

2011

Developing a Sukuk Market in the Maldives

Final Report

This report contains information that will be used to provide a set of recommendations for the Capital Market Development Authority (CMDA) project 'Developing a Sukuk Market in the Maldives'.



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About this report

As part of the Capital Market Development Authority (CMDA), 'Developing a Sukuk Market in the Maldives' project, the Securities & Investments Institute Asia-Pacific (SiiA) has conducted a fact finding mission as a preliminary step to offer advice on the introduction of Sukuk and other Shariah compliant products in the Maldives.

SiiA consultant Ms Aishath Muneeza visited Maldives in June 2011 to conduct a series of interviews with key members of the CMDA Board and Management, as well as other relevant stakeholder (Appendices B). During the visit Ms Muneeza has reviewed applicable documents (Appendices A) that are relevant for issuing Islamic capital market instruments.

This report includes observations that will form part of 'Developing a Sukuk Market in the Maldives' report which will contain advice and recommendations aiming to support CMDA in developing relevant regulatory considerations and developing relevant Shariah compliant products in major areas named in the Request for Proposal stated below:

- With reference to previous studies conducted by the CMDA and through consultant's fact finding, advise on legal framework and infrastructure to support the introduction of Islamic Capital Market products in the Maldives (including shariah screening process, structure of sukuk etc.)
- Draft relevant regulations for the introduction of sukuk market and other shariah compliant products in the Maldives (adopt the regulations set by Securities Commission Malaysia on the Islamic Capital Market where appropriate)
- Establish rules and procedures for Capital Market Shariah Advisory Council (including procedures for appoint of Members to Council, draft guidelines on the shariah compliance review process, identify mechanisms for review of compliance)
- Identify and examine current market constraints and impediments for issuance of shariah compliant products in the Maldives
- Advise on the primary market and secondary market for shariah compliant products including sukuk
- Advise on licensing structure for market intermediaries dealing in shariah compliant products
- Make recommendations to adopt international standards for shariah compliant products

As a part of this project Ms Muneeza has also conducted a project dissemination workshop and an in-house Islamic Capital Market Awareness Workshop for the staff of the Capital Market Development Authority.

This project was successfully concluded in September 2011. It is anticipated that the findings of this report will assist the regulator of capital markets in the Maldives to pioneer a full-fledge Islamic Capital Market in the future. This report is compiled by the Capital Market Development Authority.



CHAPTER ONE: CAPITAL MARKET SHARI'AH ADVISORY COUNCIL OF CMDA

1.0 Introduction

The Islamic Law or Shari'ah is a requisite to Islamic banking and finance industry. All the affairs related to the Islamic Capital Market, which is a major component of the Islamic banking and finance industry, shall hence be carried out in accordance with the principles of Islamic law. An independent entity is ideally established to monitor the Shari'ah compliance in the capital market transactions; namely Capital Market Shari'ah Advisory Council or Committee (CMSAC).

The CMSAC plays the role of the watchdog protecting the Islamicity of the transactions carried out in the Islamic capital market. As the regulator of Islamic Capital Market, it is essential for CMDA to establish a CMSAC to ensure Shari'ah compliance in all the activities that is carried out in the Islamic Capital Market of Maldives. Thus, there is no doubt about the essential requirement of having a CMSAC. However, the formulation of the essentials of CMSAC, which is at the heart of Shari'ah governance, is imperative to ascertain successful Islamic Capital Market operations. The technical aspects of institutionalizing the Shari'ah advisory body as well as their role, capacity, appointment procedures, operational guidelines and compliance review processes need to be clearly penned to pave way for the expeditious functionality of the council.

This report would assess the current practice followed by CMDA and it will analyze potential solutions and the best practice on the matter. Subsequently the guidelines and CMSAC operational necessities will be formulated and recommended.

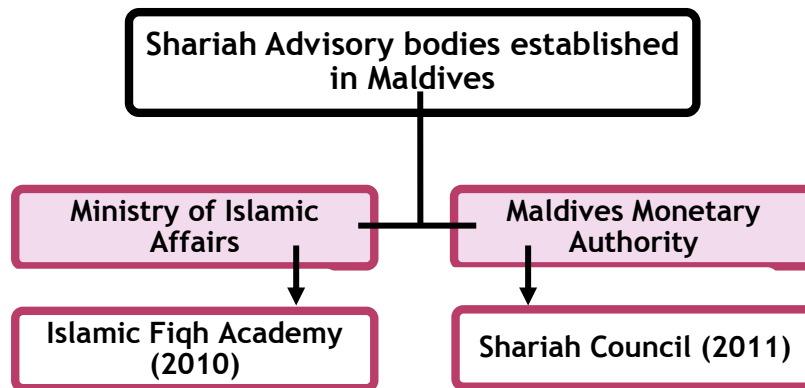
2.0 Incumbent Shari'ah Advisory Bodies in Maldives

There are two major institutions established in the country for the purpose of deliberating and addressing issues from the Shari'ah perspective. These institutions



have different mandates that complement the body under which it operates. Details of these entities are provided below:

Diagram 1: Shari'ah Advisory Institutions Operating in Maldives



2.1 Islamic Fiqh Academy

The Islamic Fiqh Academy (IFA) of Maldives created by the Ministry of Islamic Affairs of Maldives function as the advisory body to MoIA catering to any issues that need deliberation and scholarly religious consensus pertaining to general matters of religion at the national level.

This entity supplements the efforts of MoIA in unifying the views about religious issues by providing Shari'ah guidance associated to religious affairs. As the name suggests, the Islamic Fiqh Academy of Maldives is an entity that utilizes academic forethought via Fiqh. They cater for general religious matters and with a broad mandate, the tasks that they undertake are of critical religious significance.

This is an institutional body under the executive to which any other entity may refer and request aid in addressing any religious issues. Hence it is an important part of the multi-tier Shari'ah compliance assurance system.

2.2 Shari'ah Council of MMA

The Shari'ah Council of MMA is a body that functions within the organizational structure of MMA to deliberate over issues related to Islamic banking in Maldives.



Their mandate is to independently advise on Shari'ah compliancy of the Islamic banking industry.

In order to cater for the growing demand for Islamic banking services MMA has formed this council with the specific task to monitor and evaluate the banking arena. They refer to the IFA as well but with the polar difference in mandate and the required technical expertise it was essential for them to create the in-house Shari'ah advisory council. Hence, their jurisdiction and technical competency is limited to the Islamic banking services, which is also different from the capital market industry.

3.0 The Need of an SAC for ICM in Maldives

Can the existing Shari'ah advisory bodies cater for the needs of CMDA in ICM development?

Some may raise the question as to the prospect of utilizing the existing Shari'ah advisory bodies for the functions of CMSAC. In answering the query it is important to note that the requirement of the CMSAC is very different to the mandates of other Shari'ah advisory bodies. It would be unsuitable to utilize these two institutions established in the country in advising the matters related to ICM due to following reasons:

Mismatch of technical knowledge and expertise

The CMSAC requires expert and informed decisions on Islamic capital market operations. The IFA is mandated for the general Islamic compliance and fatwa issuance for national issues. Thus they are not trained to critically analyze a specific industry such as capital markets. The SC of MMA is on the other hand an entity with very specific tasks to cater for the needs of MMA in its effort to regulate Islamic Banking, thus their concerns and technical know-how ideally would be targeted towards realizing this objective, Islamic capital market may not be their forte.

Conflicts in mandate

The IFA to do research and gather the ample data for the product compliance would take a considerable period of time and the product based issues that



the CMSAC has to promptly address might take too long unless they are fully committed to it alone, which is not possible as the tasks undertaken by the IFA is critical and of crucial importance and burdening them with operational duties of CMDA is impractical and beyond their mandate. Similarly the SC of MMA has a mandate to assess and analyze compliancy of the Islamic Banking industry and it would be counter-productive to demand their input to the ICM industry which is poles apart in operational and technical aspects.

Organizational structure

The existing Shari'ah advisory bodies are placed within the organizational structures of their parent institutions and hence not practical to be solely utilized by an independent statutory entity, such as CMDA, to supplement their work.

Red-tape

The cross organizational function of such a vital body that needs to constantly convene and cater for the needs of CMDA will face a lot of barriers. The financial and operational functioning of the Shari'ah bodies are clearly identified in their guidelines and do not include dedicated services to any independent body, as they have their own tasks and objectives.

Legal Accountability

The Shari'ah advisory bodies that exist today have no legal obligation or neither does their parent organizations to cater for the CMDA's needs regarding ICM. With no legal accountability it is not sensible to allow them to act on behalf of CMDA. Hence an independent CMSAC is crucial that is solely mandated to cater for the specific needs of CMDA.

Governance Issues

The current Shari'ah bodies are governed by the respective guidelines and

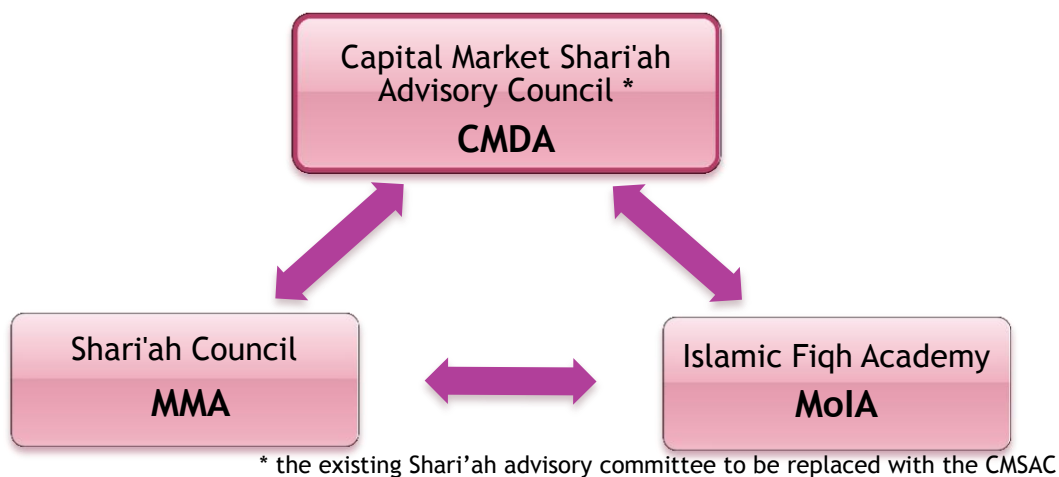


mandates that has been issued or compiled by their parent bodies. Hence governing them and liaising with them to complete tasks and provide timely responses for the efficient process required is not viable.

It is submitted here that the existing Shari'ah bodies cannot function as required by CMDA. Hence, there is a need for CMDA to create an independent CMSAC under them to cater for the emerging needs of the ICM industry in Maldives. The capital market has a unique and independent function in the economic arena. It caters for conventional and Islamic capital markets hence their competency in addressing issues pertaining to these areas need to be robust.

3.1 A synchronized model to Shari'ah compliance assurance by Shari'ahbodies

The existing Shari'ah Advisory bodies are mandated to perform specific tasks that pertain to their parent entities. In order to understand the dynamics of the Shari'ah advisory bodies, it is important to take into consideration their parent bodies and their correlation with CMDA.



In this model the Shari'ah advisory bodies currently in operation will work in harmony with each other and the capital market Shari'ah advisory council. This will supplement the specific needs of all these organizations. The specific roles and extent of relationship is provided below.

All of these three entities supplement each other in carrying their respective tasks in the society and a common factor to all these three entities is religious matters. The special mandate for MoIA is to safeguard Islam in Maldives. MMA has established Islamic banking industry in Maldives and hence, they have an SC to regulate Islamic banking matters. CMDA is responsible for Islamic Capital Market regulation and propagation, thus an independent Capital Market Shari'ah Advisory Council is fundamental for CMDA to preserve Islamicity in the ICM industry.

<p>IFA of MoIA</p>	<p>The MoIA is an executive arm of the government and the Islamic Fiqh Academy operating under their umbrella is the national advisory body for all religious matters. Hence the Capital Market Shari'ah Advisory Council (CMSAC) shall if need be utilize the IFA's view on any controversial issues and resolve the issues before recommending it to the CMDA. The IFA acts as the local context based source for the CMSAC.</p>
<p>SC of MMA</p>	<p>The Shari'ah Council of MMA is an arm of the statutory function of MMA. They are the focal points for the CMDA on matters with regard to banking and finance; hence a close relationship needs to be maintained between these two regulatory bodies, of two major functions, of the financial industry. It is hence important that the CMSAC have a liaison from the MMA who upon request of CMDA is recommended by MMA and appointed by the board of directors of CMDA. Further details are provided under the guidelines for selecting members to the CMSAC.</p>
<p>CMSAC of CMDA</p>	<p>The capital market regulatory body CMDA also has an existing Shari'ah Advisory Committee however it is recommended that they replace or upgrade it to the duly discussed Capital Market Shari'ah Advisory Council with added functions and responsibilities.</p>



4.0 Functions of the Capital Market Shari'ah Advisory Council:

4.1 Independent Supervision of Shari'ah Compliance

The fundamental function of CMSAC is to supervise Shari'ah compliance of ICM in an independent manner. Supervision towards *Shari'ah* compliance is also called *Shari'ah* supervision or *Shari'ah* review.¹ It is not an easy task to simplify the meaning of *Shari'ah* supervision as there is no uniform definition of it.

One definition of it is, "enforcing the parallelism of the activities of the institution with *Shari'ah* principles as what is stated by valid agreeable *fatwas*,"² The most comprehensive definition is what is rendered by *Asan Yusuf Dawud*. He says that in general, *Shari'ah* supervision means laying down *Shari'ah* measures (*Īwābit al-shar'īyah*)³ followed by their implementation, for the purpose to determine the rights (*Īlā'ī*) from the wrongs (*ba'īl*) starting from the very beginning of the operation, to the establishment of a continuous implementation of *Shari'ah* principles.⁴ Further, he defines that *Shari'ah* supervision technically means:

"reviewing, searching and resolving the whole activities of the operations and actions done by individuals, collective, or institutions, and other relevant bodies, to ascertain that all these activities comply perfectly to *Shari'ah* principles. This process is conducted using the approved relevant instruments and methods, explaining conflicts of laws and mistakes and then revising them quickly, followed by presentation decisions and advices for the better performance"⁵

¹ The official term used by Accounting, Auditing and Governance Standards for Islamic Financial Institutions (AAOIFI) standards is *shar'īh* review. See, Governance Standard for Islamic Financial Institutions No.1, Governance Standard for Islamic Financial Institutions no.1 on *Shar'īh* Supervisory Board: Appointment, Composition and Report, in, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions 1423-2002* (Bahrain: AAOIFI, 2002).

² Mu'ammad Za'ūr, *Daur al-Riq'bah al-Shar'īyah fī Ta'wīr al-A'ām al-Ma'rifiyyah*, as quoted by Qa'īn, 12.

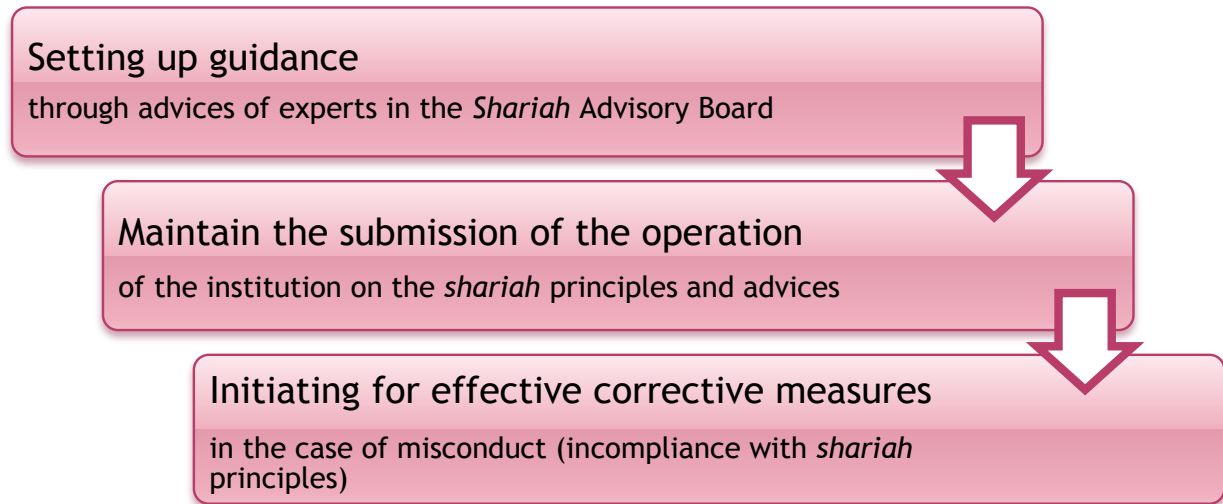
³ Here *Īwābit al-shar'īyah* of Islamic financial institution, including bank, is all elements set up for the financial institution based on valid *shar'īh* principles, on which regulation of the operations of such institution constructed. *DĒwĒd*, 15.

⁴ *Asan Yusuf DĒwĒd*, *al-Riq'bah al-Shar'īyah fī al-Ma'rifa al-Islāmiyyah*. (Al-QĒhirah: al-Ma'had al-NŌlĒ li al-Fikr al-IslĒm, 1996), 15. This definition shares with the definition given by Ābd al-SattĒr AbĒ Ghuddah in terms of basic element of supervision. Ābd al-SattĒr AbĒ Ghuddah 'Al-Asas al-Fanniyyah li al-Riq'bah al-Shar'īyah wa ĀlĒqatihĒ,' in *auliyah al-Barakah*, 4, 2002, 8.

⁵ *DĒwĒd*, 15.



It is observed from the abovedefinitions that *Shari'ah* supervision is activities which are proposed to: **First**, setting up guidance through *fatwas* and advices of experts in the *Shari'ah* Board. **Second**, maintain the submission of the operation of the institution on the *Shari'ah* principles and agreed *fatwas* and advices, and; **Third**, initiating for effective corrective measures in the case of misconduct (incompliance with *Shari'ah* principles).



4.2 The Supervision of ICM Shari'ah compliance

According to ÑAbd al-HamÊd al-BaÑIÊ, there are three instruments for supervisory activities:⁶

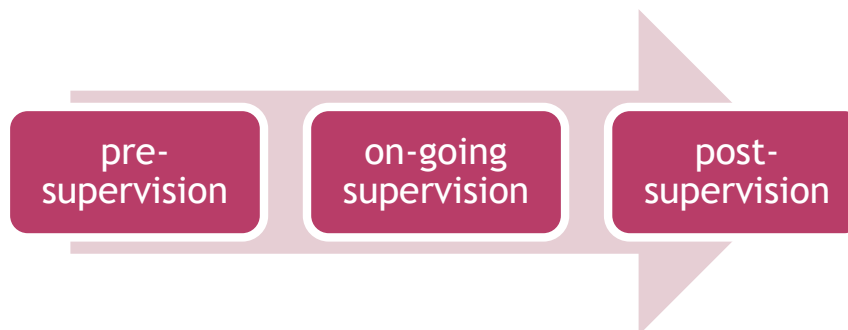
- 1) Researching on and evaluating operations of the institution
- 2) Issuing decisions relating to the product and operation which may be periodically, daily, weekly, monthly, annually, etc.
- 3) Withdrawing from or cancelling decisions and operations which are not in-line with Shari'ah principles.

⁶Abd al-Hamid al-Ba'li, "TaqninA'mal al-Hai'ah al-Shar'iyyah: Mu'amalahwaAliyatuh". Paper presented in *al-Mu'tamar al-Thalith li al-Hai'at al-Shar'iyyah li al-Mu'assasat al-Maliyah al-Islamiyyah*, 5-6 October, 2003 in Bahrain, 63, (2003, October 5-6).



4.2.1 Method of Supervision

In relation to the method of supervision that may be adopted, it could be pre-supervision (*qabliyyah/ sabiqah*), on-going supervision (*athna' al-'amal*), and post-supervision (*ba'diyyah/ la'iqah*).⁷ Pre-supervision means ascertaining *Shari'ah* compliance through analyzing portfolios and the simulation of the products. On-going supervision means the control along the practical operations of the institutioning business, such as how various financial contracts are factually undertaken by the parties involved. Post-supervision means the rechecking after the institutioning business is being undertaken. Through these three steps of control and evaluation, the compliance to *Shari'ah* can be assured.⁸



To enhance the procedures of *Shari'ah* review, the Islamic Financial Service Board (IFSB) recommends a best practice for an appropriate mechanism in obtaining rulings from *Shari'ah* scholars, applying *fatwās* and monitoring *Shari'ah* compliance in all aspects of their products, operations and activities. As the centrality of process

⁷Abd al-Sattar Abu AbĒ Ghuddah Al-Asas al-Fanniyyah li al-Riqabah al-Shar'iyyah wa 'Ilaqatiha,' in *Hauliyah al-Barkah, Majallah Mutakhassisah bi Fiqh al-Mu'amalat wa al-'Amal al-Masraf al-Islamiy* 4, 2002, 22. Also refers to, 'Abd al-Hamid al-Ba'li, *Taqnin*, 64

⁸ In auditing term, certifying permissible financial instruments through *fatwas* is called "by ex-ante *Shari'ah* audit", whereas verifying that transactions comply with issued *fatwas* is called "ex-post *Shari'ah* audit". Wafik Grais and Matteo Pellegrini, *Corporate Governance and Shari'ah Compliance In Institutions Offering Islamic Financial Services*. World Bank Policy Research Working Paper 4054, November 2006. at: <http://ksri.org/bbs/files/research02/wps4054.pdf>, accessed March 5, 2007.



of assuring *Shari'ah* compliance is in the issuance of *fatwas* and monitoring their implementation, there are two mechanisms that shall be undertaken:⁹

- 1) Both before (*ex ante*) and after (*ex post*) aspects of all financial transactions carried out by the Islamic Financial Institutions. This is important to ensure *Shari'ah* compliance of the contracts and the application of the contracts; and
- 2) Operations of the Islamic institution, including aspects such as *Shari'ah* compliance review, investment policies, disposal of non-*Shari'ah* compliant income, charitable activities, etc.

