

## **An Islamic Perspective on Capital Markets and “Islamic” Securities in Malaysia**

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Financial systems channel funds in an economy from the surplus economic units lacking appropriate investment opportunities to the deficit economic units with such opportunities. The surplus units seeking returns by employing their funds in productive activities and the deficit units interested in exploiting their investment opportunities contact one another through a network of financial markets and institutions in the economy. The participants make financial contracts in ways which satisfy their requirements regarding liquidity, denomination, maturities, and risk diversification [Anwar (1987), pp. 296-297]. In this way, the financial markets contribute to a higher production, efficiency, and economic welfare of everyone in the society [Mishkin (1989), p. 45].

In recent years, the appetite for investment in the markets of developing countries has increased manyfold [Hussain (1994), p. 2]. A good many of such developing markets are in Islamic countries such as Egypt, Turkey, Bangladesh, Pakistan, and Malaysia. Well-developed Islamic financial markets would contribute towards economic development by attracting capital inflows and checking capital flight from the Islamic nations.

Islamisation of financial institutions, especially banking and insurance, has received sufficient attention since 1950. In fact, a number of Islamic banks and insurance companies are now operating worldwide. Islamisation of financial markets has, however, received relatively little attention from the academic and practitioners, although some “Islamic” securities have been introduced in several Muslim countries including Pakistan, Jordan, Sudan, Iran, and Malaysia.

The major task of this study is to discuss the “Islamicity” of the main activities in the conventional capital markets and the Malaysian “Islamic” capital market instruments in the light of Islamic principles. The study is organised as follows. An Islamic criteria for portfolio management through capital market activities is developed in Section 2. The “Islamicity” of conventional capital market (with an emphasis on secondary markets) operations and the “Islamic” capital market in Malaysia are discussed in Sections 3 and 4 respectively. Additional recommendations towards the Islamisation of capital markets are made in the final section.

### **ISLAMIC CRITERIA FOR PORTFOLIO MANAGEMENT**

There are three broad sets of activities which are used to change a portfolio composition: production, transfers, and exchange. Production, *per se*, is a self-centred

activity which does not need social contracts. Production activities change portfolio by giving new forms to the factors already owned by the producers.

Transfers and exchange are means of changing the portfolio through social contracts. Transfers include inheritance, *zakah*, *sadaqah*, dowry, gifts, taxes, stealing, and so on. Transfers represent one-way movement of property, whereby the portfolio of one party shrinks to expand the portfolio of another party. Exchange refers to the mutual 'give and take' activities. Trade, debts, *riba*, and gambling are forms of exchange whereby the portfolio composition of each party participating in the exchange changes.

The Qur'an emphasises that *Adl* (justice) must prevail in all exchange contracts. There shall be no devouring of property of others through trading (*al-Nissa*: 29 and *al-Baqarah*: 188). *Adl* requires that the items exchanged among the parties must be of equal value. The rules followed in gambling and *riba* necessarily result in unequal exchanges of values. That is why, perhaps, the Qur'an has prohibited both gambling (*al-Baqarah*: 219; *al-Maidah*: 93-94) and *riba* (*al-Baqarah*: 275-276 and 278-280; *Aale-Imran*: 130). The objectors to the prohibition of *riba* used to argue that both trade and *riba* are similar exchange contracts. The Qur'an removed their misgivings by declaring that "Allah has permitted trade and forbidden *riba*" because *riba* (exchange of a thing, money or commodity regardless of its quality on spot or on deferred basis in unequal amounts) violates *adl* (*al-Baqarah*: 279).

Portfolio composition can be changed by trading. But trade, *per se*, does not guarantee *adl* in the sense of exchange of equal values. Values of trading commodities are approximated by the market prices. According to economic theory, the exchange of commodities in equal values prevails only in a situation of general equilibrium prevailing in perfectly competitive markets. In all other situations, market prices of goods and resources deviate from their intrinsic values. Therefore, the establishment of perfect competition in all markets would be a move towards establishing *adl*.

