are structured, in that they must be in accordance with the principles of Sharī'ah. For example, they cannot charge interest or involve short selling. Also, Islamic equity capital can only be raised for companies that are deemed Sharī'ah-compliant, in that they observe certain quantitative thresholds and are not engaged in any business activities that are non-compliant.

3. The current challenges for the ICM are strongly correlated with the level of maturity of the markets. At this stage of development of the ICM, there is an increasing focus by many jurisdictions on the need to develop deeper and more liquid Islamic capital markets. Many of the core Islamic finance jurisdictions are also emerging markets, where there is a need for more development of the capital market in general.

4. Deepening of capital markets plays an important role in supporting economic growth, mobilising savings, promoting greater information sharing, improving resource allocation, providing more diverse sources of funding to real-economy participants, and facilitating diversification and management of risk. It also promotes financial stability to the extent that deep and liquid financial systems with diverse instruments help to enhance countries' resilience to shocks that emanate, for example, from volatile capital flows. As such, it is essential that steps are taken to deepen the ICM to ensure that it is more liquid, more sound and more resilient.

5. Where Islamic capital markets are deep, liquid and well-regulated, market-based financing can play a role in narrowing the gap between the supply of and the demand for long-term financing by offering a viable alternative to the financing provided by Islamic banks. Strong, transparent and appropriately regulated ICMs are essential for the sound functioning of economies and to support efforts to drive recovery and sustainable long-term growth, including the provision of small and medium-sized enterprise (SME) and infrastructure financing.

6. Other sectors of the IFSI depend on the ICM to provide opportunities for investment. The ability to diversify investments is a common need which contributes to stability and resilience. *Takāful* operators, especially those undertaking family business, typically require stable long-term investments, such as those provided in conventional finance by long-term bonds. Islamic banks have a need for high-quality liquid assets (HQLA) to meet their liquidity requirements. Because of the way liquidity requirements are defined, the best instruments for this purpose will be short-term *sukūk* in the domestic currency which can be shown to trade in deep and liquid markets. In many cases, firms in these sectors consider that their local ICM does not fully meet their needs.

7. Jurisdictions may want to deepen their ICM for a number of reasons. Some jurisdictions are aiming to develop a full, integrated, Islamic finance ecosystem in order to serve a substantial domestic Muslim population. In that case, all the considerations set out above will come into play, although the priorities may vary in different places and at different times. For example, in some places pension funds play a substantial part in savings for retirement; in others, insurance (whether conventional or Islamic) or direct personal investments will be more prominent. Other jurisdictions see themselves as international capital market hubs and want to play a similar role in the ICM, even though they may have only a minimal Muslim population and no wider Islamic finance aspirations; Ireland, Hong Kong and Luxembourg might fall into this category. The two categories are not mutually exclusive; Malaysia, for example, would fall into both.

8. Strategies which focus on an international capital market presence often, though not always, attempt to build from existing strengths in conventional markets. Thus, a jurisdiction which has a substantial presence as a domicile for collective investment schemes (CIS) may seek to extend that presence to ICIS. A jurisdiction whose exchange has substantial international bond listings may seek to extend this to *sukūk*. Such strategies, by their nature, depend on the jurisdiction being attractive to international participants, both originators and investors.

9. Strategies aiming to develop a full Islamic finance ecosystem will nevertheless need to consider the current state of development of that ecosystem. For example, there may be a point at which shorter-term *sukūk*, to help Islamic banks manage their liquidity, are more important than longer-term ones, for family *takāful* investment, or vice versa.

10. The Islamic Financial Services Board (IFSB) has issued a number of standards for the ICM that address its specificities, which are aimed at strengthening regulation, protecting investors, and promoting the integrity and resilience of the ICM globally. These include: IFSB-6: *Governance of Islamic Collective Investment Schemes (ICIS)*; IFSB-19: *Guiding Principles for Disclosures in the ICM (Sukūk and ICIS)*; IFSB-21: *Core Principles for Islamic Finance Regulation (ICM Segment)*; and IFSB-24: *Guiding Principles on Investor Protection in ICM*.

11. In addition, the International Organization of Securities Commissions (IOSCO) has issued a set of recommendations that examines the challenges and opportunities emerging market jurisdictions face when developing and strengthening their capital markets.<sup>1</sup> While it makes five key recommendations, not all of them are appropriate to the ICM.

## **1.2 Objectives**

12. This Guidance Note (GN) aims to provide guidance on, and to highlight best practices for, developing and deepening the ICM. Specifically, it seeks to:

- provide international best practices in developing and promoting the growth of the ICM;
- provide guidance on deepening liquidity in the ICM;
- provide guidance on strengthening the regulatory frameworks and stability of the ICM; and
- promote the harmonisation of practices across the ICM.

## **1.3 Scope of Application**

13. This Guidance Note applies to Islamic capital markets.

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<sup>1</sup> IOSCO, *Development of Emerging Capital Markets: Opportunities, Challenges and Solutions*, October 2020.

## SECTION 2: GAPS AND CHALLENGES IN ICM DEVELOPMENT

14. Islamic capital markets, although fairly heterogeneous across jurisdictions in terms of levels of development, share a number of characteristics and challenges that limit the development of sound, deep and liquid markets. These characteristics and challenges include issues around availability, diversity and pricing of capital, as well as a higher cost of issuance, among other things. In addition, the lack of appropriate institutional settings and regulatory frameworks that address the specificities of the ICM or which facilitate issuances in the ICM, as well as limited market liquidity, lower the level of diversification in terms of products and types of investors, and so on, and thus affect the development and deepening of the ICM. A number of these gaps and challenges that were identified, supported by insights from a survey of IFSB members, are highlighted below. The gaps and challenges focus particularly on Islamic finance specificities.<sup>2</sup>

15. *Institutional Settings and Regulatory Frameworks.* Among the key challenges to the development of the ICM are gaps in institutional, legal and regulatory frameworks in some jurisdictions, particularly in terms of a lack of specific provisions that accommodate the differences in Islamic finance contracts. This may create challenges related to issuance of certain ICM products, enforceability of contracts in the case of default, as well as concerns around equitable treatment of issuers and investors. In terms of regulation, where specific regulations for the ICM do not exist, this may also give rise to issues related to appropriate disclosures of relevant information on issues specific to Islamic finance, the management of risks that are unique to ICM instruments, and so on.

16. *Market Liquidity and Volatility.* Given that ICMs are generally less developed and in nascent stages in most jurisdictions compared to the conventional capital markets, as well as the fact that most core ICMs are in emerging market or developing economies, the primary ICM could tend to be more volatile and a less reliable source of funds for issuers. Issuers also face a higher cost of capital compared with the conventional capital markets or generally compared with more developed markets. This tends to make it much more challenging for issuers to raise funds in the ICM for new projects, as well as presenting limitations for more growth and innovation in the ICM.

17. Market liquidity and volatility are also closely linked, given that a key indicator of liquidity is the effect that a transaction of a given size has on the market price of the instrument.

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<sup>2</sup> In general, issues related to Shari'ah-compliant equities are very similar to the conventional equity market. Although the GN deals with equity markets to some extent, many of the issues around developing equity markets are dealt with in IOSCO's report (see footnote 1) and are therefore not dealt with here.

Lack of market liquidity and limited secondary market trading in *sukūk* markets (as well as less active trading in debt markets in general) was one of the biggest issues highlighted in a survey of IFSB members. Thus, constraints on market liquidity in the ICM may also contribute to market volatility.

18. Market liquidity is an essential condition for the market to function effectively in a number of ways. First, it has significant impacts on price formation and discovery, which is essential for an efficient market; in turn, liquidity will attract both issuers and investors to the ICM. Second, it is important for financial stability, since it helps to absorb systemic shocks. A liquid market is generally able to cushion price volatility brought about by sudden shifts in investor risk appetite. It is currently difficult to achieve liquid markets in some parts of the ICM. While in areas such as Sharī'ah-compliant equities the issues are broadly similar to those for other equities in the same markets, for other products there are specific issues such as restrictions on the tradability of some Sharī'ah-compliant contracts, as well as the limitations in use of certain types of conventional instruments that provide liquidity. In addition, gaps in the legal and regulatory frameworks in some jurisdictions may also limit the use or development of a diverse range of Sharī'ah-compliant capital market instruments. Further, where ICMs are located in emerging or developing markets with less developed capital markets in general, there may be additional impeding factors, such as gaps in market structures and trading infrastructure that is available.