The *Shari'ah* board members are also always associated with the issue of independence (*istiqlaliyyah*). The importance of the independence of the members of the *Shari'ah* board is based on the factual responsibility of this board to give *fatwas* and conducting supervision, whereby their impartiality is highly demanded. Certain methods and approaches should be formulated to achieve a high degree of independence. There are some approaches that need to be considered:¹⁰

- 1). Proper status of the *Shari'ah* board members must be stated clearly in the memorandum of association. It should be made clear that they are different from staff and workers in the institution who are doing administrative work and serving the customers in the organizational structure.
- 2). Determining qualification for the members of the board. The requirements should be made in such a way which may assure that the members of the board are persons with qualification as an expert in the *al-mu'āmalah al-maliyyah* as well as a highly experienced in the practical aspect of the

⁹Islamic Financial Services Board (IFSB). (2006). *Guiding Principles On Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions And Islamic Mutual Funds)*. Retrieved May 7, 2007. <http://www.ifsb.org>

¹⁰ The classification is extracted from; al-Khalaf, 29 also Abd al-xamEd al-BaÑiE, "Istiqlaliyyah al-Hai'Et al-SharÑiyyah". Paper presented in *al-Mu'tamar al-ThEnE li al-Hai'Et al-SharÑiyyah li al-Mu'assasEt al-Maliyyah al-IslEmiyyah*, 29-30 October, 2002 in Bahrain, 25– 36



Islamic financial business.¹¹ This qualification is one of the key tools to elevate the professionalism of the members of the board and to encourage them to issue decisions and *fatwÉs* without any doubt and without any interference from other parties.

- 3). The recognition of the *fatwas* issued. The status of the issued *fatwÉs* and decisions which are binding over the management of the institution, is a proof that the independence of the *Shari'ah* board members prevails.¹²
- 4). The provision of a proper method of appointment, the period of membership, and the allowances for the members of the *Shari'ah* board. To boost the independence of the *Shari'ah* board and its members, the appointment of the members of this board and their remuneration must be made by the shareholders, following the period of membership which must be no less than the period of board of directors. The dismissal of the membership is only valid when it is decided by the board of directors, with the majority agreement of two third in attendance. This decision, will only be effective with the agreement from the shareholders.
- 5). Entitlement of the ownership of the members of the *Shari'ah* board in the share ownership of the industry. A decision to give a certain amount of the share of the industry for the members of the *Shari'ah* board needs to be considered to avoid a conflict of interest that may affect their independence in exercising their responsibilities.¹³

¹¹ The main problem in this context is , according to Mohd. Daud Bakar, "There are scholars in the pipeline but as we go on to more sophisticated products they cannot catch up easily". Thus, the lack of human resources in *sharÉÑah* advisory or supervisory appears. "The Inner Circle", *Asiamoney*, Vol.XVII, Issue 8, September 2006, 88

¹² The recognition for the issued decisions and *fatwÉs* has been deliberated in the sub chapter 4.3.2. on Duties, Responsibilities and Rights of *SharÉÑah* Board Members.

¹³ Aside from the major objection among scholars, in this regard, some experiments has been made. For example, Dubai Islamic Bank (DIB), the biggest Islamic financial institution in United Arab Emirates (UAE), in 2004, made in-house department contains bankers, lawyers and *sharÉÑah* researchers, and HussainHamedHasan, chairman of it external *sharÉÑah* board was appointed as the president of the department. Another case is the appointment of Yusuf TalalDeLorenzo as a full time executive at the *SharÉÑah* Capital in Connecticut, USA. These cases raise issues of independency versus efficiency. See, "Islam's Inner Friction" in *Asiamoney*, Vol.XVIII, Issue 10, November 2006, 76-80.



- 6). Regulated process and procedures in supervision and issuing *fatwÉs*. The existence of a regulation on the process and procedures of supervision and issuing *fatwÉs* may enhance the independency of the *Shari'ah* board. The regulation also needs to cover the relationship between the *Shari'ah* board and the board of directors, particularly in terms of the procedure for supervision.

In addition to the above, it is also parallel with the Islamic tenets, i.e. in terms of allowances or remuneration, it should be given when the job has been accomplished. This will likely maintain the degree of neutrality in making any decisions or *fatwÉs*. Thus, shareholders, whenever necessary, may determine the reasonable amount of remuneration to give.¹⁴ In addition to this, the tenure of the membership in the *Shari'ah* board, though this is subject to the policy of the institution, must bear in mind that a prolonged relationship between members of the board and the management of the institution may result in a very close interrelation which causes the lack of the independency of the board.¹⁵

It is observed from the above discussions that the mode of the *Shari'ah* board varies among industries and among countries. The adoption of a certain mode of this board by a particular institution or country indicates that there are various ways and approaches to ascertain *Shari'ah* compliance in the Islamic institutioning business. It is considered therefore, that the differences in the modes adopted does not tantamount to the difference in the understanding on the importance of *Shari'ah* compliance.

¹⁴ al-KhalÊfÊ,28

¹⁵ Ómir SulaymÊn B, et.al, *MiÑyÊr al-ÖabÏ li al-Mu'assasÊt al-IslÊmiyyah, No.5 on IstiqlÊl Hai'Êh al-RiqÊbah al-SharÑiyyah*, October 18-19, 2003, 9 (attachment), as presented in *al-MuÑtamar al-ThÊlithÊ al-Hai'Êt al-SharÑiyyah li al-Mu'assasÊt al-MÊliyah al-IslÊmiyyah*, 5-6 October, 2003 in Bahrain.



4.3A working model: SAC of Malaysian Securities Commission¹⁶

The ICMD carries out research activities and functions as the secretariat to the IISG. The latter succeeded in exploring the foundation for developing an Islamic capital market in Malaysia. Thus, the Commission viewed that it was important for the IISG to expand its role, and consequently, it was upgraded to a more formal body called the SAC on 16 May 1996. Its establishment was endorsed by the Minister of Finance and it was given the mandate to ensure that the implementation of the Islamic capital market complied with Shari'ah principles. Its scope of jurisdiction is to advise the Commission on all matters related to the comprehensive development of the Islamic capital market and to function as a reference centre for all Islamic capital market issues.¹⁷

In introducing the Islamic capital market instruments, the SAC adopted two approaches. The first approach was to study the validity of conventional instruments used by the local capital market from the Shari'ah perspective. The study focused on the structure, mechanism and use of the instruments to ascertain whether they were against Shari'ah principles. The second approach entailed formulating and developing new financial instruments based on Shari'ah principles.

The SAC is also responsible for issuing a list of Shari'ah-compliant securities (formerly known as list of Shari'ah-approved securities). Up to 28 October 2005, 857 securities were classified as Shari'ah-compliant securities by the SAC. This represented 85% of securities listed on Bursa Malaysia. The list is constantly updated and the Commission announces the updated list twice a year. It is essential for helping Muslim investors identify Shari'ah-compliant securities and at the same time, increase their confidence when making investments.

The list of Shari'ah-compliant securities was used as the basis for developing the Shari'ah Index launched by Bursa Malaysia on 17 April 1999. With the launch, investors will be able to monitor the performance of their investments more efficiently and effectively. Although the SCA does not expressly state the formation of the SAC, section 16 of the SCA stipulates that the Commission has full jurisdiction in carrying out its duties based on securities laws. Moreover, section 18 of SCA specifies that the Commission is empowered to form a committee to help it carry out its duties based on the Act, and the Commission is also permitted to appoint anyone it deems fit to be a member of such a committee.¹⁸ Members of the SAC are

¹⁶ Source: From Securities Commission Malaysia

¹⁷ NikRamlahNikMahmood, "Regulatory Framework and the Role of the Securities Commission in Developing the Islamic Capital Market", National Conference on Islamic Banking and Investment, Kuala Lumpur, 19 November 1996, p. 5.

¹⁸ Securities Commission Act 1993.



appointed by the Commission once every two years. The table on page 6 lists past and present members of the SAC.

5.0 Listing Shari'ah-Compliant Securities

Shari'ah-compliant securities are securities (ordinary shares, warrants and transferable subscription rights) of Maldives Stock Exchange -listed company which have been classified as Shari'ah permissible for investment, based on the company's compliance with Shari'ah principles in terms of its primary business and investment activities.

The Shari'ah-compliant securities list needs to be introduced to the public. The List should be updated twice a year, by reviewing the companies' annual financial reports, responses to surveys aimed at obtaining detailed company information and through specific inquiries made to the respective company's management.

In the process of determining the Shari'ah status of listed securities, the CMSAC needs to develop several basic Shari'ah criteria as guidance. The criteria should be based on the Quran and the Sunnah, as well as the general principles of Shari'ah'. In this process, CMSAC should focus on the core activities of the companies, such as goods and services that are offered to their customers. Further consideration should be given to companies that are involved in both Shari'ah-compliant and non-compliant activities by applying the concept of *maslahah* (public interest) and *umumbalwa* (common plight). For this purpose, specific benchmarks and additional criteria, such as interest income and image should be formulated to enable the CMSAC to determine the Shari'ah status of such companies. In such cases, where the financial contributions from the non-permissible activities fall below the benchmark level, the CMSAC will classify the securities of these companies as Shari'ah-compliant.

The release of the list will, to a large extent, give investors the necessary guidance, opportunities and also confidence to choose and invest in listed securities that comply with Shari'ah principles. Such a list will also stimulate the development of



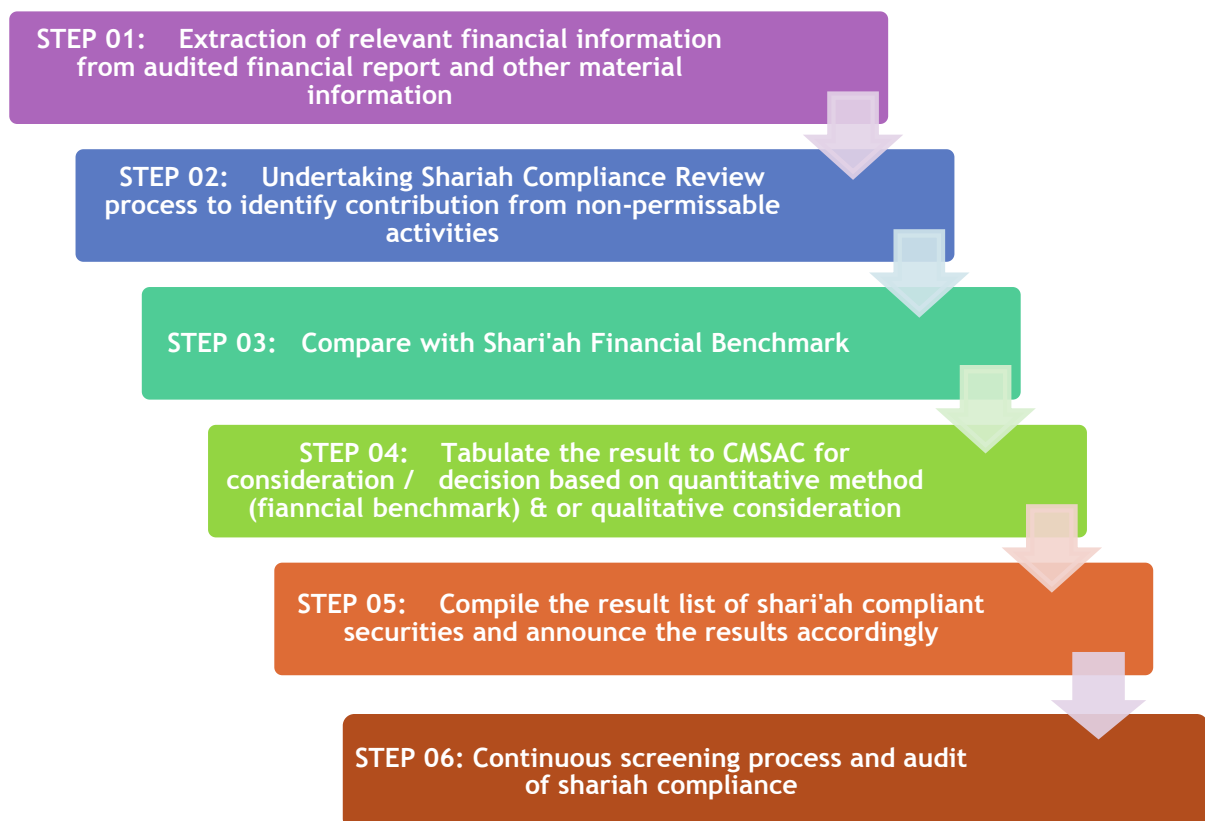
other Shari'ah-compliant products and services.

6.0 Shari'ah Compliance Mechanism

The backbone of the ICM regulatory system is the Shari'ah compliance and monitoring framework. The CMSAC should be at the helm of this effort to establish a uniform, efficient mechanism to monitor and regulate the ICM industry.

The Shari'ah compliance and review process can be segregated into 6 general steps under which numerous activities and procedures need to be conducted in a timely manner to ensure an efficient and successful review process. The smooth-running of the review and audit process for Shari'ah compliance is crucial for the successful monitoring and regulation of the ICM industry.

6.1 Shari'ah Compliance Process Overview



Step	Details	Responsible parties
Step 01: Extraction of relevant financial information from audited financial report and other material information	The first step in the Shari'ah compliance process is to collect all relevant information from the sources and do proper fact finding and probe the company in question thoroughly.	CMSAC CMDA- designated unit for ICM monitoring and compliance
STEP 02: Undertaking Shari'ah Compliance Review process to identify contribution from non-permissible activities	The activities of the company in question is closely scrutinized and assessed for its contribution or participation in non-Shari'ah compliant areas. The CMSAC compiles a standard to measure and the aspects to look into via its benchmarks, that act as the yardstick for measurement.	CMDA- designated unit for ICM monitoring and compliance CMSAC
STEP 03: Compare with Shari'ah Financial Benchmark	The Shari'ah financial benchmarks are set up and calculated based on the quantitative assessment criterion compiled by CMSAC. The process is conducted by financial experts under guidance from CMSAC.	CMSAC CMDA- designated unit for ICM monitoring and compliance
STEP 04: Tabulate the result to CMSAC for consideration / decision based on	Proper guidelines for assessment created by CMSAC for quantitative and qualitative considerations, are utilized by CMDA's staff to compile	CMDA- designated unit for ICM monitoring and compliance



quantitative method (financial benchmark) & or qualitative consideration	a report on findings and once the CMSAC approves and adds their recommendations to enhance or correct the company's actions including purification requirements.	CMSAC
STEP 05: Compile and announce the result list of Shari'ah compliant securities	The results of the Shari'ah compliance assessment should be announced as well as inform the respective companies of the details for the findings and corrective measures.	CMSAC CMDA- designated unit for ICM monitoring and compliance
STEP 06: Continuous screening and audit process of Shari'ah compliance and bi-annual reviewed list announcement	Continuous audit of the compliance should be conducted and the list of Shari'ah compliant companies reviewed bi-annually. For this to materialize very stringent and clear manual for review should be compiled and followed. The findings of the review should be checked by the CMSAC and approved by BoD of CMDA	CMDA- designated unit for ICM monitoring and compliance CMSAC

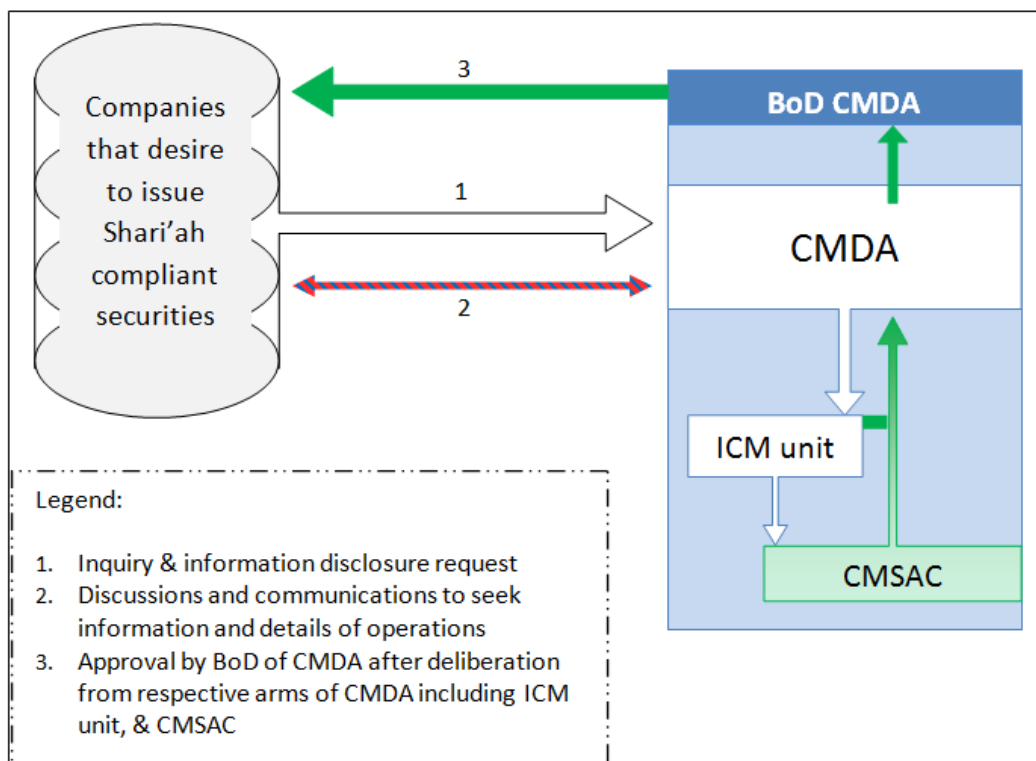


6.2 The Modus Operandi of the Shari'ah compliance mechanism

It is hence evident that the CMSAC has a crucial role to play in all aspects of ICM implementation and supervision. It is important that with a designated unit to cater for ICM needs a dedicated CMSAC needs to be functional to ensure proficient ICM regulatory operations

The dynamics of this collaboration or the modus operandi is highlighted below

Modus Operandi: Shari'ah Compliant securities request and approval



6.3 Two major processes of the Shari'ah compliance mechanism

6.3.1 Initial Shari'ah Compliancy Review

- Once a request for listing is made by a company
- ↓ The request is processed by CMDA via its ICM unit



- ↓ The ICM unit should collect all the necessary information for the quantitative and qualitative audit of the company (based on the pre-compiled benchmarks and screening criteria set by the CMSAC and approved by BoD of CMDA)
- ↓ The findings are forwarded to the CMSAC to deliberate
- ↓ CMSAC provide their recommendations and inference to the BoD for approval.
- ← Upon approval by the BoD of CMDA, the decision is communicated to the requesting company by CMDA.

6.3.2 Continuous Bi-annual Audit of Listed Shari'ah Compliant Securities

- The list of Shari'ah compliant securities is published by CMDA
 - ↓ The ICM unit collects all relevant information from the company about its operations
 - ↓ The ICM unit conducts a quantitative compliance audit and screening (based on the pre-compiled benchmarks and screening criteria set by the CMSAC and approved by BoD of CMDA)
 - ↓ The findings are forwarded to the CMSAC to deliberate
 - ↓ The CMSAC provide their inference and correctional recommendations to the BoD for approval.
 - ↓ In case of questionable or failure to meet compliancy ratios, the purification requirement is communicated to the respective companies and if not appropriately corrected the company is omitted from the revised list.
- ← Upon approval by BoD of CMDA, the revised list is published by CMDA bi-annually.

For all these functions to be efficiently executed a very proficient CMSAC needs to be established by the CMDA. The core competencies of the CMSAC should be able to complement and supplement the ICM development and regulation efforts.



Guidelines on Governance of Capital Market Shari'ah Advisory Council

1. INTRODUCTION

Compliance with Shari'ah principles is the core element of Islamic Capital Market. A Shari'ah review and advisory framework is imperative in ensuring such compliance. An effective Shari'ah framework will harmonize the Shari'ah interpretations, strengthen the regulatory and supervisory oversight of the industry and nurture a pool of competent Shari'ah advisors. Under this guideline, the regulator for ICM shall establish a Shari'ah advisory body as part of their governance structure to be known as "Capital Market Shari'ah Advisory Council" (CMSAC).

In recognition of the above, CMDA has developed the following guidelines for the appointment, duties and responsibilities of the Capital Market Shari'ah Advisory Council, to effectively play its role, the CMSAC shall operate as an independent body, with the principles of competence, confidentiality and consistency properly enshrined in its operations. It is expected that an independent CMSAC will muster public confidence, thereby promoting the growth and development of the ICM industry.

2. OBJECTIVES

These Guidelines aim to:

- (a) set out the rules, regulations and procedures in the establishment of a Capital Market Shari'ah Advisory Council in CMDA;
- (b) define the role, scope of duties and responsibilities of the Council and its members;
- (c) outline the functions relating to Shari'ah review and audit processes; and
- (d) define relationship and working arrangement between the Council and CMDA.



3. SCOPE OF APPLICATION

These Guidelines shall be applicable to the Capital Market Shari'ah Advisory Council of CMDA, the secretariat of the CMSAC within CMDA and other relevant parties involved with the CMSAC's activities.