Perfect competition is a theoretical construct which does not exist anywhere. Nobody wants to pay more than the intrinsic value of the commodities sought in exchange. But, in reality, assigning correct values to the commodities in exchange is impossible.<sup>1</sup> Therefore, the Qur'an, by virtue of being holy guidance (*al-Baqarah*: 2; *al-Luqman*: 3), has issued additional injunctions for the sake of *adl* in trading, requiring "traffic and trade with mutual consent" (*al-Nisaa*: 29) and the use of measures and weights with justice (*al-Inaam*: 152; *al-Aaraaf*: 85; *al-Rahman*: 9; and *al-Huud*: 84-85).

<sup>1</sup> According to economic theory, many trading partners enjoy consumer surplus and producer surplus (i.e., commodities are higher values than the prices paid for them) even when the trade takes place with mutual consent. If one of the trading parties deliberately transmits a false impression (say) by exaggerating positive aspects of a commodity and playing down or hiding the defects of the commodity, so that the commodity is conceived to be of a value higher than its actual value, then the excess so obtained is 'devouring', not a profit. So, even though the trading is seemingly transacted with mutual consent, it is not necessarily free from 'devouring'. Such exchanges are incompatible with the principle of *adl* as desired by the Qur'an. However, unintentional misrepresentation on the part of both parties is unavoidable and is realised in the form of economic profits accrued to a business concern.

Moreover, trade shall be conducted in *halal* (legitimate) commodities only, because *haram* (illegitimate) commodities are valueless for Muslims. The commodities shall be in possession of the sellers so that the performance of the exchange contract is ensured.

Many scholars, including Chapra (1984); Khan (1994); Metwally (1984); Zaman (1986); El Gari (1993); and Mannan (1993) have discussed the Islamicity of capital markets with reference to *riba*, gambling, *gharar*, and speculation. Prohibition of *riba* and gambling are in the Qur'an, as noted above. Prohibition of *gharar* is based on '*mutwatir*' *ahadith* [Anwar (1994), p. 4]. *Gharar* has been defined as risk, uncertainty, indeterminacy, and lack of ability to deliver the goods subject of the sale. Unfortunately, though, the interpretations are not only at variance from one another, but some of them are also in conflict with Islamic injunctions. For example, *gharar* is defined as risk. Risk is a part and parcel of business activities and, therefore, cannot be detached from trading. Undertaking business risks cannot fall in the prohibited forms of *gharar* because trading is not only commended by the Qur'an, but was also widely practised by the Prophet (PBUH) and his companions. Moreover, the Islamic principle is that anyone who wants to earn a return should be prepared to accept risk as well,<sup>2</sup> which, again, implies that taking and managing business risks cannot be *gharar*.

Speculation refers to a phenomenon of holding securities for relatively short durations. Speculation is a natural outcome of separation between ownership and management and of the flexibility of exchanging ownership [Qureshi (1988), p. 13] in the capital markets. Speculation is deemed prohibited because of the partial resemblance of its consequences with gambling. For example, speculation is objected to because both gambling and speculation result in mere redistribution of ownership among the participants. However, to the best of my knowledge, there is no reference made to speculation in the Qur'an or *Ahadith*.<sup>3</sup>

In a nutshell, all trades in financial assets are Islamic so long as the principle of *Adl* (along with other related injunctions meant to impart *adl*) is followed. The conformity of major activities in the conventional capital markets as well as Malaysian "Islamic" capital market is discussed in the following sections on the basis of the criteria of *adl*.

### 3. ISLAMICITY OF CONVENTIONAL CAPITAL MARKET ACTIVITIES

During the early period, financing of business operations was done by personal contacts among the surplus units (households) and the deficit units (entrepreneurs) as exemplified by the financial contracts made between Prophet Muhammad (PBUH) and Khadijah before his of prophethood. Such financing practices continued in the Islamic

<sup>2</sup>This is based on the *hadith*: "*al-kharaju bil daman*", meaning the entitlement to gain coextends with the willingness to accept the liability of loss [Khan (1994), p. 27].

<sup>3</sup>Evaluations based on *gharar* and speculation are problematic because there is a wide variation in the interpretation of these concepts adopted by the scholars. Therefore, the issues of *gharar* and speculation are left aside in the course of determining the Islamicity of capital market operations.