19. The lack of liquidity in the ICM remains one of the main concerns for Islamic banks, investors and Islamic fund managers. A lack of liquidity generally results in: (a) higher volatility in pricing; (b) wide spreads, as dealers demand larger premiums for the risks they undertake, although the current trends are starting to show that bid/ask spreads for *sukūk* are coming more in line with spreads for comparable instruments in the global financial industry; and (c) the inability of investors to exit their positions at fair prices. This will cause a cycle in which new investors are deterred from entering the market because of the fear that exit will also be difficult. All these concerns lead to higher costs – for example, for *sukūk* issuers – lower real investment and, consequently, slower growth. In addition, for Islamic banks, one requirement for an instrument to be admissible as an HQLA is liquidity, demonstrated by market depth and breadth.

20. Promoting liquidity in *sukūk* markets is a major area of attention. In general, both bonds and *sukūk* usually trade less than equities and tend to be traded over-the-counter (OTC). Both these features create challenges for price formation. Corporate bonds/*sukūk* also trade less than sovereign, and *sukūk* trade less than bonds in both categories. However, *sukūk*, in

particular, face a significant liquidity challenge compared to bonds, particularly because the gap in the current supply and demand for *sukūk* means that many investors in *sukūk* tend to buy and hold. Many banks buy *sukūk* to obtain a return on excess liquidity and do not intend to sell before maturity (unless there is a strong requirement to release funds). As a result, the secondary market in *sukūk* has not developed as far as it should have, and liquidity in the *sukūk* markets is generally limited even in jurisdictions with a more advanced ICM.

21. *Diversification in the Types of Investors.* Diversification in the types of investors in the ICM can play an important role in promoting the health and depth of the market. In this context, institutional investors such as foreign investment funds have played an increasingly important role in the growth of ICM (given that core Islamic finance markets tend to be emerging markets), with funds flowing into ICM products, particularly *sukūk*, encouraged by a search for yield due to a low return environment in developed jurisdictions. Markets with large numbers of institutional investors also tend to be less volatile and more efficiently allocate resources and capital to companies requiring funding. Institutional investors can also achieve economies of scale by pooling assets, employing high-quality investment professionals, developing better investment strategies and building sound risk management systems, all of which can result in better returns for investors. Nevertheless, there are challenges in the ICM with regard to attracting institutional investors. These challenges include the limited size of the ICM and liquidity, a smaller range of instruments, regulatory challenges, and limited standardisation across jurisdictions, which can create risks for cross-border activities. Thus, a practical and orderly approach by regulators to overcome these challenges will be needed, with adequate development and safeguards at both the market and regulatory levels to attract institutional investors.

22. For many Islamic markets there are also endogenous issues in the types of investors available. In some of these, it has been the State that has made the main provision for pensions and other social safety nets. In others, personal savings have tended to be invested in real estate or other tangible assets, rather than in the capital markets. Neither situation is conducive to creating a large population of institutional investors. There is also a question of whether, where they exist, institutional investors are willing to invest Islamically, or at least to offer a Sharī'ah-compliant option to their underlying clients.

23. Retail investors can also play an important role in the growth of the ICM, particularly in jurisdictions with younger populations that are Sharī'ah-sensitive and need Sharī'ah-compliant investment options, as well as in jurisdictions with Muslim populations where overall wealth is rising and investors are looking for opportunities to increase their capital and meet

their longer-term objectives through Shari'ah-compliant investments. Nevertheless, this investor base is not yet fully developed in many jurisdictions, which leaves a potential gap in funding sources for the real economy. Where retail investors are concerned, improving their access to Shari'ah-compliant investment opportunities is necessary along with addressing gaps in investor education. Educated investors generally have better comprehension of the specificities of Shari'ah-compliant products, and are better able to understand financial disclosures and to make informed investment decisions, thus improving their investment outcomes and encouraging them to further invest in the ICM.

24. *Shari'ah-Compliant Hedging Instruments.* Shari'ah-compliant hedging instruments play an important role in allowing investors to hedge their risks, which is likely, in turn, to increase their appetite for portfolio diversification, including investment in more Shari'ah-compliant assets. The development of appropriate Shari'ah-compliant hedging instruments<sup>3</sup> can allow investors to unbundle and redistribute various risks, such as foreign exchange, profit-rate, market and default risks, and, thus, facilitate greater cross-border capital flows in the ICM. The development of deeper complementary markets such as that for Shari'ah-compliant hedging instruments can also spur market liquidity, support market-making systems and encourage broader participation by facilitating the hedging of positions in the ICM. The area of Shari'ah-compliant hedging instruments is one that requires more work to identify suitable and appropriate structures.

25. Nevertheless, limited options are available in the ICM at this time, which is further compounded by differences in Shari'ah interpretation affecting their acceptability in different jurisdictions.

26. *Tools for Liquidity Management.* Effective management of liquidity risk and availability of Shari'ah-compliant liquidity management tools is fundamental to the effective functioning of institutions offering Islamic financial services (IIFS), especially those subject to banking regulation, and the ICM can play an important role. To manage liquidity risk effectively, a financial institution needs to have, among other things, adequate liquid assets of a high quality, stable funding sources, a proper asset-liability maturity balance and well-managed off-balance sheet exposures. The availability of appropriate Shari'ah-compliant liquidity management tools, including short-term *sukūk* and Islamic repurchase (repo) agreements, is important to the systemic stability and resilience of IIFS. In addition, financial safety nets, particularly

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<sup>3</sup> Provided that any hedging instrument is presented to the relevant Shari'ah board for approval.

central bank lender-of-last-resort facilities, are dependent on the availability of collateral for which, again, absence of price volatility is a relevant criterion.

27. In well-developed financial systems, the presence of an active secondary market for short-term, high-quality assets, typically issued by the government or the central bank, facilitates the liquidity management of banks, which can trade those assets or use them as collateral or repos. However, IIFS have a much more limited range of instruments available to them than conventional institutions. The availability of short-term *sukūk* with the appropriate characteristics for liquidity management would be one way of addressing the problem of liquidity management. While some jurisdictions and the International Islamic Liquidity Management Corporation (IILM) currently issue regular short-term *sukūk* intended for liquidity management, their supply is still insufficient and active trading of *sukūk* is still limited.

28. The liquidity stresses experienced by IIFS due to the disruptions caused by the COVID-19 pandemic further highlighted the need for development of a wider range of Sharī'ah-compliant central bank facilities and instruments, including short-term *sukūk* and the development of better-functioning and deeper Sharī'ah-compliant repo markets for adequate liquidity risk management of IIFS. Compared to their conventional peers, the structural constraints faced by IIFS in raising funding, including the unavailability of Islamic alternatives to repo, present significant challenges for liquidity risk management for IIFS in many jurisdictions. The IFSB has issued guidance on Sharī'ah-compliant liquidity management for IIFS and has ongoing workstreams on liquidity management tools.

29. It is also important that suitable instruments are designed to accommodate Sharī'ah-compliant alternatives to repo that are widely accepted across more jurisdictions than at present, to enable IIFS to implement Basel III and its IFSB equivalents, particularly the regulatory standards for the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). (The IFSB standards equivalent to these are IFSB-12 and GN-6.)

30. Market-making activities and the funding of trading inventories of market-makers or primary dealers are also supported by repo markets. Thus, the development of a Sharī'ah-compliant repo market is also important in facilitating market-makers' role in improving secondary market liquidity in the ICM.

31. *Taxation.* Most *sukūk* involve a complex set of transactions between parties, and this can lead to higher taxation. This is particularly the case where assets are sold into a structure and subsequently repurchased, where each transaction may be subject to some form of sales tax. In addition, some jurisdictions have specific taxes on the sale of real estate, which may



have a similar effect although on a different legal basis. Usually on a smaller scale, but possibly still significant, some jurisdictions tax individual legal documents, and the greater number of these in a *sukūk* structure may be an issue. Several jurisdictions have now addressed the question of taxation and recognise that sets of transactions within a single *sukūk* structure should face similar tax treatment to comparable conventional financial structures. However, in others, taxation issues still remain, which may be a hindrance to the choice to issue *sukūk*, particularly by corporate issuers in those jurisdictions.