4. ESTABLISHMENT OF CAPITAL MARKET SHARIAH ADVISORY COUNCIL (CMSAC)

CMSAC shall be established by Board of Directors of CMDA, by its resolution numbered. and dated

5. MEMBERSHIP OF CMSAC

5.1 Appointment and Re-appointment

5.1.1 The Board of Directors of CMDA shall appoint all non institutional members of the Capital Market Shari'ah Advisory Council, on a merit basis, after careful deliberation of relevant competencies as per the qualification and selection guidelines.

5.1.2 The Board of Directors of CMDA shall appoint the CEO of CMDA as well as the Head of the ICM unit, as the two institutional members representing CMDA on the Capital Market Shari'ah Advisory Council.

5.1.3 CMDA shall request MMA to nominate a permanent representative to the CMSAC from their Islamic Banking unit, and the Board of Directors of CMDA shall appoint the member to the CMSAC.

5.2 Term of Office

The initial term of office of all members of the CMSAC, except institutional



members, is four years. All non institutional members shall have a term of four years and shall be eligible for reappointment. The Chairman and members of the CMSAC shall remain in office until their successors are appointed.

5.3 Composition

5.3.1 The Capital market Shari'ah Advisory Council shall comprise of seven (7) members and a chairperson shall be appointed by the Board of Directors from among the seven member council

5.3.2 For the effective functioning of the CMSAC, it shall comprise of seven (7) members that represent the following institutions or technical competencies.

(i). Institutional Members

a. 2 members from CMDA

- CEO of CMDA
- Head of the ICM Unit of CMDA

b. 1 member from MMA

- Permanent representative member (preferably from Islamic Banking Section)

(ii). Non- Institutional Members

c. 1 member competent in Islamic Capital Market Development

d. 1 member competent in Usul-al Fiqh/ Islamic Jurisprudence

e. 2 members competent in Shari'ah or Islamic Commercial Law

5.3.3. Technical experts and consultants whose services are engaged by the CMSAC under 08(viii) of this guideline, may attend meetings of the CMSAC but shall not take part or exercise voting rights in giving a Shari'ah legal opinion or verdict by the CMSAC.

5.4 Criterion and Qualification

(i). A member of the CMSAC shall be an individual of Maldivian nationality,



- (ii). aged 25 years or above,
- (iii). shall not have been convicted of theft, fraud, robbery, swindling, embezzlement or corruption within the past ten years,
- (iv). shall not be a discharged bankrupt,
- (v). shall not be members of another Shari'ah Advisory Committee in Maldives
- (vi). the person should possess appropriate work ethics and should be capable of discharging the functions as a member of the council
- (vii). Non-institutional members of the CMSAC shall at a minimum, have a Post-graduate academic qualification and possess necessary knowledge, expertise or experience relevant to their competency area.

5.5 Disqualification

5.5.1 The members of the CMSAC shall be persons of acceptable reputation, character and integrity. The CMDA reserves the right to disqualify any member who fails to meet the requirements.

5.5.2 No person shall be appointed or remain a member of CMSAC who:-

- a. is of unsound mind or as a result of ill-health is incapable of carrying out his/her duties; or
- b. is declared bankrupt or suspends payments or compounds with his/her creditors including his/her bankers; or
- c. is convicted of any offence involving dishonesty or fraud; or
- d. is guilty of serious misconduct in relation to his/her duties; or
- e. fails to attend 75% of the meetings of the CMSAC in a year without satisfactory excuse.
- f. in the case of a person possessing professional qualification, is disqualified or suspended (except on his own request) from practicing his profession in Maldives by the order of any relevant authority made in respect of the individual.

5.5.3 Where a member of a CMSAC becomes unfit to hold such appointment as



provided in these Guidelines, CMDA shall terminate the appointment of the CMSAC member.

5.6 Restrictions on CMSAC membership

5.6.1 A member of the CMSAC shall not be a member of a Shari'ah advisory committee in any institution in Maldives or financial institutions under the regulatory purview of the CMDA

5.7 Resignation, Termination and Dismissal

5.7.1 A one-month notice that states the reason(s) for any resignation/termination or dismissal shall be tendered prior to such resignation/termination or dismissal.

5.7.2 Institutional members shall be dismissed/ terminated with the resignation/ removal from the position held at the representing institution or upon request by the representing institution, following official termination or dismissal issued by the Board of Directors of CMDA.

6.0 DUTIES AND RESPONSIBILITIES OF THE CMSAC

The members of the Capital Market Shari'ah Advisory Committee are expected to participate and engage themselves actively in deliberating Shari'ah issues put before them. The main duties and responsibilities of the Capital Market Shari'ah Advisory

6.1 It shall be the duty and responsibility of the CMSAC to:

- (i).** be responsible and accountable for all Shari'ah decisions, opinions and views provided by them.
- (ii).** advise the CMDA's board and management on Shari'ah matters in order to ensure that the Islamic product regulation and approval of the Authority fully comply with Shari'ah principles and also to ensure the regulatory institution's compliance with Shari'ah principles at all times.



- (iii).** endorse Shari'ah Compliance Manuals. The Shari'ah Compliance Manual must specify the manner in which a submission or request for advice be made to the Capital Market Shari'ah Advisory Council, the conduct of the Capital Market Shari'ah Advisory Council's meeting and the manner of compliance with any Shari'ah decision. The Manual shall be endorsed by the Capital Market Shari'ah Advisory Council and the Board of Directors of the Authority.
- (iv).** review and endorse Shari'ah related policies and guidelines. This shall include a periodic Shari'ah audit of products and services to ensure that operational activities and transactions of the institution are made in accordance with the principles of the Shari'ah.
- (v).** endorse and validate relevant documents for new products and services to ensure that they comply with the Shari'ah. These include:
 - a)** terms and conditions contained in forms, contracts, agreements or other legal documentation used in executing the transactions; and
 - b)** the product manual, marketing materials, sales illustrations and brochures used to describe the product or service.
- (vi).** ensure that the necessary ex-post considerations are observed after the product offering stage, namely the internal Shari'ah review processes and Shari'ah compliance reporting. This is in order to monitor the transaction's consistency in Shari'ah compliance and effectively manage Shari'ah compliance risk that may arise over time.
- (vii).** assist or advise related parties to the transaction, such as its legal counsel, auditors or other consultants on Shari'ah matters upon request.
- (viii).** provide written Shari'ah opinion to the CMDA in respect of new products and other issues referred to CMSAC.
- (ix).** provide support to the CMDA in respect of questions or queries that may be raised regarding the Shari'ah compliance of its products.
- (x).** issue recommendations on how the CMDA could best fulfill its social role as well as promote Islamic Capital Market.
- (xi).** provide monitoring and evaluation mechanisms to ensure compliance with Shari'ah principles.



- (xii).** assist on Shari’ah compliance audit.
- (xiii).** Keep appropriate records of meetings and documentation of any advice, research or opinion provided or prepared by CMSAC
- (xiv).** carry out any other duties assigned to it by the board of CMDA pertinent to their capacity as CMSAC

7.0 DUTIES AND RESPONSIBILITIES OF CMDA

To ensure the smooth running of the CMSAC, the CMDA shall:

(i). refer all Shari’ah issues to the CMSAC

CMDA shall refer all Shari’ah issues in its ICM operations to the CMSAC for advice and decision. The submission for advice or decision shall be made in a comprehensive manner for effective deliberation by the Council. This shall include explaining the process involved, documents to be used or required and other necessary information.

(ii). implement the CMSAC’s advice and decision

CMDA shall be responsible for implementing the CMSAC’s advice and decisions that are duly approved by the Board of Directors of CMDA.

(iii). ensure that product documents are validated

CMDA shall obtain validation of the CMSAC relating to Shari’ah issues in all product documentations.

(iv). prepare a Shari’ah Compliance Manual

CMDA shall prepare a Shari’ah Compliance Manual which shall be endorsed by the CMSAC. The Manual shall provide a general guideline on the operational procedures of the CMSAC as well as a code of ethics and conduct for its members. CMDA shall ensure that adequate systems are in place to monitor compliance with the code.

(v). provide the CMSAC access to all relevant documents



CMDA shall provide the CMSAC with the necessary assistance and access to all relevant records, transactions, manuals or other information that it may require to perform its duties.

(vi). provide the CMSAC with sufficient resources

CMDA shall provide the CMSAC with sufficient financial resources, reference materials, or any other support the CMSAC may require to perform its duty.

(vii). provide mandatory exposure programs

CMDA shall provide the CMSAC with sufficient financial resources, and other support that the CMSAC may require to partake in their mandatory bi-annual refreshment and exposure programs approved by CMDA, as programs that enhance the exposure of the members to the latest progress and best-practice in the ICM industry, and supplements the work conducted by CMSAC.

(viii). provide the CMSAC with specialist and technical support

Upon request CMDA, shall provide the CMSAC with technical experts in relevant fields to aid in the deliberation process.

(ix). provide the CMSAC enquiry facilities

CMDA should facilitate and enable the atmosphere and meeting arrangements with officials from any company under scrutiny that the CMSAC requests to enquire.

(x). remunerate the members of the CMSAC

The Board of CMDA shall determine the remuneration of CMSAC members. The remuneration shall be commensurate with the expected duties and functions of the Council. Apart from the remuneration, a retention fee maybe given to the members of CMSAC to prompt that the research and relevant preparations are conducted prior to the meetings, for swift decision making.

(xi). establish a secretariat for the CMSAC

CMDA shall establish a secretariat for the CMSAC to undertake the liaison activities and with the following duties:



a) Duties of the secretariat of CMSAC

- (i).** To make proper arrangement for meetings
- (ii).** To take minutes of the Capital Market Shari'ah Advisory Council meetings
- (iii).** To compile all queries to be presented to the CMSAC
- (iv).** To ensure the minutes are endorsed by the CMSAC members
- (v).** To prepare submissions to the Board of Directors of CMDA
- (vi).** To compile all resolutions made by the Capital Market Shari'ah Advisory Council
- (vii).** To update the Board of Directors of CMDA with any new developments in Shari'ah issues

8.0 REPORTING RELATIONSHIP

8.1 The CMSAC shall directly report to the Board of Directors of CMDA facilitated by the MD/CEO. All cases of non-compliance with the Shari'ah shall be recorded and reported to the Board by the CMSAC, and it shall recommend appropriate remedial and purification measures.

9.0 REPORT OF THE CMSAC

9.1 The Board and Management of CMDA shall ensure that the decisions and opinions of the CMSAC are issued and disseminated to all relevant stakeholders appropriately.

9.2 The CMSAC shall also compile an annual report, which the CMDA shall also publish as a part of its annual report.

10.0 INDEPENDENCE OF THE CMSAC

10.1 The independence of the CMSAC shall be observed at all times for it to play its supervisory role over the ICM industry without undue influence, especially from



the management of CMDA and other stakeholders.

10.2 Members of the CMSAC shall not have such relationships with any Islamic Financial Institutions, its related companies or officers that could interfere or be reasonably perceived to interfere with the exercise of independent judgment in the best interest by the CMSAC.

10.3 The management of CMDA has an obligation to provide the CMSAC with complete, accurate and adequate information in a timely manner before all meetings and on an ongoing basis in order for the CMSAC to fulfill its responsibilities.

11.0 APPRAISAL OF MEMBERS OF THE CMSAC

11.1 Members of the CMSAC shall at all times demonstrate the competence and ability to comprehend and utilize:

- (i). the technical requirements of the ICM ;
- (ii). the inherent risks in the ICM industry; and
- (iii). the management processes required to conduct its operations effectively with due regard to the interest of all stakeholders.

11.2 CMDA shall facilitate continuous professional development of members of the CMSAC, via periodic enrichment programs to keep them updated on latest developments in the ICM industry

11.3 CMDA shall specify and adopt a process for formal assessment of the effectiveness of the CMSAC and of the contribution of each CMSAC member. The process should also identify relevant gaps to enable the focus of the exposure programs for the CMSAC members.

12.0 CONFIDENTIALITY AND CONSISTENCY

12.1 Internal and privileged information obtained by the CMSAC in the course of its duties shall be kept confidential at all times and shall not be misused.

12.2 Notwithstanding the above, the CMSAC shall not be liable for breaching the



confidentiality and secrecy principle if the sensitive information is reported to the CMDA in good faith for corrective actions, in the performance of its duty in reporting serious breaches of the Shari'ah by any party or in compliance with the order of a court of competent jurisdiction.

12.3 The members of CMSAC shall at all times avoid potential conflict of interest situations

12.4 The Every member of the Capital Market Shari'ah Advisory Council shall ensure that they do not divulge, reveal, publish or otherwise disclose to any person, any information, issues, materials or publications of confidential nature in relation to the authority generally or any deal or structure proposed, communicated, furnished by CMDA or any of its clients. The obligation on the part of the members or the Capital Market Shari'ah Advisory Council and the Secretariat under this clause shall survive the cessation of their respective engagements.



CHAPTER TWO: ADOPTING INTERNATIONAL STANDARDS FOR SHARIAH COMPLIANT PRODUCTS

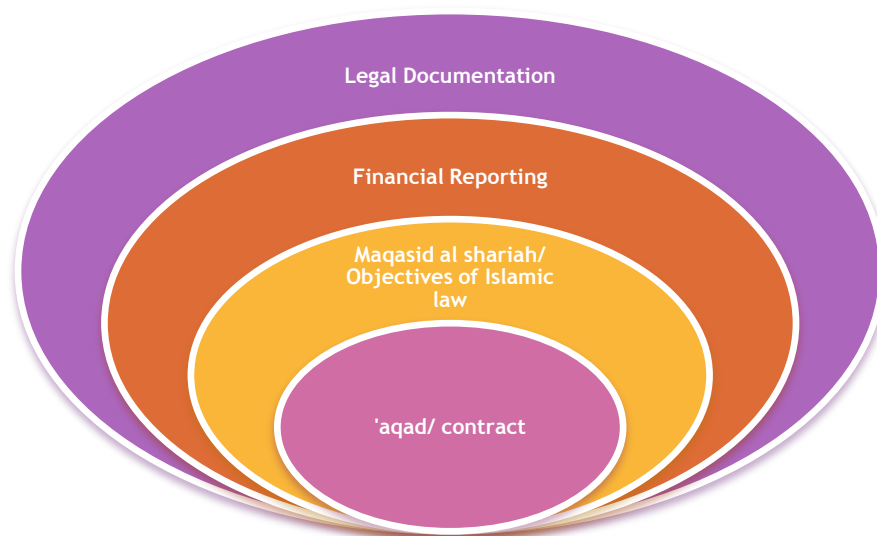
1.0 Introduction

Shari'ah compliance of Islamic financial products is imperative to ensure the integrity of the products and institutions that offer these products. This is because Shari'ah compliance is the reason that makes Islamic products different from the conventional products in the market.

Today, unlike the classical times, there are many international standards created to facilitate the Shari'ah compliant products and there are many parameters used in making a Shari'ah compliant product. It is imperative to understand the parameters used in making a Shari'ah compliant product before discussing the international standards for Shari'ah compliant product.

2.0 Methodology of Determining Shari'ah Compliance

There are main four methods in determining Shari'ah compliance and it is viewed that to enjoy the optimal results all of these four approaches shall be complementary to each other.¹⁹ Following diagram illustrates the four approaches:



¹⁹Rosly, S.A. N/A. "Shari'ah Compliant Parameters Reconsidered", viewed 1 June 2011 <<http://www.kantakji.com/fiqh/Files/Fatawa/ww27.pdf> >



To determine Shari'ah compliancy of a product it is best to go through each of the above mentioned four methods. In the first stage, one has to see whether the requirements of a contract or contracts used in the product is complied or not. The requirements of the Shari'ah contracts would differ from contract to contract. There are many international standards that explain these requirements of the Shari'ah contracts as illustrated in Table 1 below.

In the second stage, assessment would be made to see how the specific products help to achieve objectives of Shari'ah. Shari'ah compliant product shall not only be made to maximize profit, but it also shall try to eliminate harm and the benefit the society as this is the core objective of Islamic law. Hence elements like riba which harms the society and exploits the property (mal) of people would be rejected. In short, in this stage the benefits of the product would be assessed and if anything oppressive to the individual and the society is found, that element would be eliminated. The international standards formulated also looks at this angle as shown in Table 1 below.

The third stage is to comprehend the financial reporting mechanism. Accountability is achieved through accounting. The main purpose is to understand the financial strength of the institutions that deals with Shari'ah compliant products. International Financial Reporting Standards shall be followed in this stage.

The last stage is about the legal documentation. In the first stage focus would be more on the fulfillment of the Shari'ah conditions of the contracts, but in this stage terms and conditions inserted into the document with the sequence of documentation would be scrutinized. Furthermore, the legal requirements of the documents would be analyzed.

Methods Determining Shari'ah Compliancy of a product	Examples of International/National/Regional Standards for the purpose	Comments
Contract	<ul style="list-style-type: none"> • Al Baraka • Arab Banking Corporation 	Local Islamic financial institutions and regulatory



	<ul style="list-style-type: none"> • AAOIFI • Bank Negara Malaysia • Faisal Islamic Bank • Kuwait Finance House • OIC Fiqh Academy • Securities Commission (SC) • Muslim World League 	institutions have come up with the conditions of Shari'ah contracts that is acceptable to them. Even the national fatwa councils have their own views on the matter. Hence, CMDA can use all of them as a guide.
Objectives of Shari'ah	AAOIFI, OIC Fiqh Academy	Objectives of Shari'ah are considered in all the standards as a vital part to achieve.
Financial Reporting	AAOIFI, IFRS	Shari'ah Auditing and prudential auditing with Shari'ah review standards are issued now
Legal Documentation	AAOIFI IIFM and IFSB	The sequence and the clauses in the legal documentation have been emphasized by these bodies

3.0 Critical International Islamic Finance Institutions

There are many international Islamic institutions set up to facilitate Islamic banking and finance activities in the world. These institutions have come up with their own procedures and standards which are worth looking at as benchmarks. The following diagram illustrates the critical international Islamic institutions in the world.





3.1 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

AAOIFI is an international autonomous non-profit making corporate body established in Bahrain in March 1991 by Islamic Development Bank to solve the accounting problems faced by the Islamic financial institutions when they apply the existing accounting standards such as International Accounting Standards (IASs), Generally Accepted Accounting Principles (GAAPs) or domestic standards, which were developed based on conventional institutions, conventional product structures or practices.²⁰

The objective of the organization is to prepare and develop accounting, auditing, governance and ethical standards relating to the activities of Islamic financial institutions, taking into consideration international standards and

²⁰For example, in the case of Mudharabah contracts, the transaction is neither equity nor liability in nature as the depositor does not assume the rights of an equity holder (i.e., shareholder) of the Islamic financial institution and neither is he guaranteed of returns. Hence, from an Islamic accounting viewpoint, a Mudharabah account may be presented as an 'investment account', appearing as a separate line item from equity or liability on the balance sheet.



practices and the need to comply with Shari'ah rules. As at end 2002, AAOIFI has issued 18 financial accounting standards, four auditing standards, four governance standards and two codes of ethics. It has also issued a Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks. AAOIFI also takes part in efforts to achieve harmonization in concepts and application among the different Shari'ah supervisory boards of Islamic financial institutions in different jurisdictions through the preparation, issuance and interpretations of Shari'ah standards for Islamic financial institutions. In this respect, AAOIFI has successfully issued 13 Shari'ah standards as at end 2002 including standards for istisna' and parallel istisna', musharakah, mudharabah, salam, ijarah and murabahah. AAOIFI also works towards persuading regulatory authorities to adopt its standards. AAOIFI's standards are currently mandatory in Bahrain, Sudan, Jordan and Qatar. They are also being implemented as guidelines by the Monetary Agency of Saudi Arabia and are being used as the basis on which the Malaysian Accounting Standards Board (MASB) develops its domestic Islamic accounting standards.

3.2 Liquidity Management Centre (LMC)

To address the global liquidity management needs of Islamic financial institutions, LMC was established in February 2002 in Bahrain. LMC was established to assist the formation of an Islamic interbank money market that would enable Islamic financial institutions to manage their liquidity effectively. Furthermore, the establishment of LMC facilitates the collection of assets acquired from governments, financial institutions and corporations. This asset pool will be securitized through the issuance of tradable instruments or sukuk for Islamic financial services institutions to invest their surplus liquidity. By creating a secondary market for the trading of these instruments, the LMC is able to provide competitive returns on short-term, liquidity investment opportunities for Islamic financial services institutions. LMC do not publish any standards but it offers other Islamic advisory services including



but not limited to the areas of structured/project/corporate finance as well as equity raising and it has its own Shari'ah Supervisory Board.

3.3 International Islamic Financial Market (IIFM)

IIFM was established with the objective of facilitating the establishment of a cooperative framework among the existing 265 Islamic banks and other financial institutions worldwide to promote product development and the trading of *Shari'ah*-compliant products in the secondary market. It was established in November 2001, but the operation of it began on 1 April 2002. With the purpose of augmenting cross-border recognition of Islamic financial products, the IIFM is also aim to provide independent *Shari'ah* advice and guidelines for the issuance of new Islamic financial products. The Global *Shari'ah* Supervisory Committee (SSC), which was established by the IIFM Board of Directors, will take on the role of reviewing and endorsing new products. IIFM's endorsement will facilitate cross border listing on various international stock exchanges, thereby encouraging the trading of Islamic products and instruments in the secondary market. IIFM has endorsed four global Islamic bonds, issued by the Malaysian government, the Bahraini government, the Islamic Development Bank and more recently the Qatar government.