World during, as well as after, the lifetime of the Prophet (PBUH). The financiers used to select entrepreneurs on the basis of their business acumen and honesty. The same principle is followed today in financing businesses. However, corporations have taken up the role of the deficit entrepreneurs and direct personal contacts between the surplus and deficit units have changed into impersonal contacts through the financial markets and financial institutions. Stocks and debt securities are issued by the corporations to the surplus units in the primary markets as evidence of partnership and debt financing. Business performance of the corporations (run by a team of entrepreneurs) is monitored by the financial markets. Honesty of the corporations is guaranteed by the authorities through appropriate legal means. In essence, the major role performed by the capital markets, i.e., financing business by channelling funds from the surplus units to the deficit units through primary markets, is perfectly Islamic. Hence, the stocks issued by the firms which deal in *halal* activities are Islamic. The Islamic stocks may be issued on the basis of *musharakah* (joint ventures) and *mudharabah* (trust) financing.<sup>4</sup>

The conventional debt securities represent loans repayable at a stipulated date and rate of interest (*riba*) during the life time of the debt. The Qur'an permits debt<sup>5</sup> financing for a fixed period (*al-Baqarah*: 282-283), and the debt resulting from deferred trade regardless of the length of duration of the debts, but prohibits *riba* (unequal exchange) in debt transactions. In fact, parties to a debt contract are urged to write down relevant conditions insisting on preservation of *adl* in writing the debt scripts. Compliance with the stipulated terms and repayment of debt are given utmost importance. For example, the Qur'an commands that the amount of debts must be deducted to repay the debts from the inheritance of a deceased debtor before distributing it among the heirs (*al-Nisaa*: 12). As *riba* is prohibited, the conventional debt securities must be cleansed by eliminating interest clauses and other illegitimate components, or be replaced by suitable interest-free Islamic debt instruments. For example, interest-free debts contracted at (1) zero rate of interest (*riba*) in the spirit of the Qur'an<sup>6</sup> (2) a provision under which the sellers of the securities (borrowers) may voluntarily reward the buyers (lenders), following the example of the Prophet (PBUH)

<sup>4</sup>There are no direct references to *musharakah* or *mudharabah* in the Qur'an. Legitimacy of these contracts in the Qur'an may be determined by making 'remote' interpretations of *al-Nisaa*: 12 on *musharakah* and of *al-Inaam*: 156, *al-Nisaa*: 101, and *al-Maidah*: 109 on *mudharabah*.

According to Ibrahim, legitimacy of *mudharabah* is found in following *hadith*: "There are three things which have the blessing of Allah: deferred payment sale (*bai Mu'ajjal*), *al-Muqaradhadh* (*mudharabah*), and mixing barley with wheat for home consumption not for sale." (*Ibn Majah*). The legitimacy of the contract of *musharakah* has been derived from the Qur'an in *Surah al-Nisaa* which states to the effect that "They share in a third"; and the *Sunnah* to the effect that "Allah helps the partners in helping their capital safe and making their trade profitable so long as they not betray each other." [Ibrahim (1994), pp. 12-13].

<sup>5</sup>There are several *ahadith* referring to debts. For example, legitimacy of debts may be concluded from the following *hadith*: "Whoever contracts a debt intending to repay it, Allah will pay on his behalf, and whoever contracts a debt intending to waste it, Allah will bring him ruin" (*Bukhari*).

<sup>6</sup>While condemning *riba*, the Qur'an advises the creditors to get their principal debt from the debtors (*al-Baqarah*: 279).

[Anwar (1993), p. 965], and (3) the 'Time Multiple Counter Loan' (TMCL) concept<sup>7</sup> would be Islamic. Lenders have no right to demand any returns under these contracts. However, the creditors interested in pre-determined fixed returns on their funds may deal in securities tailored on the basis of *Murabahah* (mark-up sales), *bai muajjal* (deferred payment sales), *Ijarah* (renting/leasing), and *bai al-Salam* (advance payment sales).<sup>8</sup>

Trading of stocks in the secondary markets is, in essence, selling and buying of one's entitlements in the company's assets and the profits associated with them. Prices of the stocks, like those of assets, fluctuate with changes in the business and market conditions. Therefore, trading of stocks at varying prices in the secondary markets, in essence, is trading of commodities. The trading would be perfectly Islamic provided the Islamic principle of *adl* and other related injunctions are observed in the trading of the stocks.