32. *Absence of Benchmarks and Yield Curve.* Conventional finance relies heavily on precedent to establish prices and measure performance. Islamic finance inevitably faces a lack of benchmarks. Most *sukūk* are benchmarked against conventional bond yields. This is unsatisfactory. Issuers require good pricing benchmarks, if they are to be confident that the yields they offer on new *sukūk* are appropriate. It is therefore important for jurisdictions to construct an appropriate yield curve for Shari‘ah-compliant financing. To date, this has been a challenge in the ICM. Some sovereigns have had limited need to raise money in the markets, and others have preferred to issue conventional bonds rather than *sukūk*. In some cases, this has been largely a matter of familiarity; in others, debt management offices have been reluctant to pay the slightly higher yield that *sukūk* have normally required, while in others there have been legal and practical problems around the identification of assets to use as the basis of *sukūk*. However, it is essential to address these issues if *sukūk* markets are to develop.

33. *Role of Market-Makers.* In a survey of IFSB members, a number of jurisdictions highlighted the lack of market-makers as a challenge in deepening the ICM. Market-makers play a crucial role in financial markets by providing liquidity to facilitate market efficiency and functioning. Market-makers serve important functions both at issuance and in the secondary market. Many market-making firms are active in both primary and secondary markets. At issuance, market-makers, or a primary dealer system in some markets, offer a distribution and price stabilisation service. In secondary markets, bond or *sukūk* issuers generally have an incentive to improve the liquidity of their issues to reduce the premium that investors demand for less liquid instruments. Many jurisdictions therefore adopt primary dealer systems for central government bonds that combine incentive schemes with market-making obligations. Other issuers, such as regional governments, government-sponsored enterprises or supranational institutions, may also have similar but usually less formal set-ups for market-making. For less frequent issuers, including most corporates issuers, market-makers are more likely to support secondary market liquidity for a fee on a deal-by-deal basis or in return for underwriting deals and other related business with the corporate issuer. The participation of

market-makers in this way is often seen to contribute to higher liquidity levels in a market and many developed jurisdictions have introduced market-making facilities to further enhance trading, particularly in less liquid securities. The deepening of the ICM, which currently faces liquidity challenges, particularly in secondary markets, can be supported by the presence of market-makers and incentive programs to enhance market liquidity.

34. In the Islamic market, the issuance of short-dated *sukūk* denominated in major reserve currencies by the IILM uses a similar mechanism for price stabilisation. The issuances by the IILM primarily intend to provide IIFS with acceptable instruments for investment of short-term funds which are vital for the risk management operations of banks and so are supportive of the development of market-making. However, the IILM is not in itself a market-maker; rather, it is an entity that uses market-makers (primary dealers) and could perhaps support the development of market-making on a wider basis.

35. *Issuance Costs.* In principle, *sukūk* are regarded, because of their complexity, as more expensive to construct and maintain than their conventional counterparts. Together with the illiquidity premium that some investors still demand, this raises issuers' cost of capital above that for conventional bonds. Of course, some issuers may prefer *sukūk* for reasons of principle or because of the access it gives them to a different investor base. However, for corporate *sukūk* to become more widely used, which is essential for greater liquidity, they must involve a similar all-round cost (running cost plus issuance cost) to conventional bonds. The issue is whether this is possible. Standardisation is one potential way of driving down the costs associated with the issuance of Islamic products, and information technology may also provide cheaper routes to issuance.

36. *Product Development, Innovation and Standardisation.* Financial institutions, including Islamic ones, tend to be incentivised by market pressures to develop new and innovative products. The main restraint on product development typically tends to be the need to gain regulatory approval. In most markets, the regulatory approval process generally gives broad permission for firms to innovate within certain classes of investment without the need to gain specific regulatory approval for each product. However, in some markets, regulatory approval for each separate issue is required, which tends to slow down the process of innovation. For the ICM, Shari'ah approval is typically not asset class-based but issue-based. This could therefore be a barrier to product innovation as the need for issue-based regulatory approval has proved to be. Some jurisdictions have addressed this problem by establishing central Shari'ah boards at the country level that are designed to make this process as smooth and low-cost as possible, while others rely on firm-appointed experts.

37. Another challenge in the ICM that results in a lack of diversity of new product offerings and greater length of time taken for product development and approval processes is a lack of Shari'ah standardisation. These differences in Shari'ah opinions across jurisdictions may also limit product acceptance across borders and, in turn, hinder development of cross-border products. The standardisation of contractual structures for the issuance of *sukūk* would be an important step in facilitating issuers to easily structure *sukūk* and go to market quickly. It will also increase cross-border acceptability of Shari'ah contracts and diversification of the investor base, which is currently one of the major challenges for the ICM. However, several attempts to achieve such standardisation in the past have been unsuccessful.

38. *Shari'ah Scholars*. The ICM presents an additional need to obtain religious approval for each issue to confirm that it conforms to the requirements of Shari'ah. While this process is straightforward for equity issues, provided there is a set of predetermined screening criteria, for other products such as *sukūk* the approval process can demand considerable knowledge of legal and economic structures before certification can occur. This places considerable demands on the availability and expertise of Shari'ah scholars, and has been seen as an impediment to the increase in Islamic finance offerings. In addition to approval processes, there is also a need to have clear procedures in place for the eventuality where an asset is subsequently deemed to be non-Shari'ah-compliant. Thus, firms or issuers offering ICM products need to have continuous access to Shari'ah scholars who are knowledgeable in the different types of products, services and activities in the securities markets. The availability of Shari'ah scholars with adequate and detailed knowledge of capital markets is therefore very important in identifying potential Shari'ah implications, and effectively and accurately addressing them, in order to facilitate further development and growth of the ICM within and across more jurisdictions.

39. *Corporate Sukūk Markets*. Improvement in funding sources in terms of asset classes is another key need for the ICM. Corporate *sukūk* issuances have historically been low, the market being dominated by sovereign or quasi-sovereign issuances. In some cases, this is associated with weak conventional bond markets which may, in turn, be the result of broader market dynamics – for example, ready availability of bank finance as an alternative to capital markets issuances. Whether or not this is the case, corporate issuers in many jurisdictions still face significant challenges in entering the *sukūk* market, including regulatory constraints such as lack of appropriate regulations and/or the absence of a legislative framework that facilitates *sukūk* issuance, higher cost of issuance, complexity of the process, and longer length of time to market (as discussed previously), which makes it a less attractive option compared to

bonds. It is therefore important to address these issues to facilitate the development of the corporate *sukūk* market.

### SECTION 3: PRECONDITIONS FOR ICM DEVELOPMENT

40. A number of preconditions are needed if the ICM is to develop. These constitute both macroeconomic and financial market preconditions.

41. Macroeconomic preconditions include both the level of gross domestic product (GDP) of a jurisdiction and its growth rate. These are key driving forces behind the supply of funds and the demand for funds flowing into both primary and secondary capital markets. (The GDP level may also lead to deeper capital markets via other channels.) Of course, capital markets may extend beyond a single jurisdiction, and in that case a wider GDP pool will be relevant.<sup>4</sup> A further factor is macroeconomic stability, which provides the foundations for investors to invest long term, as well as fiscal policies – in particular, budget imbalances – which may affect governments' willingness to raise funds by issuing *sukūk*. A programme of sovereign *sukūk* issuances at different maturities will help to establish a yield curve, thus providing benchmarks against which to value corporate *sukūk*. A government *sukūk* market may also play a catalytic role in giving rise to a minimum threshold of trading volume and liquidity to jump-start the private market.<sup>5</sup>

42. In combination with macroeconomic conditions, the following financial market preconditions are needed to facilitate the development and deepening of the ICM.

43. *A Robust Legal and Institutional Environment.* A sound and effective legal and regulatory framework that takes into account specificities of the ICM is important in facilitating the robust growth of the market. The integrity of the ICM and the protection provided to investors are of paramount importance. Trust and confidence in the ICM can also be significant drivers of both local and cross-border retail and institutional flows of funds into the markets. These qualities can be achieved by encouraging an efficient and effective supervisory and regulatory framework covering Sharī'ah governance, strong investor protection, robust oversight of market participants, strong surveillance and enforcement of market rules and regulations, and a high level of transparency, all of which adequately recognise and address the specific features and characteristics of Islamic finance. This implies a capital markets regulator with adequate independence, knowledge, powers and resources as well as a

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<sup>4</sup> There are several examples of relatively small jurisdictions with a significant regional or global capital market presence. Examples in conventional finance would include Hong Kong and Luxembourg.

<sup>5</sup> Governments may, of course, choose to issue *sukūk* for reasons other than their funding needs – for example, to help meet the liquidity management needs of Islamic banks or to stimulate capital markets development. This point is discussed in more detail later.

competent and independent judicial system and professions such as lawyers and accountants.