3.4 Islamic Financial Services Board (IFSB)

IFSB which is based in Kuala Lumpur was established in 2002 with the objective of developing standards to mitigate the unique risks associated to Islamic financial products. It focuses to solve the lack of integrated supervision and regulation of the unique risks associated with Islamic financial products. The IFSB provides services to central banks, monetary authorities and other institutions that are responsible for the regulation and supervision of the Islamic financial services industry. IFSB has formulated international prudential and supervisory standards and best practices for Islamic financial



institutions. It also promotes good practices in risk management in the industry through research, training and technical assistance. The IFSB has developed prudential standards for the Islamic financial services industry, namely capital adequacy and risk management standards, corporate governance, transparency and market discipline.

3.5 International Islamic Rating Agency (IIRA)

In October 2002, IIRA was established by the Islamic Development Bank (IDB) in Bahrain. The main purpose of it is to rate, assess and offer independent assessments and opinions on the likelihood of any future loss by Islamic financial institutions as well as their products and services. It will also evaluate the *Shari'ah* compliance aspects of Islamic financial institutions and Islamic financial products. The data and information relating to rated entities and financial instruments will then be published and disseminated to the public. In addition, IIRA have also introduced a set of rating products and services, including *Shari'ah* transparency, for both financial products and their issuers. IIRA publishes professional analytical research for its multiple constituencies. These researches will set a high standard for the market, enhancing the level of understanding of the value of fundamental analysis in assessing default or investment risk. Seminars will be used to teach this type of analysis outside the rating agency.

4.0 Mechanism to Adopt International Standards

As seen from above, there are numerous international standards issued for *Shari'ah* compliance. But it is not practically possible to follow all the standards as they are not unified and are context based. The products that are created in Maldives need to be suitable for local context and the standard applied shall cater for the Maldivian circumstances. Thus, liberty to determine the status shall be given to SAC of CMDA. The members of SAC shall conduct appropriate research on international standards and compile the view that is most suitable to the circumstances of Maldives; and



duly submit the details to CMDA with subsequently upon approval shall become the standards adopted by CMDA on the respective product. When determining the Shari'ah compliancy of a product, it is imperative for SAC to consider the local custom and the legal infrastructure of the nation. Blind implementation or following of a single international standard might jeopardize or inhibit the growth of Islamic finance in Maldives. With numerous experiences, on the matter, the Malaysian capital market regulatory body, Securities Commission also utilizes such a case to case basis approach in determining Shari'ah compliancy of a product in Islamic Capital Market.

Appendix-i: List of Published Standards by IFSB

IFSB-11: Standard on Solvency Requirements for Takâful (Islamic Insurance) Undertakings

IFSB-10: Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services

IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services

IFSB-8: Guiding Principles on Governance for Takâful (Islamic Insurance) Undertakings

IFSB-7: Capital Adequacy Requirements for Sukuk, Securitizations and Real Estate



investment

IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes

IFSB-5: Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds)

IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds)

IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds)

IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

GN-5: Guidance Note on the Recognition of Ratings by external Credit Assessment Institutions (ECAIS) on Takâful and ReTakâful Undertakings

GN-4: Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only Islamic Financial Services

GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders

GN-2: Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murâbahah Transactions

GN-1: Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Shari`ah-Compliant Financial Instruments

Appendix-ii: List of Published Standards by AAOIFI

Standards under development include:

Shari`ah Standards

Purification of Prohibited Income



Promise and Bilateral Promise
Credit Cards
Agriculture Contract
Capital Protection
Risk Management
Fees and Commissions
Calculation of Financial Transactions Profit
Cooling of Options
Safety Options
Sincerity & honesty options
Investment Agency
Special purpose vehicles
Legal reference for Agreements and contracts for IFIs
Bankruptcy
Liquidity and Its Instruments
Financial rights and its disposal management
Capital and Investment protection

Publications

Publication	Release date	Details
Accounting, Auditing & Governance Standards (for Islamic Financial Institutions) Arabic Version	2010	23 Accounting Standards, 5 Auditing Standards, 6 Governance Standards and 2 codes of ethics
Accounting, Auditing & Governance Standards (for Islamic Financial Institutions) English Version	2010	25 Accounting Standards, 5 Auditing Standards, 7 Governance Standards and 2 codes of ethics
Shari'ah Standards Arabic version	2010	41 Shari'ah Standards
Shari'ah Standards English	2010	41 Shari'ah Standards

Appendix-iii: Standards Developed by AAOIFI:

Accounting standards:	3. General presentation and disclosure in the financial statements of IFIs.
1. Objective of financial accounting for Islamic banks and financial institution (IFIs).	4. Murabaha and Murabaha to the purchase orderer.
2. Concept of financial accounting for IFIs.	5. Mudaraba financing.
	6. Musharaka financing.



7. Disclosure of bases for profit allocation between owners' equity and investment account holders.
8. Equity of investment account holders and their equivalent.
9. Salam and Parallel Salam.
10. Ijarah and Ijarah Muntahia Bittamleek.
11. Zakah.
12. Istisna'a and Parallel Istisna'a.
13. Provisions and Reserves.
20. Islamic Financial Services Offered by Conventional Financial Institutions.
21. Contributions in Islamic Insurance Companies.
22. Deferred Payment Sale.
23. Disclosure on Transfer of Assets.
24. Segment Reporting.
25. Consolidation.
26. Investment in Associates.

Auditing standards:

1. Objective and principles of auditing.
2. The Auditor's Report.
3. Terms of Audit Engagement.

14. General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies.

15. Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies.

16. Investment Funds.

17. Provisions and Reserves in Islamic Insurance Companies.

18. Foreign Currency Transactions and Foreign Operation.

19. Investments.

4. Testing for Compliance with Shari'ah Rules and Principles by an External Auditor.

5. The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements.

Governance standards:

1. Shari'ah Supervisory Board: Appointment, Composition and Report.

2. Shari'ah Review.

3. Internal Shari'ah Review.

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Ethics standards:

1. Code of ethics for accountants and auditors of IFIs.

Shari'ah standards:



1. Trading in currencies.
 2. Debit Card, Charge Card and Credit Card
 3. Default in Payment by a Debtor.
 4. Settlement of Debt by Set-Off.
 5. Guarantees.
 6. Conversion of a Conventional Bank to an Islamic Bank.
 7. Hawala.
 8. Murabaha to the Purchase Orderer.
 9. Ijarah and Ijarah Muntahia Bittamleek.
 10. Salam and Parallel Salam.
 11. Istisna'a and Parallel Istisna'a.
 12. Sharika (Musharaka) and Modern Corporations.
 13. Mudaraba.
 14. Documentary Credit.
 15. Jua'la.
 16. Commercial Papers.
 17. Investment Sukuk.
 18. Possession (Qabd).
 19. Loan (Qard).
 20. Commodities in Organised Markets.
 21. Financial Papers (Shares and Bonds).
 22. Concession Contracts.
 23. Agency.
 24. Syndicated Financing.
 25. Combination of Contracts.
 26. Islamic Insurance.
 27. Indices.
 28. Banking Services.
 29. Ethics and stipulations for Fatwa.
 30. Monetization (Tawarruq)
4. Audit and Governance Committee for IFIs.
 5. Independence of Shari'ah Supervisory Board.
 6. Statement on Governance Principles for IFIs.
 7. Corporate Social Responsibility
 2. Code of ethics for employees of IFIs.



31. Gharar Stipulations in Financial Transactions
32. Arbitration
33. Waqf
34. Ijarah on Labour (Individuals)
35. Zakah
36. Impact of Contingent Incidents on Commitments.
37. Credit Agreement
38. Online Financial Dealings
39. Mortgage and its Contemporary Applications.
40. Distribution of Profit in Mudarabah-based Investments Accounts.
41. Islamic Reinsurance
42. Financial Rights and Its Disposal Management
43. Liquidity and Its Instruments
44. Bankruptcy
45. Capital and Investment Protection



**Appendix-iv: Model Documents Issued by IIFM
(International Islamic Financial Market)**

- ISDA/IIFM Tahawwut Master Agreement (TMA)
 - ISDA/IIFM Tahawwut Master Agreement (TMA)
 - ISDA/IIFM TMA Explanatory Memorandum
 - Tahawwut Master Agreement (Arabic Translation)

- Master Agreement for Treasury Placement (MATP)

- Copyrighted
 - Final Structure Memorandum - MATP Dated 23June2008
 - Master Murabaha Agreement
 - Master Agency Agreement for Purchase of Commodities

- Non Copyrighted
 - Final Structure Memorandum - MATP Dated 23June2008
 - Master Murabaha Agreement
 - Master Agency Agreement for Purchase of Commodities
 - Commodity Purchase Letter of Understanding

- Arabic Translation
 - Final Structure Memorandum - MATP Dated 23June2008
 - Master Murabaha Agreement
 - Master Agency Agreement for Purchase of Commodities
 - Commodity Purchase Letter of Understanding

- Related info
 - MATP Distribution List
 - MATP Adaptation Procedure

- IIFM I'aadat Al Shira'a (Repo Alternative)

Appendix- v: IIRA Rating Process

Issuer/Client	1. Signs agreement for an initial rating.
	2. Submits preliminary information materials.
IIRA	3. Conducts a preliminary study.
	4. Submits a detailed questionnaire to the issuer/client.
Issuer/Client	5. Provides detailed information in response to detailed questionnaire.
IIRA	6. Conducts pre due diligence meeting analysis.
	7. Conducts due diligence meetings.
	8. Conducts post due diligence analysis.
	9. Brief for Committee meetings is prepared.
Rating Committee	10. Decides the preliminary/initial rating.
IIRA	11. Notifies issuer of the preliminary/initial rating.
Issuer/Client	12. May appeal based on any new facts or information.
Rating Committee	13. Deliberates on appeals by issuer/client and gives decision.
IIRA	14. Notifies the decision of the Rating Committee to the issuer/client.
Issuer/Client	15. Consents to release of the rating to the public.
IIRA	16. Releases the rating to media.

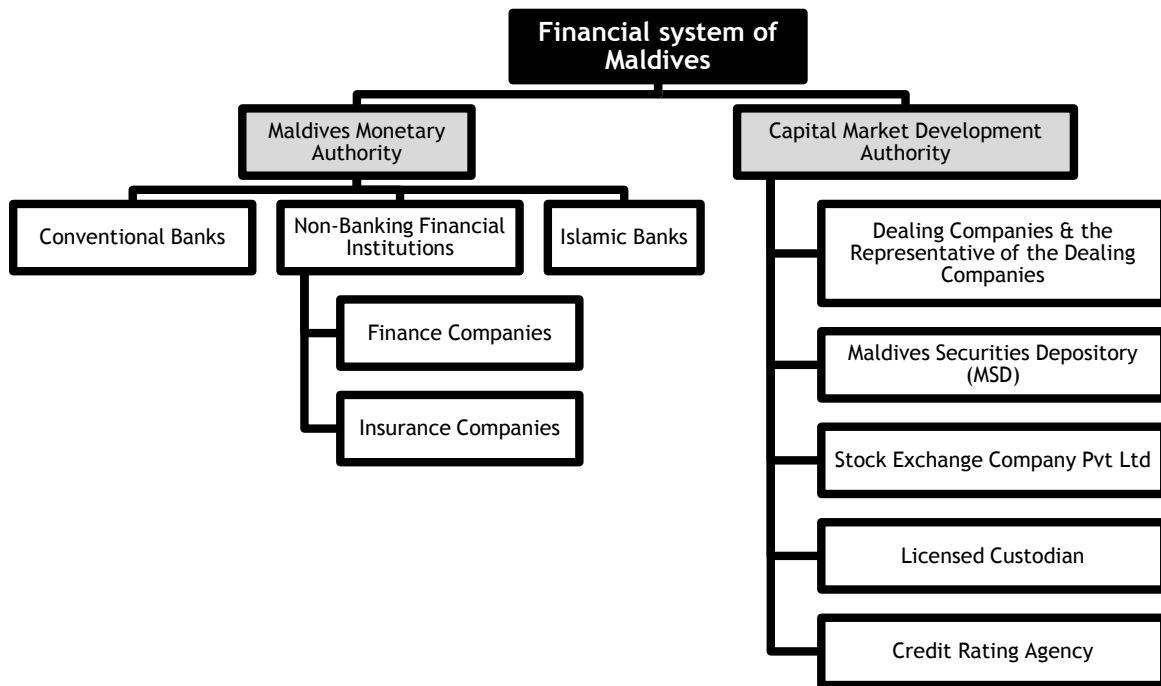


CHAPTER THREE: CURRENT MARKET CONSTRAINTS AND IMPEDIMENTS FOR ISSUANCE OF SHARI'AH COMPLIANT PRODUCTS IN THE MALDIVES

1.0 Introduction

Maldives is a small island nation with limited resources. The financial system of the country is small and is still expanding. The financial and the economic system of the country are based on conventional economics and financial principles. Islamic banking and finance began to loom in the country just early this year. Following diagram illustrates the financial system of the country.

Diagram 1: The Financial System of Maldives



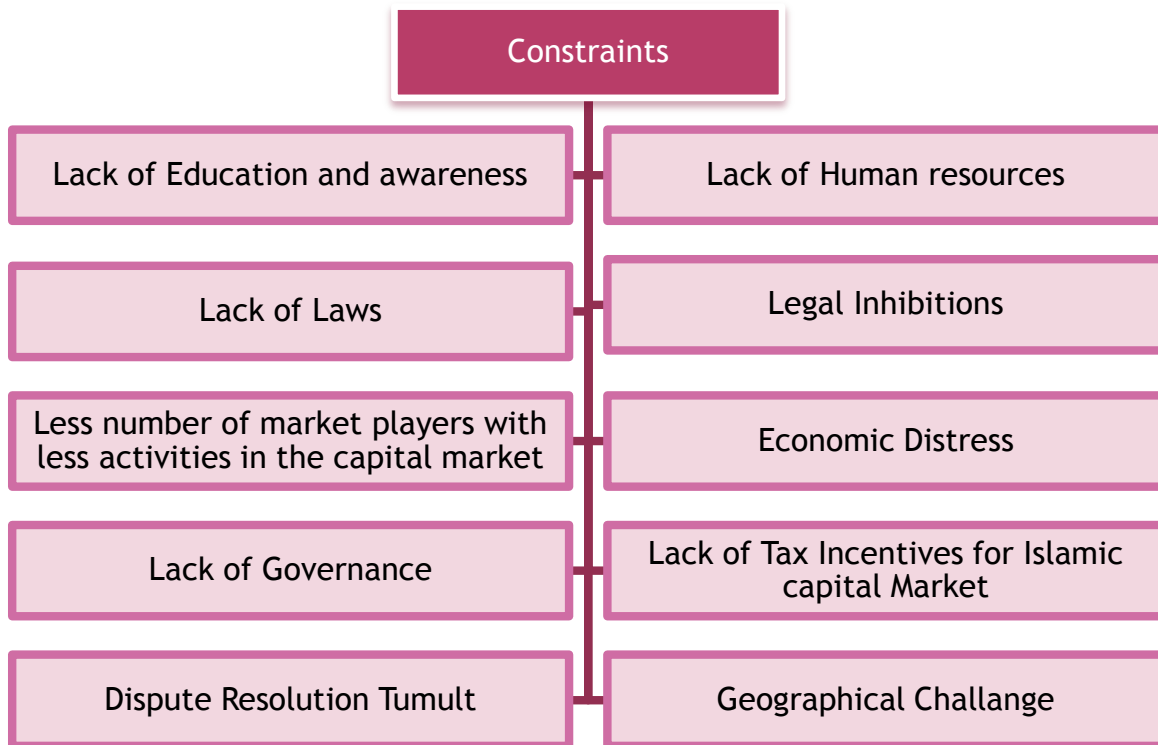
Islamic Banking and Finance is not yet fully launched in Maldives. The first form of Islamic banking and finance that is introduced to the country is takaful service given under a conventional insurance license in 2003. This was followed by the opening of the first full-fledged Islamic bank in the country, followed by the issuance of Islamic equity that gives green signal to the introduction of Islamic capital market to the country. Hence it would not be wrong to state here that Islamic Banking and Finance



is still new to the country and that it is yet to be developed properly. This means that the question of sustainability is not an issue for the time being as now the main focus is to introduce a full-fledged Islamic banking and finance industry in the country.

The current trend proves that Maldives is moving towards creation of dual financial systems; one based on conventional methods and the other one based on Islamic principles. The impediments facing the growth of Islamic banking and finance in Maldives can be highlighted as numerous. The main reason for this maybe because the country is depending on the conventional economic and financial principles and the legislations enacted in the country are molded in away to facilitate the growth and sustainability of it. Furthermore, the economic system of the country does not differentiate halal or haram activities. Hence, consumption of non-halal commodities, usage of riba in the form of interest is very common in the country. This is due to the fact that the Maldivian economy heavily depends on tourism and large portion of tourism is derived from selling of alcohol. The following diagram illustrates the existing impediments for issuance of Shari'ah compliant products in Maldives.





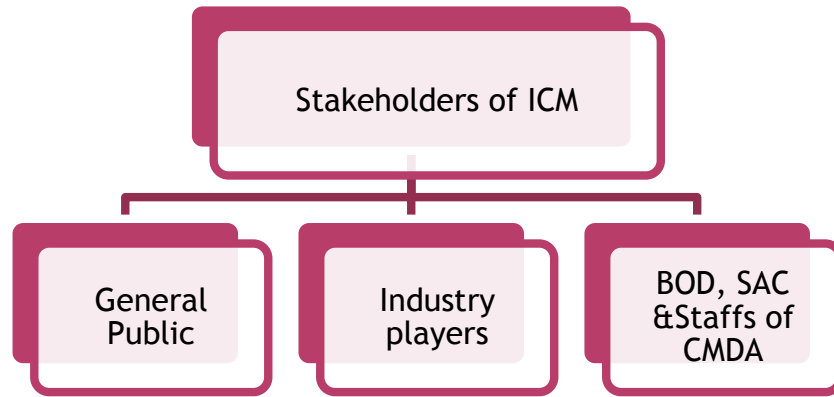
2.0 Current market constraints and impediments for issuance of Shari'ah compliant products

Following explained are the current market constraints and impediments for issuance of Shari'ah compliant products in Maldives.

Lack of Education and awareness

The biggest challenge for the introduction of Islamic capital market in Maldives is the lack of education and awareness of the stakeholders about the mechanisms in which Islamic banking and finance will work. It is imperative to conduct educational and awareness sessions to the stakeholders. The diagram below illustrates the list of stakeholders of Islamic capital market. But the point that shall be noted here that having general lectures from time to time would not help this problem. A systematic effort need to be made.





When conducting education and awareness programs on Islamic banking and finance, the audience invited to them should be categorized according to their knowledge level. For example, stakeholders shall be distributed to people who are Muslims and non-Muslims; and among these two groups again a division shall be made to people who have background in Islamic finance and to people who do not have any knowledge about it. This classification is imperative among the stakeholders as this will let the conductor or the trainer of the education and awareness session be prepared to get optimal result within the limited time allocated.

When conducting sessions to public, again the audience from the public must be selective. The audience from the public could be classified into people who know conventional finance and people who have no idea what the conventional finance is. This classification is important because, most of the public in Maldives is not exposed to the activities in the capital market and if the trainer or the conductor starts from the basics of Islamic capital market; this group of audience would have a hard time in digesting it.

Furthermore, it is vital to conduct these education and training sessions in the native language Dhivehi as this would make it easier for the population to digest it. Most of the Maldivian population lacks the required or essential vocabulary of Islamic terms in Arabic or English, hence, the only way to facilitate them understanding the background of Islamic banking and finance



is for them to have an opportunity to digest it in Dhivehi. But for some selective groups of audience and stakeholders, especially to foreigners conducting sessions in English would help.

Not only should lectures shall be organized, but leaflets and books on Islamic capital market which is written in both Dhivehi and English needs to be available in the market. Limited books on this subject matter are available in the bookshops in Maldives. Hence, the regulator could give grants for good academicians or groups of academicians in the country to write such materials in Dhivehi. As for English materials, it is available every where today. Hence the regulator could suggest some books to be sold in the bookshops. This could be done with the co-operation from the bookshop owners.

Giving financial grants to write books might be a costly and time consumed task for the regulator. Hence, the regulator may organize some essay writing competition on Islamic capital market in native language. This will give the opportunity for CMDA to get numerous written materials on the subject and the good essays could be compiled and a book could be published.

Another way to educate and aware the population is to have continuous TV and Radio programs that will focus on the matter. This could be conducted in the form of master classes where sub-topics of Islamic capital market could be dealt each week. Furthermore, in special months like ramadhan or eid, the regulator could conduct quizzes on Islamic banking and finance to the public. These will swift the learning process as then the public would learn about Islamic banking and Finance in a fun way. Likewise, some programs could be dedicated to answer the questions from public. But the regulator shall be careful not to politicize these programs by letting politicians conduct them.