All the credit market instruments can be classified into four categories with respect to the return (interest) on them [Mishkin (1989), pp. 72–75]. First, the 'Simple Loan', which is repaid at the maturity date along with an additional amount as interest. Commercial loans to businesses are often of this type. Second, the 'Fixed Payment Loan' is repaid by making equal monthly payments, each payment comprising parts of the principal debt and the interest on the debt, for a set number of years. Instalment loans and mortgages are frequently of the fixed payment type. Mortgages are loans where land or a structure serves as a collateral for the loan. The Qur'an has allowed collateral on debts (*al-Baqarah*: 283) but prohibited interest. Therefore, Islamic banks practise *murabahah-cum-bai muajjal* and *ijara* in place of fixed-payment loans. Third, the 'Coupon Bond' pays a fixed interest to the holder of the bond (coupon payment) every year until the maturity date, when the principal debt is also repaid. Treasury bonds, treasury notes, and corporate bonds are examples of coupon bonds. Fourth, the 'Discount Bond' is bought at a price below its face value (at a discount), and the face value is repaid at the maturity date. Treasury bills, savings bonds, and the so-called zero-coupon bonds are examples of discount bonds. The discount bonds do not make any interest payments during the loan period. Discounting on debts is *riba* because it represents exchange of debt in unequal amounts. In fact, in discounting, interest is

<sup>7</sup>The Time Multiple Loan Concept (TMLC) introduced by Ahmad (1989) is elaborated in his book *Towards Interest-free Banking*. According to the TMCL concept, both parties will exchange securities that are equal in worth but unequal in terms of time-periods within which accounts are to be settled. Under such a scheme, a party 'A' wishing to obtain financing from another party 'B' "borrows" \$1,000 from 'B' for one year and should also "lend" (say) \$125 to 'B' for a period of eight years so that the product of the loan amount and the time-period exchanged between both parties are equal (i.e.,  $1000 \times 12$  dollar-months advanced by party 'B' is equal to  $125 \times 12 \times 8$  dollar-months paid back by 'A').

<sup>8</sup>The Qur'an (*al-Baqarah*: 282) permits *bai al-Dayn* (trade with future obligations), which can be interpreted to cover both *bai Muajjal* and *bai salam*. The legitimacy of *murabahah* and *ijara* (as practised by Islamic banks) is disputed.

deducted from the principal debt when the bond is purchased.<sup>9</sup>

All debt securities represent fixed amounts of debts.<sup>10</sup> Trading of debt instruments at prices lower or higher than the par values (as in discounting) is unequal exchange of money, which is *riba*. Therefore, debt securities shall not be traded at prices different than their par values.<sup>11</sup>

Although trading in capital markets, *per se*, is legitimate, yet individual operations and securities may be in violation of Islamic injunctions. Therefore, the legitimacy of preference shares, futures, options, short-selling, securitisation, and all debt instruments must be examined individually. Unfortunately, it cannot be attempted here due to limitations of space. However, individual instruments traded in Malaysian "Islamic" capital market are examined below in the light of the Islamic criteria of *adl*.

#### 4. ISLAMICITY OF "ISLAMIC" SECURITIES IN MALAYSIA

Recently, a number of financial innovations bearing "Islamic" title have been introduced in Malaysia. Islamic money market was introduced on January 3, 1994. The money market comprises interbank trading in Islamic financial instruments, Islamic interbank investments, and Islamic interbank cheque clearing system. In addition, some Islamic Unit Trusts, Islamic Private Debt Securities, and an Islamic Stock Broking firm have been introduced on the capital market front.