44. Investor protection has two aspects. One has to do with upholding the rights of shareholders or other investors in the companies or funds in which they may be invested. However, in traded markets – and in intermediated transactions, in particular – it also entails protection from misleading, manipulative or fraudulent practices, including insider trading, front running (trading ahead of customers), misuse of client assets and misleading claims of Sharī'ah compliance. The structure of securities markets, as well as asymmetries of information, mean that investors are particularly vulnerable to misconduct by intermediaries as well as primary issuers and managers, but the capacity of individual investors to take action may be limited. Thus, investors should have access to a neutral mechanism (such as courts or other mechanisms of dispute resolution) or means of redress and compensation for improper behaviour. There should also be additional guidelines in relation to matters of Sharī'ah compliance and remedial processes (and purification of income) should incidents of Sharī'ah non-compliance occur. Contracts in the ICM also need to ensure clarity for investors in relation to the governing law that will guide cases of dispute (if any) and the courts where cases will be heard. This factor is important for investors wishing to gauge the legal treatment that will be accorded to Sharī'ah-compliant contracts – specifically, how courts will handle Sharī'ah-related arguments. Furthermore, full disclosure of information material to investors' decisions is one of the most important means for ensuring investor protection. This includes adequate disclosure of Sharī'ah compliance processes in relation to products and services, and of the general rights, responsibilities and exposures of investors based on the underlying Sharī'ah-compliant contracts. Investors are, thereby, better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests.

45. In many jurisdictions, to spur the development of a deep and resilient ICM, it is necessary to remove regulatory and legal hindrances by introducing laws and regulations to cater for the specificities of ICM products, enabling the creation and development of Sharī'ah-compliant financial instruments and Islamic securitisation. As already suggested, this may mean ensuring tax neutrality between Islamic and conventional instruments. It may mean providing for special purpose vehicles to permit the issuance of *sukūk*, or specifying particular disclosures. A Guidance Note like this cannot be fully specific because the changes that need to be made depend on the existing regulatory regime of the jurisdiction. Very often, a regime will have been drafted with only conventional finance in mind, but only careful examination will determine whether it creates obstacles to the Islamic counterpart. Much will also depend on

the degree of discretion given to the capital markets regulator, which may offer helpful flexibility to deal with the specificities of Islamic finance.

46. The IFSB's core principles for Islamic finance regulation (ICM segment) provide 38 core principles that represent a foundation for ICM regulation in any jurisdiction. The assessment methodology, developed to assist with the implementation of these principles, states that effective regulation depends on an appropriate legal framework which should facilitate the issuance of ICM products, enable its effective regulation and supervision, and ensure effective enforcement in the case of default in line with Sharī'ah principles. Comprehensive, adaptable and efficient regulation that takes into account the characteristics and features of the ICM is necessary to fulfil the aforementioned core principles. Regulators have a critical role to play in enforcing laws and regulations that protect investors, maintain Sharī'ah compliance, and ensure that markets operate fairly and efficiently. Equally important is the need to review the regulatory perimeters, particularly in current times to ensure that they keep up with new developments in the external macroeconomic environment as well as with structural changes in the ICM due to innovation. Regulators should be able to regularly review whether their current regulatory requirements and framework adequately address the risks posed to investor protection, Sharī'ah governance, and fair, efficient and transparent markets, as well as to the reduction of systemic risks taking into account the nature and types of ICM instruments that are present, or will be introduced, in the jurisdiction. A regular review of the perimeter of regulation will also consider the effectiveness of existing regulations and the need to modify them or to adopt new regulations in light of new market developments and the Sharī'ah specificities that arise. The regulatory framework should ensure at all times that the regulator has sufficient independence for the day-to-day operational activities, powers and resources (both financial and human) to effectively regulate and supervise market participants, products and activities and to ensure compliance with Sharī'ah rules and principles.

47. *Legal Protection of Investors.* In order to provide investors with the confidence to put their money into Sharī'ah-compliant products and services and to give them assurance that their contractual rights will be enforced if needed, legal protection in the case of default or misconduct is a precondition for investor participation in the ICM. Some aspects of this – for example, a competent and impartial court system – have already been discussed. But a feature relevant to many ICM products is that they depend on specific Sharī'ah-compliant contracts and that conformity to Sharī'ah may in some circumstances be in dispute. Investors need clarity as to how disputes with a Sharī'ah element will be handled and how contracts will be interpreted both in the courts and in alternative dispute resolution mechanisms.

48. Beyond private mechanisms of enforcement, the credibility of the securities regulator plays a key role in preventing investors and issuers from exploiting informational asymmetries as well as lack of understanding of Sharī'ah-compliant contracts, at the expense of the less informed parties. This requires regulators to have a programme of active review of information provided by issuers to ensure that it is complete, accurate and timely, as well as to respond to complaints. They also need to supervise market participants and the markets themselves with a view to deterring (and, if necessary, punishing) wrongdoing, including incidences of Sharī'ah non-compliance, changes to the Sharī'ah compliance status of a product and misinformation to investors.

49. *The Degree of International Financial Openness.* External policies – including financial openness in general, and securities market liberalisation in particular – have been shown to help leverage the expansion of local capital markets by allowing foreign capital flows into domestic markets, which might also bring about lower cost of capital and lower transaction costs, supporting both *sukūk* and equity market development.

50. Internationalisation tends to be a driver of capital market development, with the opening up of access to international investors and issuers having a number of positive effects, particularly in a jurisdiction's corporate securities market. This includes expansion of the potential pool of savings, allowing more securities issuance at lower expected yields. In addition, market liberalisation tends to reduce the cost of capital by enabling risk sharing between domestic and foreign agents. Additionally, since the circumstances, needs and expectations of foreign investors and issuers can differ from those of local investors, their entry can also increase local market liquidity and depth, including for local hedging markets. Furthermore, it can reduce volatility by lowering sensitivity to country-specific developments, even if it potentially increases exposure to global spillover effects.

51. The impacts of internationalisation will, however, be different across different parts of the ICM. The analysis is relatively straightforward in relation to equities, which tend to be listed in home markets and in the domestic currency. *Sukūk* may be issued either in the domestic currency or in a foreign currency such as US dollars. Foreign currency *sukūk* are also commonly listed on more than one exchange. The international trading of such *sukūk* is thus less closely linked to the internationalisation of the domestic market.

52. *Corporate Governance.* Effective corporate governance is critical to the proper functioning, safety, efficiency, and overall stability and resilience of the ICM, while boosting investor confidence and encouraging investors to make long-term decisions. Therein, the



ICMs need consistent and harmonised high-quality regulation for corporate governance and appropriate and timely disclosures to identify vulnerabilities that have the potential to trigger a higher level of market risks that could lead to financial instability. To this end, ICM regulators can play a prominent role in coordinating their activities, benchmark approaches and practices through implementation of international standards, while taking into consideration the special characteristics and conditions of each market. Day to day, ICM regulators deal with major issues, breaches and instabilities that can impact the ICM, which could be prevented through the presence of effective corporate governance structures, including, for example, board member selection that takes into account the need for effective oversight of Sharī'ah compliance and the necessary competence to undertake these responsibilities, as well as reliable disclosure of material information concerning relevant and unique risk factors, including quality reporting of Sharī'ah compliance, among other things, such as sustainability, social and cyber risks, and so on. The efficiency and appropriateness of the systems and controls also need to be periodically assessed, including identifying deficiencies in the control systems and the appropriate corrective action to be taken.

53. This kind of active role in corporate governance is, of course, more appropriate to actively supervised entities such as brokers, fund managers, and so on. For issuers (other than financial services companies), different corporate governance standards may apply, and responsibility for them may lie with the capital markets regulator, a listings authority (where these two are not the same) or a companies regulator. In such cases, however, the corporate governance issues and approaches are likely to be similar to those in conventional markets.

## SECTION 4: RECOMMENDED BEST PRACTICES

54. Developing and deepening the ICM is a work-in-progress for most jurisdictions as it continues to grow and evolve. Capital markets regulators may therefore need to continuously adapt regulatory provisions to ensure effective Sharī'ah governance, investor protection, market integrity and financial stability as ICM activity in their jurisdiction develops. This is particularly relevant considering the ongoing introduction of new financial products and the growing use of financial technologies in the ICM. The state of the ICM is also influenced by the state of development of other parts of the Islamic finance ecosystem, including Islamic banking, *takāful* and the supporting infrastructure of law, accountancy, Sharī'ah scholarship, and so on.

55. Each market is different in size and has its own set of characteristics; thus, there is no one-size-fits-all solution.

56. In light of the discussion in the preceding sections on the gaps and preconditions for ICM development, the GN makes the following recommendations.