The next way to promote education and awareness among the general population is by organizing seminars and conferences and short courses. At the end of these events certificates of participation could be given to the



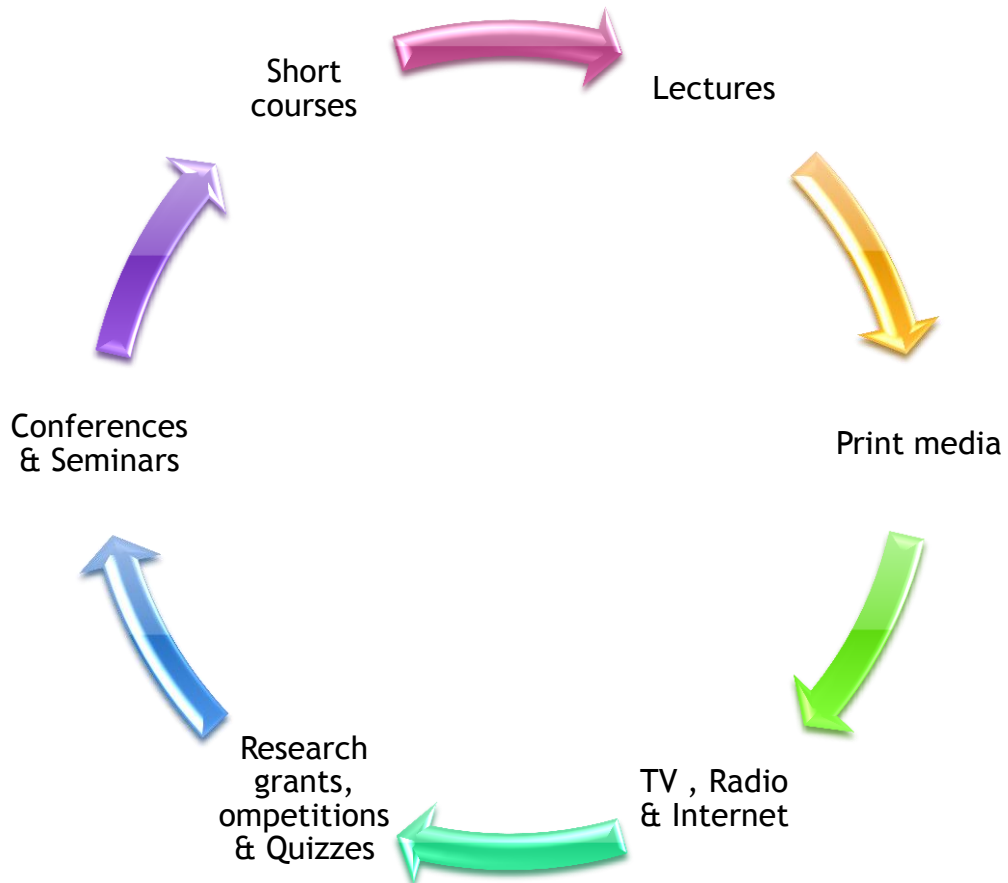
participants. This would encourage people to attend these events.

Print media could also be used as means to educate people.. The regulator could sponsor a part of a page in the local newspapers to put short articles on Islamic banking and finance. This would definitely educate the paper readers.

To educate the population living outside Male', the regulator could conduct lecture sessions in some selected islands. The month of Ramadhan would be a good time to do this. All of the above described activities shall be equally carried in islands of the Maldives too as they also need to be educated on the matter. Definitely educating the public and stakeholders would be a long process without which the success of Islamic banking and finance would not be evident to the naked eyes. Hence, this is the first matter that should be tried solving.

Not only shall the public and the stakeholders be educated. The adequate exposure to the industry and continuous training shall be given to the staffs of CMDA, including the members of SAC, the Board of Directors and the staffs. The following diagram summarizes the above stated means of educating stakeholders. The arrows between the means signify that the process should be continuous.





Lack of Human resources

For Islamic banking and finance, it is not only the religious knowledge that is needed. It requires people from different disciplines. Religious scholars are one type of people that is needed for Islamic banking in finance. In Maldives there are lots of graduates from religious fields. But this does not qualify all of them to be Shari'ahscholars or Shari'ahofficers capable of advising or handling Islamic banking and finance matters. The Shari'ahscholars or the Shari'ahconsultant/officers shall have the knowledge of Islamic fiqh muamalat or Islamic jurisprudence to qualify to deal with the matter. It is hard to find religious scholars in Maldives who possess thin quality. Hence this is and would indeed be a challenge as Shari'ahscholars play a vital role in Islamic banking and finance as watchdogs to protect Islamicity in the transactions.

Not only religious scholars specialised in usul al fiqh or Islamic commercial law



is needed. Accountants who know Islamic accounting is needed. Economists who know Islamic economics are needed. Compliance Officers who knows Shari'ah are needed. Scholars capable of carrying out Shari'ahrisk management and Shari'ah audit is also needed. Finance specialists who know Islamic finance is needed. Researchers who can do research on the development of Islamic banking and finance is needed.

Currently the country lacks adequate number of people from these disciplines. It is mainly the graduates from International Islamic University that possesses knowledge from this field. Without these people it would be impossible to sustain an Islamic finance industry parallel to conventional finance industry in Maldives. Over a night this problem cannot be solved. Hence, the regulator needs to train people from these fields. To initiate this, the regulator could propose the relevant Ministry of the country to amend the existing skill shortage list and human resource requirement list to include people to be trained from Islamic banking and finance related fields. This could be done at national level.

In an international level, there are many institutes in the world today that trains people from different fields of Islamic banking and finance. The regulator could sign a memorandum of understanding with some of these institutes and send Maldivians to be trained in the field. If not there is a danger that the foreigners would penetrate and dominate into this industry creating long term problems. When structuring Shari'ah compliant products, understanding the local circumstances and the domestic needs is essential. If not the product would not help the society and the economy to improve.

The regulator need not always send people to train abroad, but in collaboration with institutes like Harun M. Hashim Law Centre of International University Malaysia, they could always conduct Executive courses in Maldives for people who want to specialize in Islamic banking and Finance. Long distance Islamic banking and finance courses are conducted by INCEIF. The



Chartered Islamic Finance Professional (CIFP) program conducted by INCEIF is a globally recognized program that any one could enroll and do while in Maldives. Hence, it is incumbent for the regulator to explore these opportunities and start building people for the industry.

As for overseas courses on Islamic banking and Finance, International Islamic University Malaysia would be a suitable place as it has a dedicated faculty for Islamic banking and finance.

Lack of laws

In Maldives the existing legal system lacks legislations to introduce and sustain Islamic capital market. The current legal framework lacks laws that will protect investors in sukuk. Special Purpose Vehicle/Company (SPV/SPC) is essential to protect investors especially to protect them in case of bankruptcy. The existing Companies Act or any other law of the country does not provide provisions for SPC. This created a legal lacuna to protect investors. Furthermore, the country lacks laws governing trust. This again provides a lacuna in protecting the rights of investors. These two issues are the most vital things to note here as though SPC and appointment of a Trustee is not a Shari'ah requirement for issuance of Sukuk, from a legal point of view these two things are essential for the sake of protecting investor's rights.

Also currently there are no guidelines to regulate sukuk issuance, Islamic stock broking, Islamic mutual fund, Shari'ah consultancy firms, Shari'ah advisors and also regulate the secondary market of Islamic capital market. Hence, there is need for the regulator to come up with these regulations. This is because taking precaution is better than resolving issues.

Instead of introducing legislations through parliament, the regulator may regulate these aspects through guidelines as CMDA has the authority to do this.



Legal inhibitions

Some of the existing laws in the country need amendment as these laws as it is would cause problems to develop Islamic capital Market in Maldives. The following table would illustrate some of the major legal inhibitions facing the introduction and development of Islamic capital market in Maldives:

Legislation	Section	Problem	Suggestion
Land Act 1/2002	18 (d) For every land sale effected private person, a tax of 15 percent of the sale price would be levied.	This makes it costly for private people to transfer land for the purpose of issue sukuk	This provision could be exempted for sukuk transactions
Land Act 1/2002	18 (c) A land bought and registered under the name of a hundred percent Maldivian company cannot sell any portion of its shares to a foreigner.	This means that if a sukuk is made on a land registered under a hundred percent Maldivian owned company, than no portion of that land could be sold to a foreigner. This means that this type of land cannot be an underlying asset of a sukuk that requires selling of land to the sukuk holders as foreigners cannot then be part of this type of sukuk	This provision could be exempted for sukuk purposes
Land Act 1/2002	It is unsure whether an undivided portion of land could be sold to a group of people	Common ownership is essential for some sukuk structures if it involves selling of undivided portion of the land to the sukuk holders.	Provisions for common ownership needs to be inserted



<p>Revenue Stamp Law 4/70</p>	<p>(4) (a) revenue stamping for registration of private agreements that involves money</p>	<p>There will be numerous agreements involved in sukuk. If all the agreements need to be registered individually, revenue tax for each of the agreements need to be imposed. This will increase the cost for sukuk transactions</p>	<p>For sukuk purpose, tax revenue maybe taken for the Program Facility Agreement only. This would be similar to the treatment given to Maldives Islamic Bank Pvt Ltd.</p>
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Few number of market players in the capital market with few activities

The conventional market players in the capital market are also less. The main reason for this which could be identified is lack of demand. Hence, there is a probability that the competition in the market for Shari’ah complaint products might also be small. Hence, education and awareness of the stakeholders and public on how the capital market works is essential. In order to create more players in the market, it is imperative to create a demand driven field. Incentives from the regulator may create more players in the field and initiatives for this need to be taken by the regulator.

Economic distress

The economy of the country is fragile and it is now in a verge of collapse. The increase in the dollar rate has exacerbated the inflation rate in the country. The country is still struggling to recover from the Tsunami effect. People are trying their level best to meet their necessities and it has become a burden for them to deposit some portion of their income in the Pension Fund. Hence, it is risky task to introduce Islamic capital market in this scenario unless people are aware of the benefits they will be getting from it. If not, the investors may have to be brought from outsiders and in long term this may have negative effect on the basis of limited local income.



Lack of Governance

When introducing Islamic capital market, there shall be a proper governance mechanism in place. CMDA is making a good effort to do this and they have taken the first step of introducing a Shari'ah Advisory Committee. However, for the sustainability of Islamic capital market, CMDA as the regulator needs to create a special unit under them to specifically deal with the matters related to Islamic capital market. This is because, CMDA has a wide range of market players to be regulated under them, and it would be easier for them to have a separate unit under them to deal with Islamic capital market matters. It would be prudent to put this unit in place now than later as if the unit is put in place now the people in the unit would have a clear idea of what is happening. They will be part of the process. As a result, they will have the opportunity to learn and gain practical experience. This is because, the avatars of Maldivian Islamic capital market would very much depend on the local scenario. Hence, giving locals to be part of the process would give long term benefit to the authority, rather than bringing outsiders to handle the matter. Furthermore, CMDA needs to enact a proper governance code for Islamic capital market, so that from an early stage the players in the market would know what they are expected of. There is need to emphasise on the terminologies like Shari'ah audit, Shari'ah risk management, Shari'ah compliance and Shari'ah audit. These things are still new to the industry and CMDA has got the chance to put these things in place before the things get complicated.

Furthermore Islamic financial intermediaries like Islamic rating agencies and Islamic stock broking services need to be introduced to the country. There is also need to establish more Islamic banks in the country as a pathway for the creation of Islamic Inter-Bank Money Market and Islamic Inter-Bank Cheque Clearing System. Also the Securities Depository of the country needs to be independent from the Maldives Stock Exchange.



Lack of Tax Incentives for Islamic capital Market

The existing tax laws of the country do not provide adequate incentives for the players of Islamic capital market. For example, it is evident from section 5(d) of the Income Tax Act that from the annuities received from pension fund, the beneficiaries will have to pay tax to the government. Hence, even if the specific portion of the pension fund is invested in sukuk, the beneficiaries will have to pay tax from the profit received. Likewise, it is clear from section 5(e) of the Income Tax Act that the profit received by sukuk ijarah holders will be liable to pay tax to the government as receiving profit from a rented movable or immovable property is an integral part of sukuk ijarah. Furthermore, under the existing legal structure, it is questionable whether a foreigner or a foreign company could be an issuer of a sukuk or a sukuk holder especially in sukuk structures involving possession or ownership of land. Even if the existing Land Act is amended and the Foreign Investment Act is repealed, this problem would not be solved. Certain incentives to foreign companies and individuals need to be given to open the Maldivian market to the world. This would be an important step to eliminate the current dollar deficit crisis in the country.

For an emerging industry, it is imperative to be given some kind considerations. The following diagram illustrates the tax incentives given for Sukuk in Malaysia and Maldives take a similar approach.

Party	Details
Incentives for Special Purpose Vehicles	<ul style="list-style-type: none"> • Tax exemption on income received by Special Purpose Vehicles (SPV) in issuing sukuk (excluding asset-backed securities). • Companies that establish Special Purpose Vehicles for the purpose of issuing Islamic securities are allowed a tax deduction on the issuing costs incurred by the Special Purpose Vehicles. This incentive is also extended to SPV established under the Offshore Companies Act 1990 electing to be taxed under the Income Tax Act 1967.
Incentives for Issuer	<ul style="list-style-type: none"> • Tax deduction on expenses incurred in the issuance of Islamic securities approved by the Securities Commission until year of



	assessment 2015. The incentives is also extended to expenditure incurred on the issuance of Islamic securities approved by Labuan Financial Services Authority (Labuan FSA).
Incentives for Instruments	<ul style="list-style-type: none"> Stamp duty exemption on instruments used to issue sukuk in any currency.
Incentives for Investors (Institution)	<ul style="list-style-type: none"> Tax exemption and withholding tax exemption on interest or profits received by non-resident investors from investment in Islamic securities issued in any currency, other than convertible loan stock, approved by the Securities Commission. Tax exemption on profits received by resident and non-resident investors in respect of foreign currency Islamic securities approved by the Securities Commission and originating from Malaysia, other than convertible loan stock. This exemption extended to profits received from non-ringgit sukuk originating from Malaysia approved by Labuan Financial Services Authority (Labuan FSA). Stamp duty exemption on investing and trading of sukuk.
Incentives for Investors (Individual)	<ul style="list-style-type: none"> Tax exemption on interest or profits paid to an individual from investment in: <ul style="list-style-type: none"> Securities issued or guaranteed by the Government. Debentures, other than convertible loan stocks, approved by the Securities Commission.

Dispute Resolution Tumult

Currently, there is no proper mechanism established in CMDA for dispute resolution. If there is any dispute within the industry, the matter could be taken to a court of law. The persisting complains in Maldives and the rest of the world with regard to litigation is that the judges lack the technical knowledge and expertise and their judgment is unfair. To solve this hassle and commotion in the Maldivian capital market industry, it is imperative to create a dispute resolution body within CMDA to resolve capital market issues that may arise. It is crucial to note here that going for litigation would be more costly and the reputation of the industry may get tarnished if this type of a mechanism is not established within CMDA. This will minimize the dissatisfaction problems that might be created when the matters go to the court.



It would be prudent for CMDA to create an Arbitration Board to solve disputes amicably within the capital market industry. Disputes among brokers, broker/dealers, market makers, investment advisors, issuers, investors and other concerned parties relating to their professional activities shall be considered by the Arbitration Board. It is not a difficult task to establish an Arbitration Board and the benefits that would be enjoyed is endless. Arbitration Board can have three members. One member appointed by the head of the judiciary from among the experienced judges. The other two members shall be economic and financial experts proposed by CMDA and one of these members could be knowledgeable in Islamic capital market matters. CMDA may appoint and introduce each an alternate member in addition to their principal representatives to participate in Arbitration Board in case of absence of a principal member. Qualifications for alternate members shall be the same as for principal members. The budget of Arbitration Board can be formed and paid out as a part of the CMDA's budget. The Arbitration Board can have a secretariat located at the premises of the CMDA. To make the work of the Arbitration Board legal, and to make the awards given by the Board conclusive and final, it is imperative to amend the Securities Act 2/2006 to include provisions relating to the creation and governance of Arbitration Board. An example of a workable model of this kind of Arbitration Board could be found in Iran.

However, it is not entirely necessary to amend the Securities Act 2/2006 to give effect to the awards given by the arbitration board immediately as section 18 of the Contracts Act of the country clearly stipulates that if an arbitration clause is included in the agreement, the court would honor such provision. Hence, until the Securities Act 2/2006 is amended to give effect to a full fledged statutory Arbitration Board, CMDA could enter into a gentlemen agreement with the industry players to promote arbitration clause in the agreements made and on case by case basis, CMDA could form arbitration panels to solve disputes encountered within the industry. This would solve



industry disputes directly going to the court.

Geographical challenge

The biggest failure and the challenge for the Maldivian banking and finance industry is that it is unable to cater to the whole population of Maldives. Hence, it is imperative to find ways to cater to the population of Maldives living in islands other than Male', the capital. This is the only way that Islamic capital market could help to benefit the whole population of Maldives evenly. It is observed here that Bank of Maldives could play a vital role in helping CMDA as it has got some of its branches in the other islands of Maldives and this could be a way to access the island population. Everything from educating public to issuance of products shall be provided to the island populations as well. This might appear as costly. But the truth is that innovation with technology might be the solution to this challenge.

Through the help of Bank of Maldives, the supervision of the sukuk projects carried out in the scattered islands of the Maldives would be easy. The experience of Bank of Maldives in carrying out developmental projects in the islands of Maldives could be used to develop sukuk market in Maldives. Hence, for CMDA, Bank of Maldives could be the key to access the Island population of the country with a lower cost.

It is comparatively highly costly to conduct projects in parts of the country. In implementing sukuk structured for national development, especially, localities other than the capital region, it might be a challenge to conduct projects and finish them on time as transporting things and travelling and managing the products in these parts of the country will be a challenge as not all islands are accessible easily. Hence, due to unforeseen circumstances the cost of the projects may rise and this may affect the sukuk profit.



It is imperative to eliminate these constraints in order to have a full-fledged Islamic banking and finance industry in Maldives. Definitely, for a hundred percent Muslim country like Maldives, having an Islamic capital market is essential.



CHAPTER FOUR: LICENSING STRUCTURE FOR MARKET INTERMEDIARIES DEALING IN SHARI'AH COMPLIANT PRODUCTS

1.0 Introduction

Financial intermediation is the process of moving funds from surplus units to deficit units. The suppliers and users funds can be governmental bodies, private institutions and individuals. In general, there are two forms of financial intermediaries. They are the individuals, like private bankers and financial planners; and Institutions, like investment banks and fund managers.

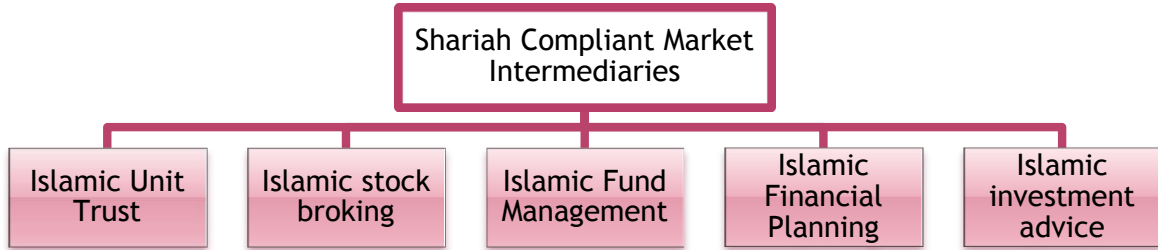
In Maldives, the market where suppliers and users of funds meet is divided into financial market regulated by Maldives Monetary Authority (MMA) and capital Market regulated by Capital Market Development Authority (CMDA). The pool of savings under MMA include conventional banks and Islamic banks, insurance and takaful operators; and under CMDA includes pension fund, and stock brokers.

Shari'ah compliant financial intermediation is a financial intermediation process that is consistent with the principles of Shari'ah or Islamic law and Islamic commercial law in particular. The products and advice offered by financial intermediaries shall be consistent with Islamic law, if it is to be called Shari'ah compliant financial intermediary. Islamic ethical principles shall be complied in both structuring of the products and the advice it offer.

In Shari'ah compliant financial intermediation, generally the relationship between the suppliers of funds and Financial Institutions, if based on the concept of mudharabah or partnership, than the financial institutions will carry no liabilities in case of loss. But if the relationship between suppliers of funds and financial institutions are based on non-mudharabah, then the relationship between the parties would be based on qard or lending relationship.

Diagram 1: Examples of Shari'ah compliant market intermediaries that could be created in Maldives by CMDA





Malaysian Practice: Single Licensing Requirement for the Players of Capital Market

A common feature of securities regulation is that only approved persons are allowed to carry on the business of providing capital market intermediation services. The framework for securities and futures regulation in Malaysia provides that a person must possess a valid licence to carry on the business of intermediation services, under which, the failure to do so constitutes an offence. There are six activities that require a license which include dealing in securities, fund management, investment advice, trading in futures contract, advising in futures contracts and futures fund management. Before the coming of CMSA, the law requires that the carrying on of the business dealing in securities and trading in futures contracts would require separate dealer's and futures broker's licenses respectively. A person who deals in securities who also wishes to trade in futures contracts would be required to hold two separate licenses. This leads to additional burden on participants intending to undertake multiple services under a single legal entity. Hence, section 58 of CMSA provides that market intermediaries should only be issued with a single "Capital Market Services License" (CMSL) to carry on the business in one or more regulated activities.

Source: Website of Securities Commission, Malaysia



2.0 Licensing Structure for Financial Intermediaries

The term “Financial and Monetary Intermediaries” refers to any physical or juridical person, other than Financial Institutions, who: a) practices the profession of foreign exchange dealing based on the purchase and sale of currencies, currency notes, coins of all kinds and travellers’ cheques; or b) acts as a stock-broker or agent who sells and purchases domestic as well as foreign stocks and bonds, in a local capacity or as agent of a foreign institution.