Agreements between the Unit Trust companies and the investors are made either on profit-sharing basis or management fee basis [Al Habshi (1994), p. 10]. Unit Trusts are Islamic as long as the funds generated are invested in the *halal* stocks only.<sup>12</sup>

With the advent of the Bank Islam Malaysia Berhad (BIMB), Government Investment Certificates (GICs) were issued by Bank Negara Malaysia (BNM) under the Government Investment Act, 1983 to take the place of "treasury bills issued by the government or by the government of any state authorised to issue treasury bills" [Ibrahim (1994), p. 22]. The GICs were issued so that the BIMB could comply with the liquidity requirement imposed by the BNM on banks because the bank, being Islamic,

<sup>9</sup>Zaman is in favour of debt discounting. According to him, discount accrues due to a difference between the principal amount of the loan and the purchase price of the bond. "The price is determined by the market forces as in normal trade. This source, therefore, is a legitimate source according to basic principles of trade in Islam." [Zaman (1986), p. 137].

<sup>10</sup>If the contracting parties are concerned about the erosion of purchasing power of their debts stipulated in monetary terms, then they will use some hedging clauses in the debt contracts to ensure that *adl* is served. Such interest-free alternatives may be found in Anwar [(1993), pp. 967-969].

<sup>11</sup>Gari agrees with this opinion as follows: "There is no room for the forces of supply and demand in fixing the price of the deed. It is a debt for certain sum known in money, hence no settlement may be made for a lower or a higher sum than the nominal value. Consequently, there is no possibility for the emergence of a secondary market for such deeds. It could be said that debt instruments ... cannot be traded in an Islamic market even though the element of interest is not there" [El Gari (1993), p. 11]. Refer to note 10 above for a contending position.

<sup>12</sup>There are 320 companies on the main board and 90 companies on the second board of the Kuala Lumpur Stock Exchange, out of which 150 and 82, respectively, are considered *halal* by the Bank Islam Malaysia Berhad.

cannot purchase or trade in interest-bearing securities such as Malaysian Government Securities and Malaysian Treasury Bills. The GICs are issued on the basis of *qardhul hasan*, whereby the purchase of GICs by institutions or individuals is considered a benevolent loan to the government. GICs are of various denominations and maturities. Each certificate has a face value in multiples of M\$ 10,000 issued at par. GICs are redeemable on maturity or on demand at BNM [Tajudin (1994), p. 13].

The holders of the GICs are guaranteed payment of the principal debt but no returns. The returns, if paid, are at the absolute discretion of the government [Khalid (1994), p. 6]. Under these conditions, the GISCs are certainly Islamic because the Prophet (PBUH) has himself done so [Anwar (1993), p. 965].

In reality, holders of the GICs have been annually rewarded by the government.<sup>13</sup> The returns are pegged on to the GDP growth rate [Kamil (1994), p. 4]. Returns declared during 1989–92 have ranged from 5.5 percent to 7.92 percent on GICs with maturities of 1–5 years [Khalid (1994), p. 7].

When BIMB commenced its operations in 1983, the ceiling for the issuance of GICs was set at RM1 billion. The ceiling was raised to RM2 billion in March 1993 with the introduction of the interest-free banking Scheme (IFBS) allowing Islamic counters in the conventional banks. The ceiling was later raised to RM5 billion in January 1994 to cater to the overwhelming demand from the institutions participating in the IFBS. The outstanding amount of GIC, as at July 30, 1994, is RM4.8 billion [Khalid (1994), p. 7] which indicates that there is a need to further increase the ceiling and introduce new Islamic instruments.

Islamic Private Debt Securities (IPDS) are normally concluded on a fixed rate, representing the cost and profits negotiated on the issue, locked-in for the whole duration of the tenor [Khalid (1994), p. 9]. A few IPDS are examined below using actual examples.

(1) The first IPDS was introduced in 1990 when a deferred sale facility under the concept of *Bai' Bithaman Ajil*, amounting to RM125 million, was syndicated by the BIMB for a multinational company. Under this facility, the BIMB arranged a group of financiers who purchased certain assets from the issuer amounting to RM125 million. These assets were then sold back to the issuer at a mark-up price (*murabahah*), representing the cost (purchase price) and a pre-determined profit-margin (mark-up). However, the payment is deferred (as *bai bithaman ajil*), so it becomes a debt. The company issued a series of promissory notes (primary notes covering the cost and secondary notes covering the mark-up) to the syndication participants with amounts and maturity dates according to the repayment schedules of the debt [Tajudin (1994), p. 18].