### 4.1 A Holistic Strategy for the Development of ICM

57. The Islamic capital markets can play an important role in meeting the financing needs of economies. They are also essential to the development of other sectors of Islamic finance which require the opportunities for investment they provide. Thus, development of the ICM should be part of the overall strategy for the jurisdiction, alongside the development of the Islamic banking and *takāful* sectors. The strategy could include a number of aspects, including coordination among national authorities, addressing the preconditions for ICM development, implementation of international standards for Islamic finance regulation, and establishing proper standards of corporate governance and Sharī'ah governance.

58. While securities regulators have a key role to play in the development of the ICM, coordination among national authorities, including other policymakers, central banks and other regulators, is also important in deepening the ICM. An important consideration is the role of taxation policies that are under the purview of other policymakers. To facilitate development of their ICM, countries may need to review and amend their tax regimes to ensure a level playing field for Islamic finance and that the tax system does not impose an extra burden on Islamic financial transactions. Further, many other measures needed for the growth of the ICM may not be within the remit of the capital markets regulator (e.g. involvement of Sharī'ah-

compliant pension funds, *takāful* companies and Islamic banks operating in the ICM). Other aspects that may benefit from a coordinated approach among different authorities are financial literacy and education, which is a key element for retail investor participation in the ICM.

59. Addressing preconditions for ICM development is another key factor in the overall strategy for deepening the ICM. This may include amendments to legislation to establish robust provisions for Islamic finance within contract law, taxation laws, bankruptcy and insolvency laws, and dispute resolution systems, which are all important preconditions for ICM development and should be addressed jointly by authorities.

60. Regarding Islamic securities, the regulatory regime may need to ensure, where it is necessary to address any differences from conventional practice or Sharī'ah specificities, a clear framework for creation, trading and settlement; effective and efficient investor protection; appropriate disclosures; clarity of obligations of Sharī'ah boards and advisers; and so on.

61. Some changes are likely to require changes to primary legislation; the example of insolvency law has already been given. Others may impact on broader government strategy – for example, the internationalisation of capital markets – or the way in which pensions and other forms of social security are provided. Strategy should therefore not be confined to regulators and is likely to require the involvement of primary ministries.

## **4.2 Increasing Institutional Investor Participation**

62. Developing a deep and diversified domestic institutional investor base has long been recognised as an important contributor to capital market development. Institutional investors can be instrumental in increasing the appetite for a broader set of assets that are issued and traded in the ICM. Given that they have sizeable resources, institutional investors can create the necessary demand for the Sharī'ah-compliant securities issued by both the private and the public sector. In principle, this demand should be able to gradually create its own supply. However, only some institutional investors will be Sharī'ah-sensitive and seek investment only in Sharī'ah-compliant assets, while others may simply want exposure to the ultimate obligor regardless of whether the obligor issues *sukūk* or conventional bonds. Thus, only part of the demand from institutional investors for Sharī'ah-compliant securities will drive the supply of Sharī'ah-compliant assets. To the extent that the authorities in a jurisdiction can encourage the participation of institutional investors, the focus should be on those most likely to have an active preference for Sharī'ah-compliant securities. Developing an institutional investment

base is partly related to how and to what extent individuals save for the longer term and for protection against adversity. In some economies there is scope to encourage greater saving through pension funds, family *takāful*, ICIS, and so on, all of which can contribute to the institutional investor population in the ICM.

63. Notably, institutional investors currently make up the majority of the investor base for ICM products. A survey of IFSB members indicated that *sukūk* issuances in most jurisdictions are primarily targeted only at institutional investors. Mechanisms such as large unit sizes may also be used to make them inaccessible to retail investors. Nonetheless, the proportion of investment by institutional investors in the ICM is still relatively small when compared to conventional markets. Moreover, the presence of institutional investors is not, by itself, a sufficient condition for market deepening. In particular, if funds are overwhelmingly allocated to sovereign *sukūk*, little impact should be expected on the issuance of new corporate *sukūk*. Likewise, if institutional investors follow buy-and-hold strategies in the *sukūk* market, they will be of little help in invigorating market liquidity.

64. To attract greater institutional investor participation, regulators should ensure a level playing field for foreign institutional investors and implement strategies to increase the depth and diversity of the domestic institutional investor base. Prudent expansion of investment options in the ICM can broaden the role and impact of institutional investors and improve secondary market trading. Policies to promote greater penetration on the part of institutional investors such as pension funds and *takāful* companies can also help to dampen volatility as well as create a domestic constituency that raises corporate governance standards and improves efficiency of the ICM.

### **4.3 Deepening Liquidity in the Market**

65. Market liquidity is an essential condition for the market to function effectively, for several reasons. First, it has significant impacts on price formation and discovery, which are the building blocks of an efficient market; in turn, this attracts both issuers (as a source of low-cost funding) and investors (as a source of investment opportunities). Second, it is important for financial stability and strength, as it helps to absorb systemic shocks. A liquid market is generally able to weather adverse external shocks and better cushion price volatility brought about by sudden shifts in investor risk appetite. However, it is currently difficult to achieve liquid markets in certain ICMs, due to gaps in market structures, infrastructure and regulatory frameworks such as those that lower transaction costs.

66. Deepening market liquidity in the ICM and enhancing overall market microstructure, as well as widening the available product range offered, is important to attract global order flows and to enhance the market's overall value proposition and the value recognition of individual listed entities. A number of important building blocks are required for deepening market liquidity, including increasing the supply both of Sharī'ah-compliant investment products and of hedging instruments available in the market. Observations of conventional markets suggest that the availability of deeper complementary markets such as derivatives that facilitate the hedging of risk exposures and thus enable investors to tailor their exposures more closely to their preferences, perceived opportunities or other constraints, tend to increase investors' propensity to enter trades in particular capital markets and have been seen to improve liquidity in those markets.

67. Increasing the heterogeneity of market participants in terms of transaction needs, risk appetites and investment horizons can also enhance market liquidity. This requires some thought about the different kinds of institutional investors to encourage. For example, pension funds have a long investment horizon; risk appetites vary; general *takāful* undertakings commonly have a horizon of a few years and a low risk appetite; and actively managed ICIS may be trading daily, often with a relatively high risk appetite. Further, encouraging foreign participation in the ICM increases competition to domestic players, as well as extending the market's reach into the international liquidity pool. Other steps include improving the trading infrastructure of exchanges through technological advancement in trading systems, as well as developing inter-market linkages and restructuring exchanges to allow them to efficiently tap multiple markets for liquidity.

68. Liquidity is a critical component in capital market development. Regulatory authorities should explore initiatives that will encourage the long-term development of the different elements that contribute towards deepening market liquidity. The main objective for regulators should be to achieve a sustainable degree of liquidity in the markets, while also ensuring that the market is able to absorb and withstand any adverse impact that may arise in the event of a financial crisis. Thus, regulatory efforts should be targeted to support the development of a structural framework that can ensure deep, broad and robust markets.

69. The deepening of primary market liquidity could be supported by increased issuances in the primary market, including sovereign issuances, as well as by establishing measures that encourage and facilitate more issuance of *sukūk* by corporates for their funding requirements. Given the limited corporate participation in the *sukūk* market in general, authorities should facilitate the development of the corporate *sukūk* market by enhancing market infrastructure,

amending taxation frameworks and widening the investor base, which can attract corporate issuers to enter the market. In recent years, the largest proportion of corporate market issuances has been from the financial sector, with a large part of this comprising regulatory capital *sukūk* issued by Islamic banks. Encouraging and facilitating more *sukūk* issuances to meet regulatory capital requirements of Islamic banks may be something that capital markets authorities may also explore with their central banks.

70. To enhance secondary market liquidity, measures should also consider introducing market-making mechanisms in the ICM to ensure that large-volume transactions for institutional investors are possible at (essentially) all times. Market-makers often contribute to higher liquidity levels in a market, with the introduction of market-making facilities helping to enhance trading, particularly in less liquid stocks. Lack of liquidity of *sukūk* (both sovereign and corporate) has a number of consequences for the market, and opens an important niche for market-makers to provide liquidity and facilitate execution of investor orders. Market-makers may be formal or informal. Informal market-makers do not need any incentives. However, formal market-makers have an obligation to provide liquidity even when they might choose not to do so and require an incentive. Thus, formal market-makers are only possible when a market authority is able to grant privileges and enforce obligations. Establishing market-making programmes in the ICM can therefore support the deepening of liquidity in secondary markets.