The current trend under the Act is that CMDA will have to grant separate licenses for each of the activities a company wants to carry out in the capital market. It would be prudent to have a single licensing framework for this purpose. This is because, Maldives is a small place with few market players and each market player would have multi functions and it would be difficult on their part to administratively manage multiple licenses, and apply for license to carry out specific activities in the capital market. This would definitely lessen the administrative hassle and the paper cost. It shall be noted here that all the financial intermediaries under the purview of CMDA shall be licensed. Even the consultancy firm’s shall apply for licenses. Under the existing Act there are two types of licenses granted; Islamic Capital Markets Services or representative license²¹ and Islamic Financial Advisers or representative license.²²

The current law relating to license is explained in the table below:

Section	Subject	Provision
31	Licensing conditions (s.31)	(a) (1) A dealer’s license or an investment adviser’s license shall only be granted or renewed provided the applicant meets such financial requirements as may be prescribed by this Act and Regulations made there under.

²¹ See section 29 of the Act

²² See section 30 of the Act



		<p>(2) No person shall be granted a license under this Act unless the person satisfies the conditions laid down in this Act and within the last 10 years has not been convicted of any offence involving fraud or dishonesty, or where the applicant is a company provided none of the directors of the company has been convicted of any such offence.</p> <p>(3) Where the license is issued to an individual he should not have been adjudged a bankrupt in the Maldives or elsewhere, or if a company, it should not be wound up or an order or resolution for winding up has not been made.</p> <p>(b) Where the Authority thinks fit, by written notice they may vary a licensing condition or may impose additional conditions in relation to a license.</p>
<p>32</p>	<p>Application for license and other matters pertaining to renewal of licenses</p>	<p>(a) The Authority may renew a license on such terms and conditions as may be prescribed by the Authority under this Act.</p> <p>(b) A person who, in connection with an application for a license or for renewal of a license, willfully or knowingly makes a statement which is false or misleading or omits to state relevant matters is guilty of an offence punishable on conviction by a fine not less than Rufiyaa 25,000 and not exceeding Rufiyaa 100,000 or imprisonment for a term of not less than 3 months and not longer than 1 year together with a fine of Rufiyaa 75,000.</p> <p>(c) Where on an application for a license or renewal of a license, the Authority refuses to grant or renew the license the aggrieved party may appeal to the Minister within 30 days of decision of Authority. The Minister's decision on the matter shall be final and binding and the Authority shall act in accordance with that decision.</p> <p>(d) Where the Authority revokes a license, the</p>



		aggrieved party may apply to court within 30 days of that decision.
33	Term of License	With the exception of the license granted to the Stock Exchange, unless otherwise specified, all licenses granted or renewed under this Act shall be valid for a period of two years from the date of the grant or renewal as the case may be.
34	Revocation or suspension of license	<p>(a) A license shall be deemed to be revoked on the occurrence of the following events:-</p> <ol style="list-style-type: none"> 1. Where the license was granted to an individual, upon his demise or where he is adjudged a bankrupt; 2. Where the license holder is a company, an order or resolution for winding up has been made. Where a company holding a license decides to wind up the company, the Authority has to be informed of that decision 3 months prior to the winding up of the company. <p>(b) The Authority may revoke a license issued under this Act provided:-</p> <ol style="list-style-type: none"> 1. In the case of a licensed person who is an individual – <ol style="list-style-type: none"> (i) Where a court order for levy of execution in respect of any of his debts has not been satisfied; (ii) if he has not carried out any business under the license issued to him or he ceases to carry on the business for which he was licensed; (iii) if he has been adjudged a bankrupt in any jurisdiction; (iv) if, in the case of a representative, the license of the dealer, in relation to whom



the representative's license was granted, is revoked and within a month after the said revocation he has not started representing another dealer licensed under this Act;

- (v) if the Authority has reason to believe that the licensed person is not performing his duties efficiently, honestly or fairly;
- (vi) If he is convicted of an offence involving fraud or dishonesty;
- (vii) If the licensed person fails to comply with any provision of this Act or regulations made there under or condition(s) applicable in respect of the license.
- (viii) If a holder of a license issued under this Act is sentenced to imprisonment for a term longer than 6 months or banishment or house arrest for the same duration.

2. In the case of a licensed company -

- i. If an order for winding up of the company is made under section 93 of the Companies Act or the process of winding up of the company has already commenced;
- ii. Where a court order for levy of execution in respect of any debts of the company has not been satisfied;
- iii. if a receiver or a receiver and manager has been appointed whether in the Maldives or elsewhere by a court or creditors in respect of the company's property;
- iv. if it has entered into any arrangement in relation to its debts with its creditors;
- v. if it ceases to carry on the business for which it was licensed under this Act;
- vi. if the Authority has reason to believe that the licensed entity, or any of its directors



or employees, is not performing his duties efficiently, honestly or fairly; or

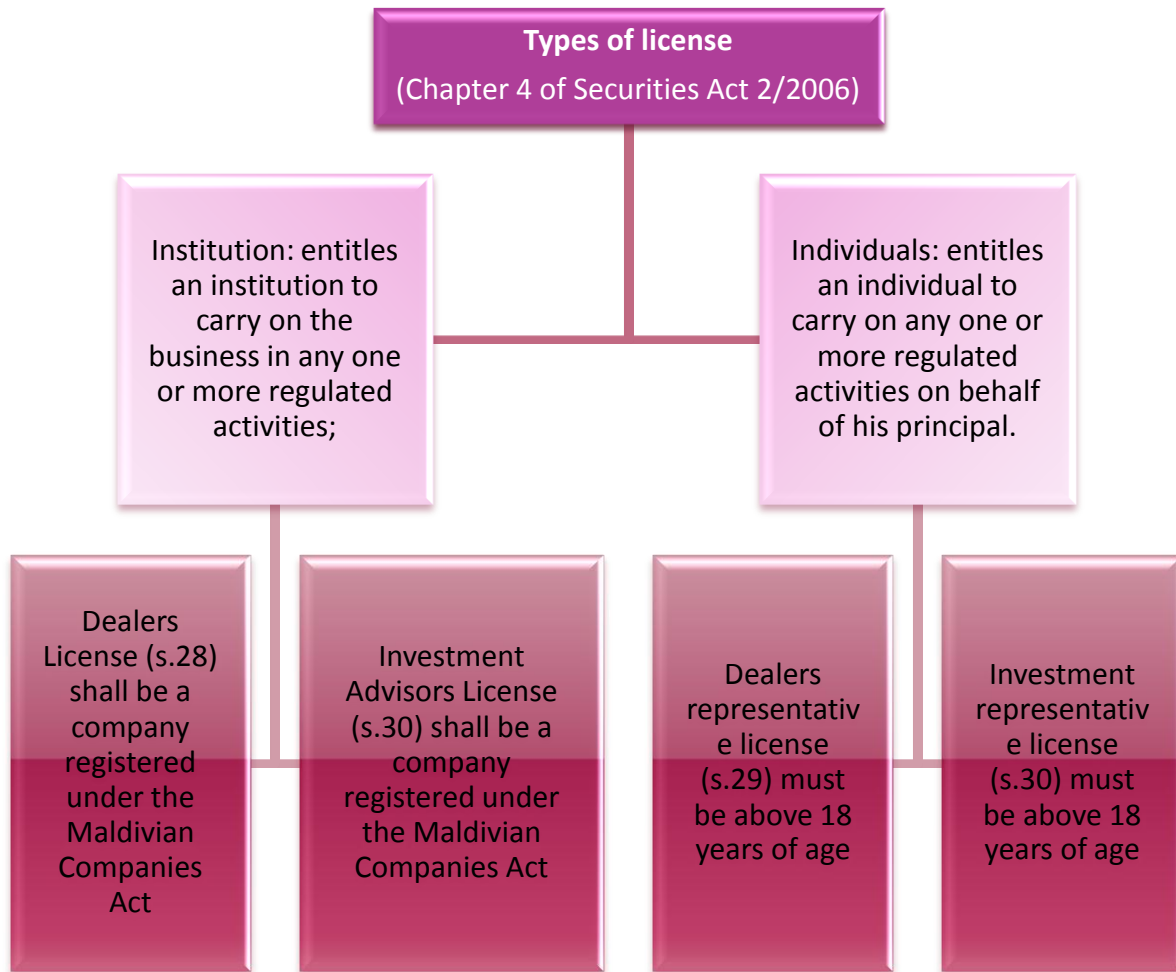
vii. If the licensed entity contravenes any provision of this Act or regulations made there under or any condition(s) applicable in respect of the license.

(c) In the case to which subsection (b) applies, the Authority may instead of revoking a license, suspend the license for such a period as may be prescribed and the Authority may at any time remove such a suspension order.

(d) Due to revocation or suspension of a license issued under this Act:

1. any agreement or transaction relating to the trading in securities entered into prior to the suspension or revocation or after the suspension or revocation will not be deemed terminated; and
2. any rights or obligations arising under such a transaction or agreement shall not be affected.



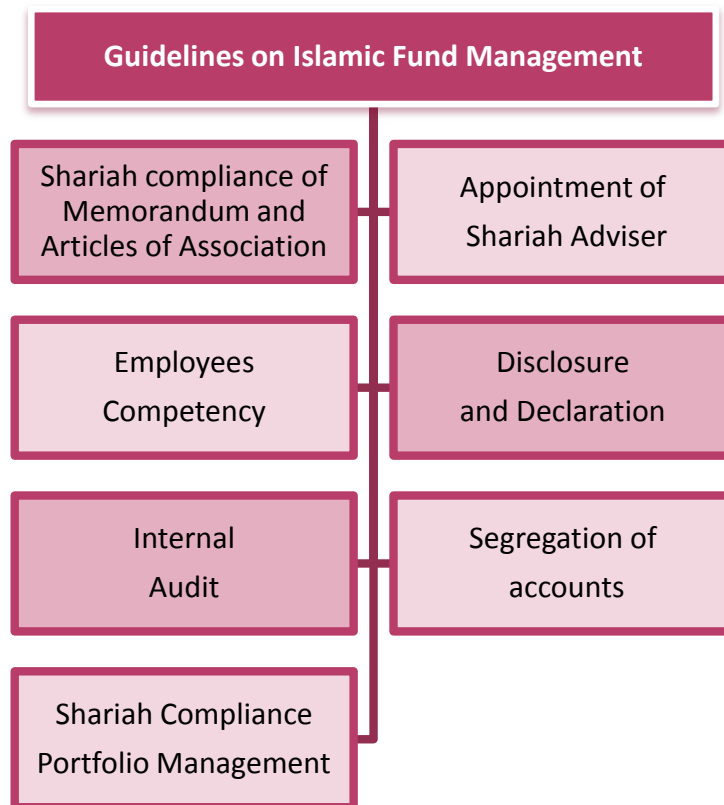


It could be observed here that the existing approach or structure could be used in giving license to Islamic financial intermediaries. Since the market is small in Maldives, it would be prudent to issue separate license for different services. However, there shall be specific conditions attached to the licenses given apart from the general conditions stipulated in the Securities Act 2/2006. The guidelines made for the regulation for different Islamic financial intermediaries would provide the specific conditions that shall be met. For example, the guidelines on Islamic fund management would provide the specific conditions to be attached to Islamic fund managers. A sample of this is provided in the next part of this report. Hence, CMDA need to enact adequate guidelines for the purpose of regulating the financial intermediaries.



Sample: Guidelines on Islamic Fund Management

The Guidelines on Islamic Fund Management sets out the requirements that must be followed by the Islamic fund manager that carries Islamic fund management activities as well as the fund manager that operates under an Islamic “window”. This Guideline provides certain prerequisites that must be observed by the players in fund management activities. The requirements are as follows:



The explanation of the above mentioned requirements:

1. **Shari’ah compliance of Memorandum and Articles of Association**

The Memorandum and Articles of Association of the Islamic fund manager must state that all activities must be carried out according to Shari’ah principles. This requirement however is not applicable to the Islamic fund manager that works under Islamic “window”.

2. **Appointment of Shari’ah Adviser**

The management is required to appoint the Shari’ah adviser (at least one) to advise



on all aspects of Islamic fund management business including structuring investment instruments and documentations to ensure compliance with relevant regulations and Shari'ah principles.

3. **Employees Competency**

The Fund manager is required under the Guidelines to sustain employees' competency by providing adequate and sufficient training on Shari'ah knowledge on Islamic finance and capital market. This requirement is particularly applicable to the compliance officer who is responsible to ensure overall compliance in the operations of Islamic fund management.

4. **Shari'ah Compliance Portfolio Management**

The Islamic fund manager must maintain Shari'ah compliance in the operation and management of its investments activities, maintenance of accounts, and risk management. It should be noted that the similar guidelines should always be observed by the fund manager who manages the Islamic fund operating under Islamic "window".

5. **Disclosure and Declaration**

The Guidelines also requires the Islamic fund manager and the manager who manages the Islamic fund under Islamic "window" to prepare annual written disclosure and declaration of Shari'ah compliance of their activities.

6. **Internal Audit**

The Islamic fund manager must provide and maintain appropriate system for Shari'ah audit to ensure compliance with the Guidelines and the relevant securities laws.

7. **Segregation of accounts**

The Islamic fund manager who works under the Islamic "windows" must maintain separate accounts for the Islamic and conventional funds and investments.

To facilitate the operations of Islamic fund management, the Guidelines further provides the lists of possible Shari'ah principles and concepts that may be applied in the structuring, investment and operations of the Islamic fund. The lists, however, are not exhaustive, and the Islamic fund management activities should not only be confined to those mentioned principles, but may adopt or extend to other Shari'ah compliance principles approved in fiqh al-muamalat.



CHAPTER FIVE: PRIMARY MARKET AND SECONDARY MARKET FOR SHARIAH COMPLIANT PRODUCTS INCLUDING SUKUK

1.0 Introduction

The platform for primary and secondary market for Shari'ah compliant product is already in place. What is lacking now is the mechanism to stipulate the conditions and some additional enhancement features for Shari'ah compliant products in primary and secondary markets. In short, this simply means that the Shari'ah compliant products including sukuk would be offered in the existing markets with a slight change.

2.0 Primary Market for Shari'ah Complaint Products

In the primary market, securities are offered to public for subscription for the purpose of raising capital or fund. When it comes to Shari'ah compliant products, there is no issue in the primary market level as Shari'ah compliant products will be dealt in the same manner as a conventional product that is sold in the primary market of Maldives.

In this level, the only concern would be to structure Shari'ah compliant products with innovation to attract investors and to disclose its information adequately to the public. Islamic indices for equity and Islamic credit rating will be needed to properly convey the information to the investors. Hence, agencies providing Islamic indices and Islamic credit rating would be important.

Furthermore, laws to protect investors, such as laws to create SPV and govern trustee is needed. Sukuk generally involves either sale of an asset or participation in a business venture and adhere to Shari'ah conditions and, in case of securitization, to realize bankruptcy remoteness, the Sukuk assets/ business would be owned by a separate legal entity other than the Issuer, which is the SPV. The existing Company law does not provide a proficient mechanism to set up and continue transaction specific special purpose companies. A regulatory framework facilitating the establishment of special purpose companies with nominal share capital would boost the confidence of the stakeholders in Islamic capital markets.

The most critical issue that needs to be solved for the time being to start issuing



sukuk is to compromise the statutory requirement stated in the section 23 (a)²³ Companies Act 10/96 of Maldives which expressly states that only a public company could issue shares or debentures to the public. It shall be noted that section 23 of the Act shall be read with the definition of debenture stated in section 102 of the Act that is quoted below:

A debenture is any written document issued as evidence by the company to the lender upon payment of money to the company by the lender upon the mortgage of the company assets or not.

Debentures shall not include the following:

1. Bill of exchange
2. Promissory note
3. Letter of credit
4. Any document or debt instrument that arise due to the day to day general business activities of the company, between the company and the customers.
5. Insurance policies.
6. Any document issued by a bank upon opening a savings or current account in the bank, a deposit certificate, pass book or any similar documents.

Hence, under the existing legal infrastructure, a private company would not be able to issue a sukuk unless and until this provision of the companies Act is amended by ousting sukuk in the definition of debenture. However, a public company could still offer sukuk and to protect the interest of the investors, it might not be the best option to allow private companies to offer sukuk. The actual difficulty would arise when a public company tries to create a company to perform the job of an SPV for sukuk issuing purpose. Under the existing law, this company would be unable to issue sukuk as the company would be a private company and as a result, it would not be able to immediately become a public company.²⁴

3.0 Secondary Market for Shari'ah Compliant Products

Secondary market is an equity trading avenue in which already existing/pre- issued securities are traded amongst investors. Secondary market could be either auction or dealer market. While stock exchange is the part of an auction market, Over-the-Counter (OTC) is a part of the dealer market. Currently, only issuers who are listed

²³ “Companies other than those registered under this Act as public companies shall not sell shares or debentures to the public”

²⁴ Listing Rules shall be fulfilled



on the Official List of Maldives Stock Exchange (“MSE”) may apply to list its securities on the Exchange.

Under the existing circumstance, if a company wants to issue and list debt securities it shall fulfill the conditions set out in the Debt Securities Guidelines. It is imperative to have separate guidelines to regulate sukuk as the behavior of a conventional bond and sukuk would be different. Hence, it is vital to formulate a way to list Islamic securities including sukuk in MSE in a distinctive manner. The listing requirements (Debt Securities Listing Guideline) need to be amended to include this. Furthermore, there is need to create a mechanism to trade sukuk over the counter as not all the sukuk issued maybe able to fulfill the criteria set out in the Debt Securities Guidelines.

In case of debt listing, the Listing Rules (Main Board) of MSE (paragraph 1.3) and the Listing Rules (Second Board) of MSE (paragraph 4) talks about interest (riba). This shall be replaced with the word profit in case of sukuk. This amendment is essential if the existing Listing Rules are used to list Islamic securities.

To trade Islamic equities in the secondary market, it is imperative to have a separate list called while list to ensure transparency in the dealings of Islamic equities. It is suggested to have a separate set of Listing Rules to list Islamic securities (“White List”) as this would be easier for the investors and to the company dealing with Islamic stock broking services to deal with. However, one may always think that this procedure maybe too costly and irrelevant for the time being due to limited number of market players.

4.0 Major constraints for Shari’ah compliant products in Primary & Secondary Market in Maldives

The major constraints for Shari’ah compliant products in secondary market in Maldives are discussed below.

- i. Shari’ah constraints:** All Shari’ah compliant products cannot be dealt in the



secondary markets. If the structuring of a Shari'ah compliant product is based on a debt contract like Murabahah, salam or istisna, that specific sukuk cannot be traded in the secondary market. Annex 1 would illustrate the reasons why these sukuk are not tradable in the secondary markets and Annex 2 would explain the types of sukuk that could be traded in the secondary market. Hence, if Shari'ah compliant wants to be dealt in the secondary market, it shall be structured in a way to overcome this Shari'ah constraint. Furthermore, to deal with Shari'ah compliant equities, an Islamic stock broking needs to be introduced. A model guideline for this purpose is given in Annex 3.

- ii. Legal constraints:** For sukuk, there is need to amend the listing requirement guideline (Debt Securities Listing Guideline) of MSE. The need for this arise because, there are some additional Shari'ah requirements that shall be imposed on selling and buying of sukuk depending on the underlying contract used. Hence, it would be prudent to issue guidelines to lay down the Shari'ah conditions stipulated in dealing with sukuk in the secondary markets. Not only this, there is also need to legalize Islamic stock broking business in Maldives. License for the Islamic brokers could be given using the same procedure as the conventional brokers. Formulating a guideline would be sufficient to regulate the special matters related to it. Annex 3 provides a sample guideline for this purpose. Furthermore, adequate laws are needed to create Islamic rating agencies and Islamic indices in Maldives, so that the Shari'ah compliant products can be rated for the convenience of market players. In addition to this, laws to regulate SPV and Trustee needs to be enacted.
- iii. Market constraints:** The number of players in the market offering conventional services to the public is also small. Hence, for optimal results it would be best to find a way to increase the patrons of Shari'ah compliant products and educate the players in the market including the public about Shari'ah compliant products and how they work. If not, Shari'ah complaint



products may be ideal and hence may become illiquid due to lack of critical mass and market makers and brokers. Hence, there is need to overcome the structural bottlenecks by using innovation in structuring Islamic products. Furthermore for benchmarking the performances of the Islamic Equity in the Capital Market, various indices need to be created.

- iv. Institutional Constraints:** Currently, the role of Maldives Securities Depository is played by the Maldives Stock Exchange. This definitely defeats the purpose of having a separate entity to handle the securities depository. To gain the confidence of investors and the market players and to overcome the possibility of the mingling of funds, it is essential to have a separate body detached from the Maldives Stock Exchange to handle the matters of Securities depository. This is vital for not only for the establishment of Islamic capital market; but this is also crucial for the sustainable development of conventional capital market in Maldives.
- v. Information System and technology constraints:** The existing information system for the capital market activities and the payment system is inadequate to attract players and investors to the capital market as modern technology have not been used to issue and deal with securities and also to disseminate information about the activities in the capital market. An automated sukuk issuing and trading platform would save time and cost for the investors and other stakeholders and would open Maldivian market to the foreign investors. Countries like Malaysia and Saudi Arabia has proved the benefits of this to the world. Hence, it is imperative to use technology to enhance the role of capital market in Maldives. This is also a crucial factor for the development of the conventional capital market in Maldives.