<sup>13</sup>In fact, a committee, comprising representatives from the Economic Planning Unit (EPU) and the Religious Affairs Section of the Prime Minister's Department, the Ministry of Finance, and Bank Negara, has been set up to advise the Government on the rate of return to be declared each year on the GICs.

These notes are tradable in the secondary market [Khalid (1994), p. 7].

These securities contain several components: first, a set of assets is sold to a syndicate by a company at one price and then the same assets are bought back by the same company from the same syndicate at another price. That is, one set of assets commanded two different prices at the same time. This is contrary to the requirements of *adl*. Second, buy-back price payable by the company to the syndicate becomes a debt on the company which is allowed by the Qur'an as *bai al-dayn*. Third, the debt is securitised, i.e., a set of promissory notes (scripts) is issued to the syndicate members which is a technical formality evidencing terms of the debt. Fourth, the scripts which essentially represent debt are traded at varying prices in the securities market. The trading of debt scripts at prices other than par values, as explained above, is *riba*.

(2) Cagmas Berhad recently introduced a scheme known as the 'Islamic Housing Debt Securitisation' Scheme'. Under the scheme, Cagmas mobilises funds by issuing *mudharabah* bonds, known as 'Bon Mudharabah Cagamas' (BMC). The BMCs are issued on the basis of profit-sharing or *Al-Mudharabah*, whereby bondholders and Cagmas would share the profits based on a specific profit-sharing ratio. Then Cagmas uses these funds to purchase existing Islamic housing debts of BIMB and IFBS at a discount. The discounts represent profits to be shared between Cagmas and the BMCs holders.

The first series of the scheme was launched on March 1, 1994, in which Cagmas purchased RM30 million of BIMB's housing debt and issued BMC of the same amount to fund the purchase [Khalid (1994), p. 8]. The BIMB house financing facility bears return of about 6.3 percent per annum. On the basis of a profit sharing ratio of 90:10 respectively between the financiers and the Cagmas, the return to the BMCs holders from their subscription to the said bonds will be 5.7 percent annually. [Kamil (1994), pp. 4-6].

Securitisation of housing debt is a technical matter but its sale at a discount to Cagmas is an act of *riba* because a debt shall be exchanged only at par value. *Mudharabah* contracts between the financiers and the Cagmas to share profits in the ratio of 90:10 are legitimate, but the "profits" themselves are nothing but *riba*.

(3) A recent example of Islamic debt securities (IDS) with detachable warrants is the issue made by Petronas Dagangan Berhad (PDB). The IDS are like zero-coupon bonds except that the IDS was issued as a consequence of securitisation of an existing *qardhul hasan* extended by Petronas to the PDB. The IDS issues are enhanced with warrants. It is the first Islamic instrument listed on the Kuala Lumpur Stock Exchange.

The PDB issued a RM300 million redeemable unsecured IDS together with 120 million detachable warrants. IDS represent a debt whereby notes are issued by the issuer and subscribed by investors at a discount. Discounting is an act of *riba* as noted above. Upon the maturity of the notes, the holder will be repaid the full face value of the notes. Warrants are created and issued by a resolution of the company that gives the right to



the registered holders to buy new ordinary shares in the company at the prescribed price. There is a time limit to the subscription period of the warrants. The IDS and warrants are issued and traded on discount basis [Aziz (1994), pp. 4-5]. The warrants are normally issued at a premium. Premiums entitle the holders of the warrants to purchase company stocks at the strike price if prices of the stocks rise during the warrants period. The warrants are not Islamic because they represent exchange of scripts of nil intrinsic value against a price.

(4) Islamic Accepted Bills (IAB) are short-term papers equivalent to bankers' acceptances; the underlying contract is the *al-Murabahah* (cost-plus) financing contract. BIMB, as the financier, enters into trade financing contracts of *Murabahah* with the clients in order to facilitate the financing of their imports; the credit here is created from the deferred payment flexibility that is extended to the client. Then the debt is securitised through the issuance of IAB with maturities ranging from 30 days to 6 months. The IABs are actively traded in the Islamic interbank money market. Total average volume currently outstanding is about 20.5 million. Current yield ranges from 4.2 percent to 4.4 percent per annum. Trading of the IABs is *riba* as debts will not be traded at a price different than the par values.