71. A conducive regulatory framework for the ICM may also encourage foreign investment participation. This may include the incorporation of minimum standards of investor protection for the ICM. The IFSB has issued a set of Guiding Principles for Investor Protection in the ICM, which addresses specificities for the ICM, alongside a comprehensive investor protection framework. While much of investor protection is focused on small retail investors, who are only rarely direct participants in cross-border investment, there are aspects of investor protection that are certainly relevant to institutional investors and the commonly recognised category of “professional” or “qualified” investors.

72. As discussed in more detail in recommendation 4.8, regulators could also examine their ability to lower explicit transaction costs in the ICM, including transaction commissions, taxes and fees. These measures are expected to increase both market participation and liquidity, which will then lower the implicit transaction costs by adding market depth.

#### **4.4 Increasing Retail Investor Participation**

73. Increase in retail participation can be an important contributor to enhancing market liquidity, given that pools of savings in the retail segment are essentially natural sources of liquidity. In addition, the diversity of market participants in the ICM, with their differing needs, risk appetites and investment horizons, tends to have a more positive impact on liquidity than would a focus only on institutional investors.

74. Greater trading access brought about by the increase in online trading or digital platforms can also be a significant factor in attracting retail investors. However, some markets may also experience excessive volatility as a result of online trading. It is therefore important for regulators to focus not only on encouraging a higher degree of retail participation in the ICM, but also on primarily attracting informed investors who are aware of the risks and benefits of investing in the ICM. In order to achieve this, regulators may develop initiatives targeted at improving retail investors' awareness and understanding of the ICM and Islamic finance through investor education programmes such as investor seminars and roadshows or other awareness-raising programmes about the ICM, as well as encouraging the development of more ICM products in the jurisdiction that are targeted at the retail investor base.

#### **4.5 Promoting Greater Certainty for Investors and Standardisation of Legal Documentation and Procedures for Sharī'ah-Compliant Issuances**

75. Standard-setting bodies, together with regulators, should also work to facilitate the convergence of criteria for determining which instruments and transactions are Sharī'ah-compliant, as well as to standardise legal documents and procedures, which would promote greater certainty for investors on the application of Sharī'ah in the execution of contracts, particularly its application to issues that are currently controversial.

76. Standardisation of documents could also overcome the issues around jurisdictional differences in Sharī'ah interpretation and the differences in the accepted forms of contracts, by helping to make Sharī'ah-compliant contracts internationally acceptable across jurisdictions. This, in turn, can attract more international flow of funds into ICM products. While some efforts have been made to achieve this, the standardisation of documentation has thus far faced some difficulties due to diverging Sharī'ah opinions on certain issues that make arriving at a consensus at a global level challenging, as well as the low adoption of standardised Islamic contracts that have been issued thus far.

#### 4.6 Providing Financing for the SMEs Segment and Infrastructure Projects

77. SMEs currently have limited options in seeking financing. The ICM can play an important role in improving access to Shari'ah-compliant financing and addressing the intermediation gap between the supply and the demand. SMEs may tend to represent a relatively high investment risk and, in many jurisdictions, continue to face impediments that discourage them from raising financing in the capital markets. Challenges facing SMEs in accessing market-based financing include the loss of management control; costs of an initial public offering and listing requirements; and limited interest from investors and analysts, among other issues.

78. Recommendations by IOSCO on measures to improve SME financing that are applicable to the ICM include addressing areas such as establishing separate equity and fixed-income markets with regulatory requirements tailored to SMEs, establishing market advisers and market-making systems, and introducing alternative methods of financing such as Shari'ah-compliant private equity and venture capital which can be equally applicable to the ICM.<sup>6</sup>

79. For ICM to play a greater role in the provision of long-term financing for SMEs as well as to infrastructure projects, it is necessary to address the issues and challenges facing long-term financing and the opportunities for growth. Islamic finance can provide products in equity markets, *sukūk* markets and pooled investment vehicles that provide practical solutions to broadly recognised challenges for the financing of SMEs and infrastructure projects.

80. The regulatory framework of the market directly impacts the ability and willingness of SMEs to access the ICM. At the same time, regulatory incentives can also be utilised to influence issuers of Shari'ah-compliant instruments to participate in both SME and infrastructure financing in the ICM.

81. Jurisdictions could also improve the financing conditions for SMEs or infrastructure projects by increasing the availability of Shari'ah-compliant financing, diversifying sources of Shari'ah-compliant financing and lowering cost of funding through the ICM. Improved financing conditions can be driven by changes in regulations, efforts to cater to the needs of existing investors, issuers being able to access a wider investor base, the development of new investors or intermediaries, and the development or establishment of new markets.

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<sup>6</sup> IOSCO, *SME Financing through Capital Markets*, July 2015.



Governments can help to catalyse the market for Sharī'ah-compliant SME securities, as well as infrastructure projects, by also encouraging institutional investor participation.

#### **4.7 Providing Diversified Investment Choices in the ICM**

82. The range of investment instruments available in the ICM is an important factor in increasing a market's attractiveness to investors and improving market liquidity. Thus, the development of the ICM requires improving the diversity and breadth of available Sharī'ah-compliant products, which would also help to provide options to a wide range of investors with different trading strategies, risk appetites and investment horizons. This can be done through dual and cross-listings, as well as via quality companies with good value propositions, supervision and corporate governance. Allowing dual listings will encourage domestic companies to adopt international best practices (e.g. in disclosures and accounting standards). Furthermore, the attractiveness of available Sharī'ah-compliant investment instruments to investors is also a crucial factor in facilitating the mobilisation of savings into the ICM. For example, developing the ICIS segment of a market can help to efficiently mobilise large pools of savings in the market.

83. Regulators may also consider how different types of Sharī'ah-compliant offerings can be tailored to specific needs, such as those targeted specifically at retail investors, limited offerings directed to institutional investors, and private placements directed to a small number of investors.

#### **4.8 Reducing Costs of Issuance of ICM Products**

84. Improving the cost competitiveness of *sukūk* compared to conventional bonds may help to encourage corporate issuers to opt for the issuance of *sukūk* over bonds. Currently, the main deterrents to the issuance of *sukūk* are what is seen to be a more cumbersome issuance process, a longer time frame and higher costs, compared to conventional means of raising finance. To further develop the ICM, simplifying product offering procedures and broadening offering methods can also be useful in encouraging more issuers to choose to issue in the ICM. Regulators may seek to expedite the approval or registration procedures for primary issuances and streamline the offering documentation requirements, removing undue administrative impediments. To create a level playing field between *sukūk* and conventional bonds and to encourage more *sukūk* issuance, some jurisdictions have implemented tax

neutrality through the removal of taxes related to the transfer of assets and the way *sukūk* returns are taxed as compared with bonds. The unique underlying structure of Islamic transactions may trigger additional tax charges such as sales tax, real estate capital gains tax, income tax and double stamp duty.<sup>7</sup> Thus, tax frameworks in jurisdictions would need to reflect that Islamic finance transactions are actually financing in nature and be treated on a similar basis as conventional financing. Ensuring tax neutrality between Islamic and conventional capital market products may mean, for example, providing an exemption on capital gains or transaction taxes for the sale of underlying assets or properties into a *sukūk* structure and, in others, ensuring that the tax treatment of “profit” from Islamic securities is equivalent to that of “interest” income from conventional securities with similar economic characteristics. In addition to a tax-neutral framework, some jurisdictions have also implemented additional tax deductions and waivers to incentivise issuers and investors to opt for *sukūk*. These steps have been observed to encourage more corporate issuances in such jurisdictions compared to those that have not yet implemented them.

85. To increase the attractiveness of raising funds through *sukūk*, other measures may also be taken to ensure cost-competitiveness; for example, taking steps towards standardising *sukūk* frameworks in order to reduce the complexities of *sukūk* issuance and lower legal fees, as well as facilitating more efficient Sharī‘ah approval processes, may help to reduce the overall costs of issuance.

86. There is also much interest in the ability of technology to reduce the costs of *sukūk* issuance and trading, particularly at smaller scales. Distributed ledger technology may reduce the costs associated with dealing, custody, and so on, and artificial intelligence may reduce the costs of legal and Sharī‘ah research and of document drafting. Innovations of this kind have not yet delivered decisive cost advantages, though they may do so in the future and regulators should certainly be open to their use.