5.0 Recommendations to Curb the Major constraints for Shari'ah compliant products

It is not impossible to overcome the major constraints in the secondary markets for



Shari'ah compliant products in Maldives. However, continuous effort would be needed to overcome them. Following suggested are the ways to harmonize the existing secondary market to offer Shari'ah compliant products including sukuk:

- I. Establishment of Islamic stock broking service parallel to the conventional broking service
- II. Creating platform to trade sukuk over the counter
- III. Replacing the existing manual system used to deal with securities in the stock broking service with an automated sukuk trading platform like FAST and a new payment system like the RENTAS (Real Time Electronic Transfer of Funds and Securities) System in Malaysia, which is a real time gross settlement system (RTGS) for the transfer and settlement of high value ringgit denominated interbank funds and scripless securities transactions.
- IV. Confirming CMDA's SAC's view on sale of debt and issuing a resolution to expressly state the position of CMDA in this
- V. A regulatory framework facilitating the establishment of special purpose companies with nominal share capital
- VI. Laws to regulate trustee is needed
- VII. Structuring sukuk that could be traded in the secondary market to overcome the structural bottlenecks
- VIII. Create Islamic Rating Agencies and Islamic indices
- IX. Amendment of listing requirements to include White listed securities
- X. Educating the market players and the public about the behavior of the Shari'ah compliant products
- XI. Waiving of tax owed by foreigners who would like to deal with Islamic securities need to be considered
- XII. Furthermore, a sophisticated information technology system needs to be established to enhance cross border capital flow and increase participation of foreign investors in the Maldivian capital market.



Annex: 1**SAC OF SECURITIES COMMISSION OF MALAYSIA'S RESOLUTION ON SALE OF DEBT (BAI AL DAYN)²⁵****RESOLUTION**

At its 2nd meeting on 21 August 1996, the Shari'ah Advisory Council (SAC) unanimously agreed to accept the principle of *bai` dayn* i.e. debt trading as one of the concepts for developing Islamic capital market instruments. This was based on the views of some of the Islamic jurists who allowed this concept subject to certain conditions. In the context of the capital market, these conditions are met when there is a transparent regulatory system which can safeguard the *maslahah* (interest) of the market participants.

INTRODUCTION

From the Islamic jurisprudence point of view, *dayn* encompasses a wide scope, including payment for product, *qardh* (loan) payment, *mahr* (dowry) payment before or after cohabitation, that is *mahr* which has not been given after the marriage *'aqd* (contract), rental, compensation for crime committed (*arsy*), compensation for damages, money to be paid for divorce (*khulu`*) and for purchase orders which have not yet arrived (*muslam fih*).²⁶ In the context of the Islamic capital market, *bai` dayn* is the principle of selling the *dayn* which results from *mu`awadhat maliyyah* contracts (exchange contracts), such as *murabahah*, *bai` bithaman ajil* (BBA), *ijarah*, *ijarahmunthiyah bi tamlik*, *istisna`* and others.

ARGUMENTS THAT SUPPORT THE PERMISSIBILITY OF BAI` DAYN

The *bai` dayn* principle has always been a point of contention among past and present Islamic jurists. However, there is no general *nas* or consensus (*ijmak*) among those who forbid it.²⁷ In general, the majority of Islamic jurists are unanimous in allowing the activity of selling debts to the debtor.²⁸ They only differ in

²⁵ Produced from www.sc.com.my

²⁶ Wahbah Al-Zuhaili, *Al-Fiqh al-Islami wa Adillatuhu*, Dar al-Fikr, Damascus, 1989, vol. 4, p. 432.

²⁷ Ibnu Qayyim al-Jauziyyah, *Ilam al-Muwaqqi`in*, Dar al-Fikr, Beirut, vol. 1, p. 388.

²⁸ Al-Zuhaili, *Al-Fiqh al-Islami*, vol. 4, p. 433.



opinion about selling the debt to a third party for the reason that the seller will not be able to deliver the sold item to the buyer.

At its 8th meeting on 25 January 1996, the IISG identified the *'illah* (reason) for why some Islamic jurists do not allow *bai` dayn*. The *'illah* generally touches on the risks to the buyer, *gharar*,²⁹ absence of *qabadh*³⁰ and *riba*.

Opinions of Past Islamic Jurists

The Hanafi *Mazhab* looked at *bai` dayn* from the aspects of potential risks to the buyer, debtor, and the nature of the debt itself. They were unanimous in not permitting this instrument because the risks cannot be overcome in the context of debt selling. The debt is in the form of *mal hukmi* (intangible assets) and the debt buyer takes on a great risk because he cannot own the item bought and the seller cannot deliver the item sold.³¹ The Maliki *Mazhab* allowed debt selling to a third party subject to certain conditions to facilitate the use of this principle in the market. The conditions are as follows:

- (a) Expediting the payment of the purchase;
- (b) The debtor is present at the point of sale;
- (c) The debtor confirms the debt;
- (d) The debtor belongs to the group that is bound by law so that he is able to redeem his debt;
- (e) Payment is not of the same type as *dayn*, and if it is so, the rate should be the same to avoid *riba*;
- (f) The debt cannot be created from the sale of currency (gold and silver) to be delivered in the future;
- (g) The *dayn* should be goods that are saleable, even before they are received. This is to ensure that the *dayn* is not of the food type which cannot be traded before the occurrence of *qabadh*; and

²⁹Please see the resolution on *gharar* for further explanation.

³⁰*Qabadh* means the control and ownership of the item bought. It depends a lot on *'urf* or the normal recognition of the local community. Please see the resolution on *qabadh* for further explanation.

³¹Al-Kasani, *Badai'i` al-Sana'i`*, Dar al- Fikr, Beirut, vol. 5, p. 148.



(h) There should be no enmity between buyer and seller, which can create difficulties to the *madin* (debtor).

The conditions set by the Maliki *Mazhab* can be divided into three categories:³²

- (a) To protect the rights of the debt buyer;
- (b) To avoid debt selling before *qabadh*; and
- (c) To avoid *riba*.

The Syafi'i *Mazhab* was of the opinion that selling the debt to a third party was allowed if the *dayn* was *mustaqir* (guaranteed)³³ and was sold in exchange for *'ayn* (goods) that must be delivered immediately. When the debt was sold, it should be paid in cash or tangible assets as agreed. Ibnu al-Qayyim was of the opinion that *bai' dayn* was permissible because there was no general *nas* or *ijmak* that prohibited it. What was stated was the prohibition of *bai' kali' bi kali'*.³⁴

Results of the study showed that the main reason for the clash of opinions on *bai' dayn* among the past Islamic jurists centered on the ability of the seller to deliver the items sold. This was stated by Ibnu Taimiyyah himself and was also based on statements made in the great books of the four *mazhab*.

The argument of the Islamic jurists that prohibited *bai' dayn* to a third party for fear that the buyer will have to bear great risks (Hanafi *Mazhab*) has some truth in it. This is especially true if there is an absence of supervision and control. In this context, the buyer's *maslahah* should be safeguarded because he is the party that has to bear the risks of acquiring the debt sale while making the sale contract. In the Malaysian context, the debt securities instruments based on the principle of *bai' dayn* are regulated by

³²Al-Dusuqi, Hasyiah al-Dusuqi 'ala al-Syarh al-Kabir, Dar Ihya' al-Kutub al-Arabiyyah, Cairo, vol. 3, p. 63.

³³ Dayn *mustaqir* is redemption-guaranteed debts, e.g. compensation value of damages and properties of the debtor. Please refer to Al-Syirazi, Al-Muhazzab, Dar al-Fikr, Beirut, vol. 1, p. 262.

³⁴ Ibnu Qayyim, I'lam al-Muwaqqi'in, vol. 1, p. 388. *Bai' kali' bi kali'* is *bai' nasi'ah bi nasi'ah* which means a debt sale that is paid by debt. For example, one buys food on credit for two months. When the time comes, he should redeem his debt. However, he says to the seller: "I still have no food to pay my debt, so sell it to me for another period." The seller then sells it to him for another period and increases the price. In this case, the buyer did not receive anything in exchange when being charged for extending the period of payment.



Bank Negara Malaysia and the Commission to safeguard the rights of the parties involved in the contract. Therefore, the conditions set by the Maliki *Mazhab* and the fears of risks by the Hanafi *Mazhab* can be overcome by regulation and surveillance.

Thus, it can thus be concluded that although there are differences in opinions on *bai` dayn* among the Hanafi and Maliki *Mazhab*, there is a convergence point which states that *bai` dayn* can be used if there is a regulatory system that protects the buyer's *maslahah* in an economic system.

The fifth condition set by Maliki *Mazhab* relates to the exchange of *ribawi* goods. In the context of the sale of securitised debt, the characteristics of securities differentiate it from currency, and hence, it is not bound by the conditions for exchanging goods.

Annex: 2

Table 1: Examples of Tradable and non-tradable Sukuk in the Secondary Market³⁵

Tradable Sukuk	Explanation
Mudarabah certificates	Certificates of <u>permanent</u> ownership in a company and businesses <u>without</u> control and management rights.
Musharakah certificates	Certificates of <u>permanent</u> ownership in companies and businesses <u>with</u> control and management rights.
Redeemable Musharakah certificates (Musharakah term finance certificates; MTFCs)	Certificates of <u>temporary</u> ownership in businesses and companies <u>with/without</u> control and management rights.
Fixed rate Ijara certificates	Ownership of durable assets given on rent and/or ownership of usufructs of durable assets. Rent is fixed for the period of the contract.
Floating rate Ijara certificates	Ownership of durable assets given on rent and/or ownership of usufructs of durable assets. The rent is re-

³⁵ Tariq, A.R. 2004, MANAGING FINANCIAL RISKS OF SUKUK STRUCTURES, viewed 1 February 2011 <<http://www.kantakji.com/fiqh/Files/Markets/c86.pdf>>.



	priced periodically in accordance with movements of a specified benchmark in the framework of a Master Ijara Agreement.
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Non-tradable Sukuk	Explanation
Istisna' and/or BBA/ Murabaha certificates:	The ownership of debt arising from an Istisna' and/or Murabaha financing. For example, construction of a road project is carried out on the basis of a cost plus arrangement where the cost is \$100 million and the mark-up rate is 10%. The \$110 million will be paid back in installments without differentiating the principal and coupons. The \$110 million can be in the form of non-tradable debt certificates that are similar to zero-coupon bonds in some of its features. Debt cannot be traded in Islamic law ² . Therefore, these certificates are not tradable.
Salam certificates	In salam, funds are paid in advance and the commodity becomes debt. The funds paid can also be in the form of certificates representing the debt. These certificates are also non-tradable.

Source: Tariq (2004)

Annex: 3

SAMPLE: GUIDELINES ON ISLAMIC STOCK BROKING SERVICE³⁶

1.0 Preamble

1.1 These Guidelines is made pursuant to section 60 (a) of the Securities Act 2/2006 to regulate Islamic Stock Broking Service in Maldives.

1.2A Participating Organization who conducts its stockbroking business in accordance with Shari'ah principles whether on a full fledge basis or 'window' basis ("Islamic Participating Organization") is required to adhere to the regulations and guidelines made on the subject to regulate the conventional market.

2.0 Objectives

2.1 The objective of this guideline is to provide guidance to the Islamic Participating Organizations in respect of practices recommended to be observed in the

³⁶ Modification of Best Practices In Islamic Stock broking Services issued by SC, Malaysia



carrying out of Shari'ah compliant stock broking services undertaken by the Islamic Participating Organizations whether on a full fledged basis or 'window' basis; and to meet the national aspirations to further develop the Islamic Capital Market in Maldives.

3.0 DEFINITION:

3.1 In these guidelines:

"MSE" means Maldives Stock Exchange

"hibah" means a gift awarded to a person. For the purpose of these guidelines, the term "hibah" defined herewith will be used together with the term "token" for ease of reference.

"ibra" means an act by a person to withdraw his rights i.e. his rights to collect payment from a person who has the obligation to repay the amount borrowed from him.

"Islamic Participating Organization" means a company licensed by the Authority to conduct stock broking business in accordance with Shari'ah principles whether on a full fledged basis or 'window' basis.

"Islamic stock broking services" means the business of trading in securities carried out by an Islamic Participating Organization on the stock market of Maldives Stock Exchange whether on full fledged basis or via an Islamic window services.

"Islamic window services" means Islamic stock broking services provided by the Participating Organizations, other than on a full fledged basis.

"Murabahah" means a contract that refers to the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved.



The settlement for the purchase can be settled either on a deferred lump sum basis or on an installment basis, and is will be specified in the agreement.

“Shari’ah” means Islamic law, originating from the *Qur`an* (the holy book of Islam), as well as practices and explanations rendered by the prophet Muhammad (*pbuh*) and *ijtihad* of ulamak (personal effort by qualified Shari’ah scholars to determine the true ruling of the divine law in a subject matter on which the revelation is not explicit).

“Authority” means Capital Market Development Authority

“riba” means an increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party. It covers interest both on commercial and consumer loans, and is prohibited according to Shari’ah. For the purpose of these guidelines, the term *“riba”* defined herewith will be used together with the term “interest” for ease of reference.

“Takaful operators” means any company offering takaful or Islamic insurance services

“ta’widh” means penalty agreed upon by the contracting parties as compensation that can rightfully be claimed by the creditor when the debtor fails or is late in meeting his obligation to pay back the debt. For the purpose of these guidelines, the term *“ta’widh”* defined herewith will be used together with the term “compensation” for ease of reference.

“uqud muawadha” means contracts of exchange.

“wadiyah yad amanah” means Goods or deposits, which have been deposited



with another person, who is not the owner, for safekeeping. As *wadiah yad amanah* is a trust concept to safeguard clients and remisers trust money. The depositors are not entitled to any of the profits but the depository may provide returns to the depositors as a token of appreciation. For the purpose of these guidelines, the term “*wadiah*” defined herewith will be used together with the term “custody” for ease of reference.

4.0 INTERPRETATION

4.1. Unless the context otherwise requires-

- (a) words denoting the singular shall also include the plural where applicable and vice versa;
- (b) word importing the masculine gender shall include the feminine and neuter genders and vice versa.

5.0. Adequate human resources with the necessary qualification, expertise and experience to manage and administer the provision of Islamic stockbroking services

5.1 An Islamic Participating Organisations should, at all time, has adequate human resources with the necessary qualification, expertise and experience to manage and administer its provision and affairs in respect of its Islamic stockbroking services.

5.2 An Islamic Participating Organization should provide adequate and proper training whether internal or otherwise for all of its employees, not only to equip and familiarize its employees with the necessary knowledge in



conducting the Islamic stock broking services, but also to enhance the technical knowledge of its employees in respect of all the applicable legal and regulatory requirements, as the case may be, in conducting Islamic stock broking services as well as the operational and the internal control and policies of the Participating Organizations in its conduct of Islamic stock broking services. Training should also be conducted for its employees involved in its front office activities such as Dealers Representatives in order to enhance their skills and professionalism, and apprise them of the developments of the Islamic capital market to enable them to give accurate, adequate and updated information or advice to the clients.

5.3 Particular attention should be given to the training of the Compliance Officer, who should be responsible to monitor the activities carried out and services provided, in relation to the Islamic stock broking services, are in compliance with Shari'ah principles. In this respect, the Islamic Participating Organization is encouraged to appoint a Compliance Officer who has exposure to Shari'ah knowledge.

6.0 Compliance with Shari'ah principles, regulations, standards or rulings issued by the Authority.

6.1 An Islamic Participating Organization shall ensure that its Islamic stock broking services are carried out in such way that it adheres to and complies with the Shari'ah principles and regulations, standards or rulings issued by the Authority, as may be amended from time to time.

7.0 Operations, Systems and Procedures comply with Shari'ah principles, and regulations, standards or rulings issued by the Authority

7.1 Participating Organisations should establish and implement adequate policies, systems, operational procedures and internal controls in relation to the company's day to day business operations in respect of the Islamic



stock broking services to ensure that it complies with the Shari'ah principles. This is also to ensure that the risk associated with such affairs relating to the Islamic stock broking business is properly managed.

7.2 In respect of a Participating Organization who operate an Islamic window services, the systems and controls should be in place to ensure appropriate separation of the Islamic stock broking services from the conventional stock broking services and other conventional business of the Participating Organization.

7.3 For the purposes herein, an Islamic Participating Organization should, at all times, adhere to Shari'ah principles in carrying out its Islamic stock broking services which principles include but not limited to the following :

(i). No *riba* or interest

(a) *Riba or interest on accounts opened, operated or maintained by the Participating Organization.* Under no circumstances, unless otherwise expressly allowed by the Authority, that any accounts opened, operated or maintained by the Islamic Participating Organization, either for its clients or for the Islamic Participating Organization itself accrue or be attributed with interest. The trust accounts maintained by the Islamic Participating Organization will be placed under *wadiah yad amanah*. *Hibah* is usually given by the licensed Islamic banks at their discretion.

(b) *Financings:* All financings undertaken for the Islamic Participating Organization itself or offered by the Islamic Participating Organization to its clients e.g. margin financing and discretionary financing, in connection with the Islamic stock broking services provided by the Participating Organization, should be confined to the financings which adheres to Shari'ah principles e.g. financings which are based on *Murabahah*.



(c) *No interest on settlement of trade:* Interest or any other charges which operates as an interest or penalty in relation to any amount outstanding pursuant to settlement of trade should be prohibited.

(ii). Segregation of funds:

(a) All funds maintained by the Participating Organization whether for itself or its clients in respect of the Islamic stock broking services should be segregated from those funds maintained by the Participating Organization in respect of its conventional stock broking services. This is to avoid co-mingling of the funds derived from the Islamic stock broking services and funds derived from conventional stock broking services. In the event the assets mentioned herein are, co-mingled, such comingling will result in the former to become non Shari'ah compliant.

(b) For Islamic window services the Islamic Participating Organization should ensure that the trading account of the clients within the Islamic window services is clearly tagged and used as trading account for the purpose of Islamic window services only.

(iii). *Ta'widh or compensation on late and default payment:*

For clients who defaulted in its payment or delay in making payment to the Islamic Participating Organization in respect of trades executed by the Islamic Participating Organization, the Islamic Participating Organization may impose a ta'widh on the late payment. *Ta'widh* or compensation can be imposed if it is found that deliberate delay in payment is present on the part of the investor to settle payment of the principal or profit at the rate in the manner prescribed by the Authority. The rate cannot be compounded and in addition, upon request by the client for an early settlement, a rebate (*ibra'*) will be allowed.



(iv). Investments:

The proprietary investments, either short-term or long-term investments of an Islamic Participating Organization should be confined only to Shari'ah-approved investments instruments, as issued or approved by Authority.

(v). System:

The system that is being applied and operated by the Islamic Participating Organization should where possible facilitate and support the conduct of the activities and operations of the Islamic Participating Organization in a Shari'ah compliant manner. For example, the trading system applied and operated by the Islamic Participating Organization should be able to identify/tag Shari'ah compliant securities from the list of securities that are available to be traded.

8.0 Responsibility of the management of Participating Organisations

8.1 The responsibility for ensuring that the Islamic Participating Organization complies with Shari'ah principles and the regulations, standards or rulings issued by Authority in the provision of the Islamic stock broking services should ultimately rests with the board of directors of the Islamic Participating Organization.

9.0 Audit

9.1 The department that is carrying out the internal audit functions for the Islamic Participating Organization should conduct audit in relation to the Islamic stock broking services of the Participating Organization for the purposes of examining, reporting and evaluating on the adequacy and efficiency of the Islamic Participating Organization's management, operations and internal controls to ensure that the quality and integrity of the Islamic stock broking



services provided to its clients and the Shari'ah principles and all regulations, standards and rulings issued by the Authority.

10.0 Compliance Functions

10.1 The Compliance Officer of the Islamic Participating Organization should monitor compliance of the Islamic Participating Organization with these guidelines, the Shari'ah principles and all regulations, standards and rulings issued by Authority, as amended from time to time.

11.0 Transparency

11.1 An Islamic Participating Organization should in relation to its Islamic stock broking services indicate very clearly to all its clients whether it is offering a full-fledge Islamic stock broking services or Islamic window services. For example, the letter head of the Islamic Participating Organization should indicate that it is operating a full-fledge Islamic stock broking services or Islamic window services.

12.0. Memorandum &Articles of Association

12.1 The Memorandum and Articles of Associations of an Islamic Participating Organization who is providing Islamic stock broking services on a full fledge basis should stipulate amongst others that it is providing the Islamic stock broking services and that its corporate mission is amongst others to achieve its commercial objectives within the confines of Shari'ah principles.

13.0 Advertisement

13.1 An Islamic Participating Organization may advertise their Islamic stock broking services provided that it complies at all times with the requirements prescribed by Authority pertaining to advertisement.

13.0 Insurance

13.1 An Islamic Participating Organization is encouraged to procure any



arrangement akin to an insurance policy from *Takaful* operators covering amongst others comprehensive crime and professional indemnity.