## 5. RECOMMENDATIONS TOWARDS ISLAMISATION OF CAPITAL MARKETS

All such forms of financing and trading scripts in the primary and the secondary markets, respectively, which maintain *adl* among the participants, are Islamic. In this respect, all debt instruments traded on discounts and containing clauses on interest will be discontinued. However, new Islamic instruments will have to be introduced to perform their functions. Instruments may be based on the already-known Islamic modes of financing or new modes which do not violate the aforementioned Islamic principles.

Perfect competitive markets are presumably favourable to *adl*. In reality, only financial markets are relatively closer to the perfect competitive models. Competitive financial markets yield profits close to the normal profits in equilibrium. However, performance in the capital markets depends heavily on the use of available information and technology. The task of an Islamic state will be to provide competitive financial environment which conforms with the *shariah*, Islamic ethics, and the public impression of *adl*.

Literal conformity of operations with the *shariah* does not guarantee their acceptance by the public. Market operations shall be such that the public is convinced of their consistency with the Islamic norms of *adl*. For example, the *murabahah* and *bai bithaman ajil* operations are consistent with the *shariah* but the public suspects their permissibility because they do not seem to reflect *adl*. Similarly, the rules of *shariah* might dictate forms of business, but the spirit of business (exchange according to the

intrinsic values of the commodities) will result only if market participants observe Islamic ethics.

Islamic governments would also have to set up independent agencies throughout the country to disseminate and advertise basic financial data, investment opportunities, and Islamic objectives served by investing in various securities, in a language accessible to the semi-literate masses with some savings which can be mobilised for the sake of economic development. For example, the masses should be educated on benefits, costs, and other implications of investing in the capital markets concerning liquidity, expected returns, use of securities as collateral for other purposes, and so on. Mass media, advertising, public lectures, workshops, and other suitable means may be used for this purpose.

Physical facilities for the efficient conduct of market operations will be guaranteed by the state as was done by the Prophet (PBUH) by establishing a "tax-free" market in Medina [Kallek (1994), pp. 2-4]. Similarly, the Prophet (PBUH) checked insiders' trading by banning the buying of commodities from the ill-informed villagers outside the market-place so that they could know and benefit from the market information. An Islamic state shall implement measures to check insiders' trading in the capital markets.

Trading in the capital markets is the game of a few wealthy people in the Muslim countries. So the wealth keeps on circulating among them only. This situation is certainly contrary to the teachings of the Qur'an, which commands that wealth shall not make a circuit between the wealthy among you (*al-Hashr*: 7). Therefore, it is essential that the capital markets be so developed that wealth circulates among the widest possible segments of population in the country. It is possible to make a headway towards this through the capital markets by securitisation of finance into shares in small denominations and encourage the participation of people of small means [Mannan (1993), p. 60]. Of course, if Muslims develop a habit to acquire stocks, bonds, and other financial instruments with their savings, then they would contribute towards a wider circulation of wealth as well as enhancement of capital formation. Perhaps it will be made obligatory that every adult citizen hold shares of a certain minimum value. In fact, even *Zakah* recipients can be drawn into the financial markets without interrupting their spending plans [Anwar (1992)].

Finally, capital markets can be relied upon for developing perfect competitive markets wherein exchange would yield normal returns according to *adl*, mutual consent of the participants, and Islamic requirements regarding wider circulation of wealth.

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## Comments

Muhammad Anwar's paper is on a subject of vital importance. He offers a *Shari'ah* appraisal of the attempts to build the Islamic money market in Malaysia. The author addresses the traditional stock market as well as money market operations. Trading of company shares (stock market operations) and tradeability of debt securities are two separate topics. The author assesses both issues mainly on the criteria of *adl* (justice) and *riba*. Perhaps this explains his clubbing of two separate themes into one paper.