#### **4.9 Developing Benchmarks by Expanding the Maturity Range and Volume of Sovereign *Sukūk* Issuances in Domestic and Foreign Currencies**

87. The basic building block of a robust domestic *sukūk* market is the development of a sustainable supply of domestic *sukūk* from both the public and private sectors. Key to this is the establishment of a sovereign benchmark yield curve. Benchmarks play a crucial role in the

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<sup>7</sup> Tax structures vary widely between jurisdictions. In addition, similar taxes may be known by different names, and vice versa. For these reasons, the examples given can be no more than that, and each jurisdiction will need to consider what neutrality implies within its own tax regime.

efficient functioning of the primary and secondary *sukūk* markets. The development of a domestic currency sovereign benchmark provides an essentially risk-free yield curve as a basis for pricing sub-sovereign and private-sector issues. This requires the government and government agencies to make available different maturities for sovereign *sukūk* issues.

88. In the conventional capital markets, the yield curve is constructed on the back of issues with different maturities, reaching far into the future. Similarly, government *sukūk* issuances form the foundations for development of the ICM by providing the necessary benchmarks. Often governments tap the government bond or *sukūk* market only when they need to finance budget deficits through this market. Jurisdictions that are in fiscal surplus may therefore not face a financing need that serves to increase government *sukūk* issuances, while others may choose to tap into the bond market rather than the *sukūk* market for budget financing. However, for jurisdictions with an objective of developing their ICM, one of the key roles served by issuing government *sukūk* is to provide a benchmark (as the risk-free standard) for the rest of the ICM and this is therefore one of the foremost reasons for increasing issuances in the sovereign *sukūk* market as well as widening the range of maturities. (Such issuances also support the development of other Islamic finance sectors by offering investment options for Islamic banks and *takāful* undertakings, and their availability as collateral helps to facilitate interbank markets and financial safety nets.)

#### **4.10 Addressing Legal, Regulatory and Structural Challenges in Developing a Wider Range of Sharī'ah-Compliant Liquidity Management Tools in the ICM**

89. Enabling IIFS to meet their liquidity management needs through short-term *sukūk*, or to raise funding through Sharī'ah-compliant repo markets, requires a number of existing challenges to be addressed, including differences in Sharī'ah interpretation, ease of issuance and need for standardisation of contracts, and limitations in the regulatory or legal frameworks. To address some of these challenges that hinder growth of the market, standard setters have issued some guidance on Islamic repos. For example, the IFSB has issued various standards that address some of the challenges that Islamic banks face regarding liquidity management. The IFSB, however, does not provide a specific model for an Islamic repo mechanism, leaving it to individual jurisdictions and the approval of relevant Sharī'ah boards and the regulatory authorities. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has also issued a Sharī'ah standard on repurchase agreements, which prescribes the Sharī'ah rulings on repurchase and their application by IIFS. It covers the parameters for

permissible forms of repurchase, through sales and leasing (*ijārah*) contracts, setting out the Sharī'ah rulings on repo and reverse repo, and the main permissible alternatives. Additionally, the International Islamic Financial Market (IIFM) has issued an alternative standard for Islamic repos ("collateralised *murābahah*") based on using collateral in order to remove the need for a binding sale-and-buyback agreement. This standard is intended to enable IIFS to manage their liquidity requirements using *sukūk* or Islamic securities portfolios.

90. Given that the most commonly used collateral by IIFS is currently *sukūk*, enabling the development and use of Sharī'ah-compliant alternatives to conventional repo structures<sup>8</sup> could also help to stimulate and expand the secondary *sukūk* market, which is typically dominated by buy-and-hold investors.<sup>9</sup>

91. However, there are a number of limitations in the existing alternatives. This may include, for example, that ownership of the underlying security is never transferred in Sharī'ah-compliant repos, which limits the ability of the "lending" party to use the collateral (which is one of the main drivers of capital market repos) as well as whether national regulations have implications for how effectively collateral can be used in the case of default to fulfil the obligation under the agreement. Another challenge is that some jurisdictions lack sufficient Sharī'ah-compliant securities to use as collateral in an Islamic repo-like structure. In order to further develop Islamic repos, jurisdictions would therefore need to establish deep and developed markets where Sharī'ah-compliant securities are sufficiently available in various features, including tenors, prices and liquidity characteristics.

#### **4.11 Implementing International Standards and Ensuring that Regulatory Requirements and Supervisory Frameworks Adequately Address Any Specific Risks Posed by ICM Products and Services**

92. Regulators should be able to regularly review whether their current regulatory requirements and framework adequately address any specific risks posed by ICM products and services to investor protection, fair, efficient and transparent markets, and reduction of systemic risks. A regular review of the perimeter of regulation should consider the effectiveness of existing regulations and whether they need to be modified, or whether new

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<sup>8</sup> Referring to AAOIFI Sharī'ah standard no. 58.

<sup>9</sup> Increased use of such structures may facilitate efficient liquidity management for IIFS

regulations are needed in light of existing gaps or new market developments in the ICM and any Sharī'ah specificities that it raises.

93. Policymakers and regulators should also work together to ensure consistent and timely implementation of international standards for the ICM, making use of the capacity-building and technical assistance programs offered by global standard-setting bodies such as the IFSB.

94. It is also important for regulators to promote proper corporate governance standards in ICM, as good corporate governance promotes a transparent and efficient market and enhances investors' confidence in the market, hence attracting a higher degree of investor participation in the market. Regulators should ensure that companies that have accessed the ICM to fulfil their financing needs have clear, transparent, timely and complete disclosure of material information, including information relevant to Sharī'ah issues. In addition to appropriate corporate governance frameworks that take into account the specificities of Islamic finance, it is also important that regulators ensure the implementation of appropriate Sharī'ah governance standards that ensure any claims made regarding the Sharī'ah compliance of capital market products are valid and that appropriate Sharī'ah governance frameworks are applied to different types of ICM instruments. Regulators should also reinforce mechanisms to monitor Sharī'ah compliance, and clarify the enforceability of agreements in case of disputes and the procedures for purifying tainted income.

95. Further, a holistic strategy for market development should take into account the necessary sequencing and pace of implementing international standards, including those issued by the IFSB, considering the stage of development of the ICM in each jurisdiction.

96. Regulators should have in place efficient supervisory and enforcement programmes that ensure efficient supervision of ICM intermediaries and conduct issues. Regulators should also be effective in their supervision of business conduct and ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed, including those related to Sharī'ah governance structures. Regulators should proactively supervise and monitor ICM intermediaries' behaviour and consider conduct implications, particularly during market stress and volatility, to detect indicators of emerging conduct threats and issues of Sharī'ah non-compliance.

97. Supervisory approaches also need to facilitate early detection of stresses in the markets, by developing financial risk indicators, proper risk assessment of firms, and stress-testing frameworks, among others, that take into consideration the specific nature and characteristics of the ICM.

98. Supervisory and enforcement measures should also be designed to prevent market abuse by building sound surveillance capacity. Market abuse undermines market integrity and investor confidence in the ICM. Regulators should have comprehensive inspection, investigation and surveillance powers designed to detect and deter manipulation and other unfair trading practices.

99. It is also important for regulators to monitor challenges arising from financial innovation. With new products and the increased use of technology in the ICM, there is a need for regulators and market participants to have efficient supervisory mechanisms in place, which could incorporate innovation technologies such as RegTech and SupTech. Innovation in the ICM should be encouraged and facilitated where it has the potential to improve market efficiency or to satisfy unmet demand. Regulators, however, need to monitor carefully any innovation which involves opacity and improper risk management approaches or Sharī'ah issues that may undermine confidence in the ICM. Regulators also need adequate resources, proper training and statutory authority to be able to keep close supervision of innovative financial products that are billed as Sharī'ah-compliant. Authorities should aim to strike a balance between innovation, diversification and regulation. With the COVID-19 pandemic, an increase in digital technology has also been observed. While the development of ICM requires it to embrace such changes in the industry and to keep up with advances in technology, this should be accompanied by the necessary regulatory policies and structures to support their growth, keeping in mind cyber-security issues and Sharī'ah compliance.

#### **4.12 Integrating Sustainability into Legal and Regulatory Frameworks for ICM Considering the Associated Risks and Opportunities**

100. The agenda for global sustainability has advanced in recent years as policymakers and market participants increase efforts to promote financial markets that support long-term sustainable economic development, including socio-economic and environmental factors. These issues are relevant for jurisdictions that seek to develop their ICM, which can provide opportunities to help meet global sustainable development needs while delivering long-term and resilient growth. The ideals of Islamic finance, sometimes articulated through the Maqasid

al-Sharī'ah, can be linked strongly with the aims of sustainability and, indeed, other areas of socially responsible investment (SRI) such as education.<sup>10</sup>

101. Different jurisdictions are at varying stages of progress in creating an enabling market environment for sustainable finance, but many have sustainability-related initiatives in their jurisdictions. These initiatives relate to disclosure frameworks, incentive structures, public and private collaborations, data collection methods, and external reviews and assessments. Further, there are also a growing number of sustainability-related Sharī'ah-compliant products and instruments, including green and sustainable *sukūk*, sustainable and SRI Islamic funds and ESG indices that are Sharī'ah-compliant.