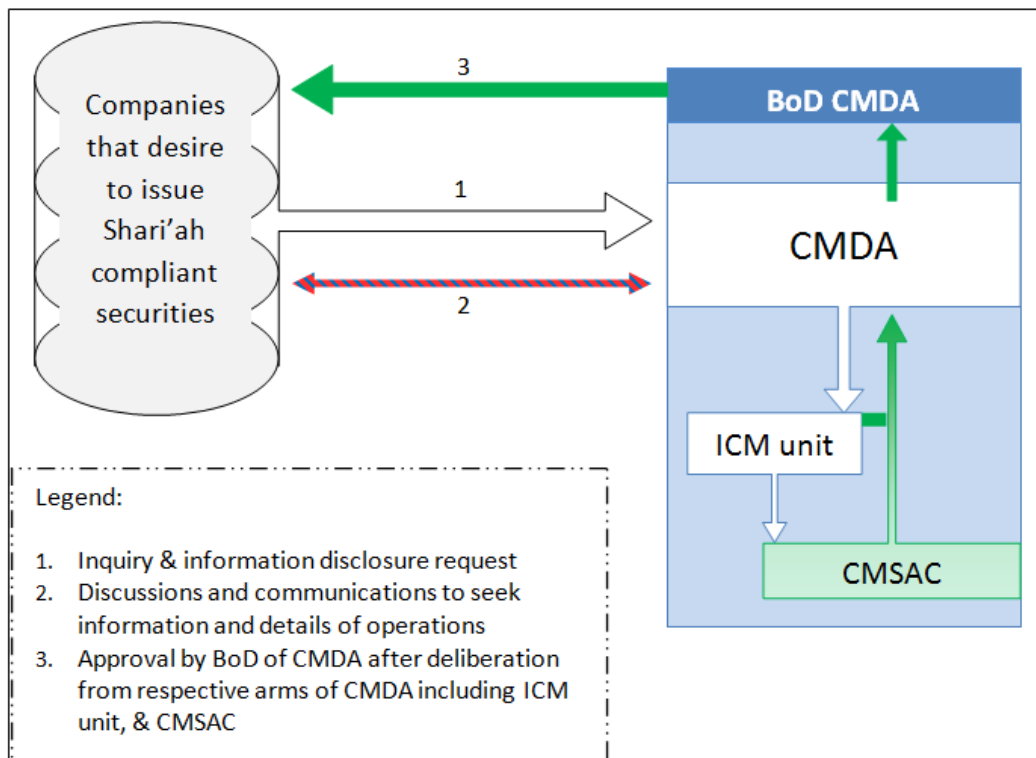
CHAPTER SIX: SHARIAH SCREENING MANUAL FOR THE ISLAMIC CAPITAL MARKET

1.0 Shari'ah Compliance Screening Mechanism

The Shari'ah compliance screening mechanism is two tiers in nature and hence has two components. It consists of the Pre-IPO screening and the Shari'ah stock screening processes.

Both these screening processes are undertaken by the following bodies as shown in the diagram below. The CMDA's CMSAC and its ICM unit are the key units responsible to conduct the screening.

Modus Operandi: Shari'ah Compliant securities screening



1.1 Two major processes of the Shari'ah compliance screening mechanism

1.1.1 Pre-IPO Shari'ah Compliance Review



- Once a request for listing is made by a company
 - ↓ The request is processed by CMDA via its ICM unit
 - ↓ The ICM unit should collect all the necessary information for the quantitative and qualitative audit of the company (based on the pre-compiled benchmarks and screening criteria set by the CMSAC and approved by BoD of CMDA)
 - ↓ The findings are forwarded to the CMSAC to deliberate
 - ↓ CMSAC provide their recommendations and inference to the BoD for approval.
- ← Upon approval by the BoD of CMDA, the decision is communicated to the requesting company by CMDA.

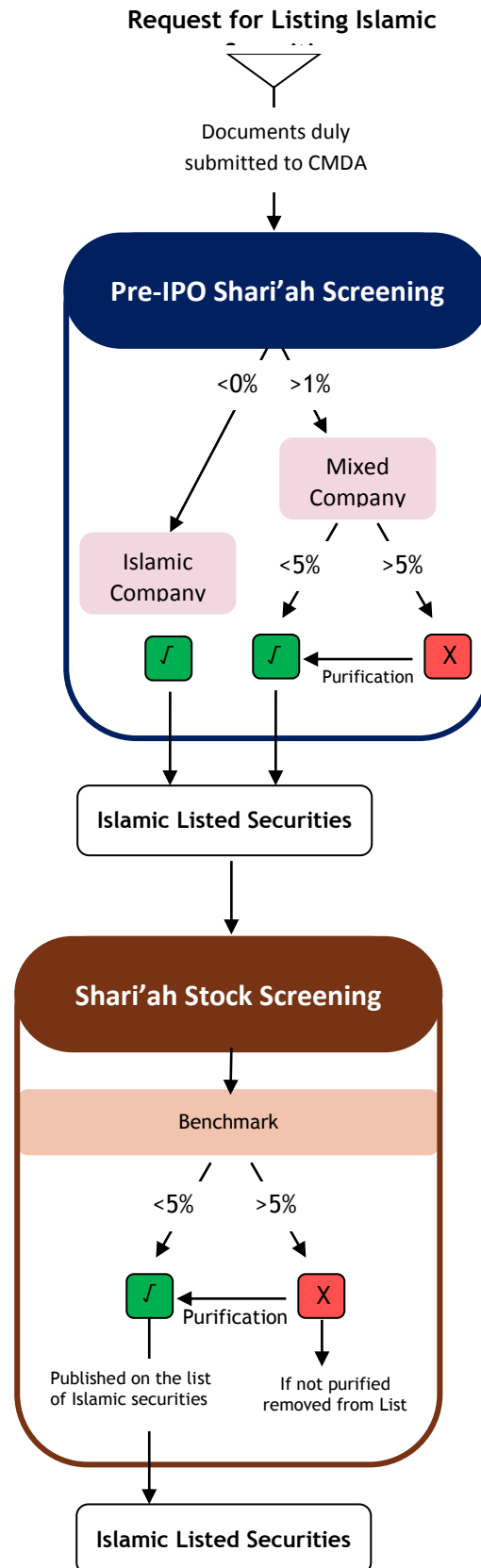
1.1.2 Shari'ah Stock Screening

- The list of Shari'ah compliant securities is published by CMDA
 - ↓ The ICM unit collects all relevant information from the company about its operations
 - ↓ The ICM unit conducts a quantitative compliance audit and screening (based on the pre-compiled benchmarks and screening criteria set by the CMSAC and approved by BoD of CMDA)
 - ↓ The findings are forwarded to the CMSAC to deliberate
 - ↓ The CMSAC provide their inference and correctional recommendations to the BoD for approval.
 - ↓ In case of questionable or failure to meet compliancy ratios, the purification requirement is communicated to the respective companies and if not appropriately corrected the company is omitted from the revised list.
- ← Upon approval by BoD of CMDA, the revised list is published by CMDA bi-annually.

For all these functions to be efficiently executed a very proficient CMSAC needs to be established by the CMDA. The core competencies of the CMSAC should be able to



complement and supplement the ICM development and regulation efforts.



GUIDELINES ON PRE-IPO SHARIAH COMPLIANCE REVIEW

1. The purpose of this guideline is to set out the criteria used by CMSAC to enable the applicant to furnish the relevant information which may not be available in the financial accounts in order to determine compliance of its securities with the principles of Shari'ah. The Shari'ah Advisory Council (SAC) of SC has applied a standard criterion in focusing on the activities of the companies listed on Bursa Malaysia. As such, subject to certain conditions, companies whose activities are not contrary to the Shari'ah principles will be classified as approved securities. On the other hand, companies will be classified as non-approved securities if they are involved in the following core activities:
 - a) Financial services based on riba (interest);
 - b) Gambling;
 - c) Manufacture or sale of non-halal products or related products;
 - d) Conventional insurance;
 - e) Entertainment activities that are non-permissible according to Shari'ah;
 - f) Manufacture or sale of tobacco-based products or related products;
 - g) Stockbroking or share trading in Shari'ah non-approved securities; and
 - h) Other activities deemed non-permissible according to Shari'ah.

2. The CMSAC also takes into account the level of contribution of interest income received by the company from conventional fixed deposits or other interest bearing financial instruments. In addition, dividends received from investment in Shari'ah non-approved securities are also considered in the analysis carried out by the CMSAC.

3. For companies with activities comprising both permissible and non-permissible elements, the CMSAC considers two additional criteria:
 - a) The public perception or image of the company must be good; and
 - b) The core activities of the company are important and considered *maslahah* ('benefit' in general) to the Muslim ummah (nation) and the country, and the non-permissible element is very small and involves matters such as *`umum balwa* (common plight and difficult to avoid), *`uruf* (custom) and the rights of



the non-Muslim community which are accepted by Islam.

2.1 Introduction

A mixed company can be defined as a company in which its core business activities are *Shari'ah* compliant, but at the same time involved in some other prohibited activities. In order for a mixed company to be classified as a *Shari'ah* compliant company, it shall pass both qualitative and the quantitative *Shari'ah* screening analysis stated below. If not, it will not be considered as a *Shari'ah* compliant company. The stock screening process of mixed companies consist of three main stages:

- Qualitative screen - screening in terms of company core activities, products and industry.
- Quantitative screen - Computation of set of financial ratio and compare them against specified benchmarks.
- Purification process - The portion of income derived from non-halal activities would be given for charity.

2.2 Qualitative Screens

As per the 'Guidelines on *Shari'ah* Compliance Review for Pre-IPO Securities' passed by the Board of Capital Market Development Authority, companies operating in the following sectors are not *Shari'ah* compliant:

- i. Conventional *riba* (interest) based financial services;
- ii. Gambling;
- iii. Manufacture or sale of non-halal products or related products; and
- iv. Other activities deemed non-*Shari'ah* compliant by the relevant Authorities.



2.3 Quantitative (Financial) Screens

In quantitative screens benchmarks are used to determine whether a business is *Shari'ah* compliant although there are some elements of non-compliant activities. The benchmarks set by the different scholars based on Quran and *hadith* as there are no specific benchmarks prescribed in the Quran or the *hadith* for the amount of acceptable limits with regards to financial analysis. Quantitative financial screening uses number of financial ratios and compare against respective benchmarks. The data for determining financial ratios are taken from audited financial statements of the company. In quantitative analysis company shall passes the prohibited income screening test, debt screening test and liquidity screening tests.

2.3.1 Financial Benchmarks:

The 5 percent benchmark

- To assess the level of mixed contributions from the activities that is clearly prohibited such as *riba*, gambling, liquor and pork.

The 20 percent benchmark

- This benchmark is used to assess the level of contribution of mixed rental payment from Shari'ah non-compliant activities, such as rental payments from premises used in clearly prohibited activities.

The 25 percent benchmark

- To assess the level of mixed contributions from the activities that are generally permissible according to Shari'ah and have an element of *maslahah* to the public, but there are other elements that may affect the Shari'ah compliance status of these activities for e.g. hotel and resort operations, share trading or stock broking, as these activities may also involve other activities that are deemed non-permissible to the Shari'ah.

The 33 percent benchmark

- To assess the level of debt and liquid asset used by the company.



2.3.2 Financial Screening Ratios

a) Prohibited income screens:

Today most of the companies are involved in interest payments and receipts. Many companies have no alternatives other than conventional banks to invest their money and eventually earn interest. And there are some companies involved in non-halal activity in its business operations. Benchmarks set by the *Shari'ah* scholars as to the extent prohibited income are allowed for Shari'ah compliant companies. Following are the ways to measure the prohibited income permissibility:

Non-permissible income /Revenue	≤5%
PBT of Subsidiary or Associate company (non-halal activity)/PBT of the Group	≤5%
PBT of Subsidiary or Associate company(mixed rental income)/PBT of Group	≤20%
PBT T of Subsidiary or Associate Company (hotel & resort)/PBT of Group	≤25%
Turnover of Subsidiary or Associate company (non-halal activity)/Turnover of the Group	≤5%
Turnover of Subsidiary or Associate company (Mixed rental income) /Turnover of the Group	≤20%
Turnover of Subsidiary or Associate company (Hotel & resort)/Turnover of the Group	≤25%

b) Debt screens

There are also limits on the level of payments of interest. The following threshold can be used:

Total debt/Total Assets	<33%
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c) Liquidity screens

It is important for a *Shari'ah* compliant company to have a low liquidity ratio as returns should be gained from the illiquid asset only, otherwise it would lead to the purchase of money for money or less. The following threshold can be used:

- Account Receivable/12 month moving average Market Capitalization <33%



- Cash + Interest bearing securities/Total Assets <33%

2.4 Purification of Income:

Purification is the process by which the non-*Shari'ah* compliant element is identified, calculated and given for charitable purposes. There are two main approaches for purification of equity stock, which is dividend purification and *haram* income purification. The concept of 'purification' in relation to equity stocks is only applicable, where the non-compliant income is 5% (or less) of total revenue.

The total amount of purified portion will be given to the charity.

Dividend purification is calculated by:

- $(\text{Prohibited Income}/\text{Total Income}) \times \text{Dividend received}$

Haram income purification is calculated by:

- $(\text{Prohibited Income}/\text{No. of Shares issued at the end of the period}) \times \text{Number of shares held}$



3.0 Manual on Shari'ah Stock Screening

1.0 Preamble

This manual is created to facilitate the Shari'ah stock screening process done by CMSAC of CMDA. CMSAC have formulated a number of rules to ensure that the instruments traded are Shari'ah compliant, known as the screening process. In undertaking this process, the following parameters shall be taken into account. The main objective of screening the stock is to ensure that the stock or security that one purchases or invest in does not contain any prohibited elements that make it Shari'ah non-compliant.

2.0 Meaning

In this manual:

Shari'ah	means principles derived from the primary and the secondary sources of Islamic law that is being approved by any of the four Sunni schools of jurisprudence
Umum balwa	means a prohibited element affecting most people and difficult to avoid
Maslahah	means public interest
CMSAC	means Shari'ah Advisory Committee in CMDA
CMDA	means Capital Market Development Authority of Maldives
Uruf	means custom and usage



Haram	means prohibited in Islamic law
Tainted income	means an income that needs to be purified per clause 4.3
Shari'ah compliant securities	means ordinary shares or equities of a company listed in Maldivian Stock exchange
Shari'ah stock screening	means a process of determining whether a stock or security is Shari'ah-compliant or not. It consists of various Shari'ah principles that form the criteria which should be used to determine whether the stock or security is Shari'ah-compliant or not
Disqualified company	means those securities which were earlier classified as Shari'ah-compliant securities but due to certain reasons, such as changes in the companies' operations, are subsequently considered Shari'ah non-compliant.
White listed company	means a company declared as a company that can issue Shari'ah compliant securities and is listed in the white list of the Maldivian Stock Exchange
Zakat	means zakat from earnings

3.0 Role of CMSAC

The role of Shari'ah experts is critical, being a key component to ensure that Islamic capital market products are Shari'ah compliant. The CMSAC was



established in May 2011 by the Board of Directors of CMDA mainly to advise CMDA on Shari'ah matters pertaining to the Islamic Capital Market. Shari'ah compliance of stocks is done under the guidance of CMSAC.

4.0 Screening Process

For stocks to be "Shari'ah compliant", it must satisfy ALL the key processes given below:

4.1 Qualitative Screening Process

4.1.1 The general requirement in evaluating the status of Shari'ah-approved securities is that the company must not be involved in the following core activities:

- (a) Financial services based on riba (interest)
- (b) Gambling
- (c) Manufacture or sale of non-halal products or related products
- (d) Conventional insurance
- (e) Entertainment activities that are non-permissible according to Shari'ah
- (f) sale of tobacco and abusive drugs
- (g) Stockbroking or share trading in non-Shari'ah approved securities
- (h) Any other activities deemed non-permissible according to the Shari'ah principles.

4.1.2 The CMSAC also takes into account the level of contribution of interest income received by the company from conventional fixed deposits or other interest-bearing financial instruments. In addition, dividends received from investments in non-Shari'ah approved securities are also considered in the analysis carried out by the CMSAC.

4.1.3 For companies with activities comprising both permissible and non-permissible elements, the CMSAC considers the following additional criteria:

- (a) The core activities are not against Shari'ah principles. The haram



element must be small compared to the core activities.

(b) Public perception or image of the company must be good or exemplary.

(c) The core activities must be considered *maslahah* (in the public interest) to the Muslim *ummah* and the country, and the non-permissible elements present must be minimal and involve matters such as *umum balwa* and *uruf* (custom).

4.2 Quantitative Screening Process

5.2.1 The CMSAC has also established several benchmarks based on *ijtihad* (reasoning from the source of *Shari'ah* by qualified *Shari'ah* scholars) for the purpose of determining the acceptable level of mixed contributions from permissible and non-permissible activities of a company. If the contributions from non-permissible activities exceed the following thresholds, the securities of the company will not be classified as *Shari'ah* approved:

(a) The 5% benchmark assesses the level of mixed contributions from the activities that are clearly prohibited, such as *riba* (interest-based companies like conventional banks), gambling, and activities derived from liquor and pork, which are deemed *haram*.

(b) The 10% benchmark assesses the level of mixed contributions from activities that involve the element of *umum balwa*. An example of such a contribution is the interest income from fixed deposits placed in conventional banks. This benchmark is also used for tobacco-related activities.

(c) The 20-percent benchmark assesses the level of contribution of mixed rental payment from *Shari'ah* non-compliant activities, such as rental payments from premises used in gambling, sale of liquor, etc.

(d) The 25% benchmark assesses the level of mixed contributions from



the activities that are generally permissible according to the Shari'ah and have an element of maslahah. However, there may be other elements that could affect the Shari'ah status of these activities and must be taken into consideration. Activities under this category include hotel and resort operations, share trading and stockbroking as these may also involve other related activities that are deemed non-permissible according to Shari'ah rules.

In addition to the above, a 33 percent benchmark is made to assess the level of debt and liquid asset used by the company.

4.3 Purification Process

Upon completion of the above stated processes, if there is a tainted income, CMSAC will calculate a Dividend Purification Ratio (DPR). This ratio is provided to investors for purification purposes, it is calculated as:

$$\text{Dividends} * (\text{Non Permissible Revenue} / \text{Total Revenue})$$

5.0 Documents to be submitted

The company applying to be a white listed company needs to submit the following documents:

- (a) Annual Report
- (b) Prudential Audit Report
- (c) Shari'ah Audit Report made by an independent Shari'ah scholar approved by CMDA
- (d) Any other document requested by CMSAC or CMDA

In addition to this, CMSAC has the power to invite the applicants for an interview to extract information.

6.0 Declaration of a Shari'ah compliant company

It is the Board of Directors of CMDA that has the power to declare a company as a Shari'ah compliant company and the company would be classified as a white-listed security.



7.0 Surveillance Process

7.1 The Shari'ah screening process for all the companies declared as Shari'ah compliant shall be carried out bi-annually. The composition of Shari'ah-compliant securities is reviewed periodically on a quarterly and annual basis. The purpose of doing this is to accommodate extraordinary events such as delisting, bankruptcy, merger, takeover etc. which may affect the status of the stocks.

7.2 For this purpose, the following documents shall be submitted:

- (a) Annual Report
- (b) Shari'ah Audit Report carried out by an independent Shari'ah Advisor
- (c) Prudential Audit Report
- (d) Zakat payment details
- (e) Any other document requested by CMSAC or CMDA

8.0 Charity fund

The tainted income shall be preserved in a separate account declared as a charity fund and this money shall be used to fulfill the Corporate Social Responsibilities of the companies and a confidential report on how the funds were spent shall be submitted to CMDA annually by the company who has to fulfill the purification process.

9.0 Screening out and disqualification

9.1.1 During the selection process, each company's audited annual report is reviewed to ensure that the company is not involved in any non-Shari'ah compliant activities. Those that are found to be non-compliant are screened out.

9.1.2 During the surveillance process, if it is found that the company is Shari'ah non-compliant, then the company is disqualified. If this happens then the company is called a disqualified company.

9.1.3 The grounds for screening out and disqualification shall be given in writing by CMDA



9.1.4 The disqualified company shall inform the Investors who hold their securities to liquidate it and that any capital gain arising from the disposal of such company's securities made at the time of the announcement can be kept by the investors. However, any excess capital gain derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channeled to charitable bodies.

10.0 Application Mode, Fees and costs

The application mode, fees and costs for the Shari'ah screening process shall be determined by CMDA and it will be published in the website of CMDA from time to time.

11.0 Conditions to be observed by a white listed company

11.1 Prospectus Requirement

Every white listed company after it is being notified under clause 6.0 shall submit the prospectus endorsed by its Board to CMSAC before disclosing it to the public. The prospectus shall include all the relevant Shari'ah information about the securities and shall comply to the any regulation/guidelines issued by CMDA to regulate prospectus. The prospectus shall be issued to public once it is being approved by CMSAC.

11.2 Zakat Payment

Every company declared as a white listed company shall pay zakat as prescribed by Shari'ah and zakat payment shall not be made from the tainted income.

11.3 Observance of Shari'ah Corporate Governance Principles

Every company declared as a white listed company shall observe the Shari'ah corporate governance principles which include performing



Shari'ah audit and review of the company by an independent party approved by CMDA.

11.4 Inhibitions in dealings

No white listed company shall refrain from dealing with any of the core activities prohibited in clause 4.1

Failure to do any of the above stated things may result in company categorized in any of the groups stated in clause 9.0

12.0 Changes to the prohibited items

CMSAC has the power to change the prohibited items from time to time.



Appendices A

Documents reviewed so far:

- ❖ Capital Market Shariah Advisory committee's Operational Guidelines
- ❖ Islamic Banking Regulation 2011
- ❖ Debt Securitises Listing Guidelines
- ❖ Maldivian Land Act
- ❖ Law on Foreign Investments in the Republic of Maldives
- ❖ Law of Contract in Maldives
- ❖ The Companies act of Republic of Maldives
- ❖ Care Ratings - Structured Finance Criteria

Appendices B

Participants:

- ❖ Ministry of Finance and Treasury
- ❖ Ministry of Islamic Affairs
- ❖ Maldives Stock Exchange
- ❖ Bank of Maldives PLC
- ❖ Maldives Islamic Bank
- ❖ Amana Takaful
- ❖ Maldives Tourism Development Corporation
- ❖ State Trading Organisation
- ❖ Housing Development Finance Corporation
- ❖ Maldives Pension Administration Office
- ❖ Stock Brokers Maldives
- ❖ Care Rating Maldives
- ❖ Attorney General's Office
- ❖ Maldives Monetary Authority
- ❖ Maldives Transport and Contracting Company



- ❖ Islamic Fiqh Academy
- ❖ CMDA Capital Market Shariah Advisory Committee
- ❖ Board Members of CMDA
- ❖ Senior Executive Committee (CMDA)