According to the author, *adl* requires that the items exchanged among the parties must be of equal values. This position needs reconsideration. *Adl* is a legal concept in the Islamic lexicon. In dealings of the human beings with one another, *adl* means giving others their rights, which become due as the result of entering into *Shari'ah*-permitted exchanges. Thus, for example, A can sell a kilo of apples to B for Rs 100— of course, with the latter's consent. The price can as well be Rs 50 per kilo. Both transactions would be perfectly legitimate: there is no *adl* or lack of it in either case. Furthermore, in this instance of the apples versus rupees exchange, the question of equivalence of values of rupees and apples is irrelevant for the following reason. The price of apples simply represents the rate at which both the seller and the buyer willingly exchange property rights of their apples and rupees, respectively. The buyer seeks utility, and the seller the ability to buy other things. The two of them are not directly comparable.

Even in a simple loan transaction, when there is no inflation, if one takes into account the cost of recollection of money and that in the form of the income foregone, in real terms the sum which a lender gets back under the *A'hkam* (*Shari'ah* edicts) of *riba* is necessarily less than the sum given by him. Thus, this exchange too does not fit into Dr Anwar's criteria of *adl* in terms of the equivalence of values.

Again, the author is not on safe ground when he speaks of perfect competition: "According to economic theory, exchange of commodities in equal values prevails only in a situation of equilibrium in perfectly competitive markets. In all other situations, market prices of goods and factors deviate from their intrinsic values. Therefore, the establishment of perfect competition in all markets would be a move towards *adl*." In the normal case of increasing marginal costs,  $P=MC$  as a firm's decision rules do not mean that all intra-marginal units are being sold at their intrinsic 'marginal cost' values.

In Section 3 of the paper, the author gives some Islamic guidelines for issuance and tradeability of stocks and debt securities. He correctly notes that the trading of shares is like the trading of commodities. If so, the *Shari'ah* position on various issues ought to be determined like the *Shari'ah* edicts for trading. These include (i) no trading of '*haram*' (something prohibited), (ii) no *riba*, (iii) no selling of something non-existent, (iv) principles for forward buying and selling, and so on. The author does not go into all these issues. The paper is largely devoted to matters related to debt securities

issued in Malaysia during the last few years.

The creation and tradeability of debt securities is a controversial matter. The author contends that debt can be contracted on the basis of zero rate of interest, and securitised. We do not see any problem with this position. It is also acceptable that issuing a zero-interest bond at a price below its face value amounts to *riba*. Similarly, there does not seem to be any fundamental *Shari'ah* problem with the notion of the creation of debt on the basis of *murabahah* (mark-up sales), *bai muajjal* (deferred payment sales) or *bai salam* (advance payment sales). However, creating debt on the basis of *ijarah* (renting/leasing) contracts is doubtful. Likewise, there is a need to review the Islamicity of the "Time-Multiple Counter Loan" concept on grounds of *riba*. However, the idea of debtors' "routinely" rewarding the creditors with an excess over and above the principal, though voluntarily, is a mockery of the *A'hkam* of *riba*.

In his review of Malaysian debt securities, the author fails to note that there is *riba* in the "by-back transaction" underlying the creation of Islamic Private Debt Securities (IPDSs). We share his reservations about there being *riba* at the stage of the creation of BMC *modarabah* bonds by Cagmas Berhad. The author holds that the trading of existing debt securities at prices other than their par values in *riba*. This general position needs to be reviewed in the light of the principles for transferability of debt securities: Under certain conditions, the difference between the sale price and the par value of a debt security may not be *riba*. The elaboration of this point is beyond the scope of this comment. In passing, one may note that the preceding points also apply to the tradeability of Islamic Accepted Bills (IABs).

The Islamic Debt Securities (IDSs) avoid the aforementioned problems of *riba* associated with the creation of the IPDSs and BMCs. However, the offer of detachable warrants brings *riba* into the picture again because the creditor in a debt cannot have contractual claims in any form—other than the principal—against the debtor. Any discrepancy in the giving and taking-back of the principal in loan transactions is *riba* [Tahir (1994)].

One cannot disagree with most of the recommendations made by Dr Anwar towards the Islamisation of Capital markets. However, caution is warranted against taking a tinted view of *adl*. On the whole, this is a timely and informative paper for all those who are trying to develop new Islamic financial instruments to meet the diverse needs of business and industry.

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