102. Given the alignment of Sharī'ah investing with sustainable finance, some jurisdictions have focused their efforts on further developing the sustainability and SRI ecosystem while leveraging on Islamic finance. These include, for example, development of SRI *sukūk* or sustainability frameworks to finance Sharī'ah-compliant green, social and sustainable projects and to introduce various incentives to promote sustainable asset classes where issuers are eligible for tax deduction and grants to offset the external review costs incurred (e.g. in the issuance of sustainable *sukūk*).

103. Regulators may also require disclosure with regard to material ESG-specific risks (including transition risks) and opportunities in relation to governance, strategy and risk management of a Sharī'ah-compliant issuer. This information should be part of the overall disclosure that the issuer makes. Where regulators determine that ESG-specific reporting is needed, regulators and issuers should aim to ensure adequate data quality for ESG-specific reporting. Furthermore, sustainable Sharī'ah-compliant instruments should be clearly defined in terms of types of contracts used and should refer to the categories of eligible projects and activities that the funds raised through their issuance can be used for. Funds raised through sustainable Sharī'ah-compliant instruments may, for example, be utilised for projects and activities falling under one or a combination of three main categories – namely, environmental (such as renewable resources, combating/mitigating climate change, pollution and waste, and other environmental opportunities); social (such as human capital, product liability and other social opportunities); and governance. Regulators may define a list of eligible projects and activities for their jurisdictions, taking into account that an eligible project or activity cannot, at the same time, do any significant harm to any of the other ESG categories.

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<sup>10</sup> A third, overlapping, concept is environmental, social and governance (ESG) investing. The main difference from the other concepts is that ESG explicitly includes in its weightings the governance of the organisation receiving finance.

104. Regulators should establish requirements for the offerings of sustainable Shari'ah-compliant instruments, including, among others, the use and management of the funds raised through the issuance of such instruments, and the processes used by issuers for project evaluation and selection. Regulators may also establish ongoing disclosure requirements regarding the use of the funds raised through the issuance of sustainable instruments, including the extent of unutilised funds, if any. Regulation may also provide for measures to prevent, detect and sanction the misuse of the funds raised through the issuance of sustainable instruments.

105. The issues around sustainable finance and related disclosures will be dealt with in more detail in the IFSB guidance note (GN-9) on sustainability-related issues and disclosures.

#### **4.13 Encouraging, Monitoring and Regulating Development of Technology-Driven Products, Services and Infrastructure in the ICM**

106. Innovative business models and emerging technologies have been rapidly transforming the financial services industry, which presents opportunities for growth and development of the ICM. These include financing platforms such as peer-to-peer (P2P) financing and equity crowd funding (ECF); retail trading and investment platforms, including robo-advisers and social trading; and institutional trading platforms and the application of distributed ledger technologies (DLTs) (including blockchain technologies) to the securities markets. Shari'ah-compliant versions of many of these technologies have also emerged, but the extent of development, as well as its regulation, across ICM jurisdictions differs significantly from country to country.

107. While some jurisdictions have established tailored rules and regulations for fintech platforms, others do not have a tailored framework and operators are required to comply with existing regulations. Even fewer jurisdictions have issued specific rules or additional obligations for Islamic fintech platforms specifically. Given the nascent stage of such technologies and the limited application of Islamic models, the risks and benefits as well as challenges still need to be determined and ongoing regulatory oversight of developments and dialogue on the progress of regulation in this area is important. However, one common issue for several types of platform is clarity on what claims of Shari'ah compliance are made (a) about the platform and its operations;<sup>11</sup> and (b) about the investments offered or made through the platform – in particular, the compliance of the firm or activity in which an investment is

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<sup>11</sup> For example, the forms in which financing is provided, whether it be banks with an Islamic bank, etc.



made. In the latter case, particularly, it is important to be clear about what claim is made, with what authority, and whether the platform has itself assessed that claim. This is a matter that regulators should address in creating the relevant frameworks. IFSB-24 provides best practices for regulation of P2P financing and equity crowdfunding, cryptoassets, as well as retail trading and investment platforms (such as robo-advisers etc.), including recommendations related to Shari'ah governance, disclosure requirements, marketing and promotion and protection of client assets, as well as the applicability of other relevant Islamic capital market regulations and investor protection measures to new technologies in the Islamic capital market.

108. Jurisdictions may explore how technological solutions can enhance efficiency and investor access to the ICM. Such measures can also seek to facilitate the channelling of global investment flows into domestic ICM. For example, the increasing adoption of mobile and internet technology to offer ICM products has served to improve the participation of retail investors who might otherwise have limited access and/or funds to invest. Thus, financial technologies and digital financial services in the ICM can improve retail investors' access to Shari'ah-compliant products and services, as well as significantly contribute to improved market liquidity. Digital solutions tend to provide fast and highly mobile channels for both trading and distribution of products and services. This can have the capacity to attract large masses of retail investors to the ICM. At the same time, the competition that it posed to traditional trading channels can lead to an overall reduction in trading costs for investors.

109. Technological enhancements in the secondary markets could serve to improve market access, as well as provide for different trading models. New technologies may also act as enablers for the development of other market structures such as market-making capacity, all of which could contribute towards enhancing liquidity in – and ultimately deepening – the markets. Technological enhancements, including online trading, remote access mechanisms, electronic communication networks or alternative trading platforms that provide access to a larger pool of investors, and those that would actively trade in the market, could help to improve the problem of liquidity in the ICM.

110. At the same time, it is important to ensure that the regulatory and supervisory approaches to technological developments in the ICM ensure financial stability as well as adequately address Shari'ah-related issues. The failures of (conventional) P2P lenders in some jurisdictions have demonstrated that some new business models do carry risks. Regulators have taken various approaches to monitor and address the rapid technology-driven changes in the industry, including establishing dedicated fintech offices, contact points

and hubs, while others have launched regulatory sandbox frameworks that enable innovators to experiment with fintech solutions. One of the challenges that regulators may face is that while technology firms operate globally, regulation is conducted largely within national or sub-national borders. The local nature of regulation may create challenges regarding cross-border supervision and enforcement, whereas regulatory inconsistency across jurisdictions increases the potential for regulatory arbitrage. A similar challenge may occur in relation to Shari'ah compliance where there is a lack of consensus across different jurisdictions. Regardless of the approach taken by a jurisdiction, it is important for regulators to consider and address Shari'ah specificities in developing their regulatory frameworks for financial technologies and digital services.

## DEFINITIONS

<b><i>Ijārah</i></b>	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. An <i>ijārah</i> contract is binding on both contracting parties.
<b>Islamic Collective Investment Scheme (ICIS)</b>	Any structured financial scheme that, fundamentally, meets all the following criteria: <ul style="list-style-type: none"> <li>a. Investors have pooled their capital contributions in a fund (whether that fund is in a separate legal entity, or is held pursuant to a contractual arrangement) by subscribing to units or shares of equal value. Such units or shares constitute, in effect, claims of ownership of the undivided assets of the fund (which can consist of financial or non-financial assets), and give rise to the right or obligation to share in the profits or losses derived from those assets. Whether or not the Islamic collective investment scheme is managed by the institutions that established or sponsored it, it is financially accountable separately from those institutions (i.e. it has its own assets and liabilities profile), but excluding <i>ṣukūk</i>.</li> <li>b. The fund is established and managed in accordance with Sharīah rules and principles.</li> </ul>
<b><i>Murābahah</i></b>	A sale contract whereby the institution sells to a customer a specified asset, the selling price of which is the sum of the cost price and an agreed profit margin. The <i>murābahah</i> contract can be preceded by a promise to purchase from the customer.
<b>Sharīah board</b>	Jurists specialising in contemporary transactional jurisprudence, who are well acquainted with and experienced in the Islamic financial system in particular and the Islamic economic system in general. They issue binding Sharīah pronouncements and recommendations, and oversee the task of supervising and auditing the institution.
<b><i>Ṣukūk</i></b>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or a specific investment activity that is Sharīah-compliant.
<b><i>Takāful</i></b>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.