Understanding Islamic Capital Market

SEC NIGERIA

SECURITIES AND EXCHANGE COMMISSION NIGERIA

MISSION STATEMENT

To develop and regulate a capital market that is dynamic, fair, transparent and efficient, to contribute to the Nation's economic development

VISION STATEMENT

To be Africa's leading Capital Market Regulator

OUR CORE VALUES

Governance, Fairness, Integrity, Excellence, Loyalty, Discipline

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Introduction

Every economy consists of surplus and deficit units. Surplus units are those whose income exceed consumption within a particular period while deficit units are those who either spend more than the income earned or require funds to complete or initiate projects in the real sector of the economy. While the real sector of the economy produces the nation's output of goods and services, the financial sector plays the vital role of intermediating the financing needed to fund this productive capacity. It does this by mobilizing the savings of surplus units and channelling them to the deficit units. Figure 1 shows the relationship between the financial and the real sectors, and the role of the capital market (alongside other markets in an economy) in the intermediation of funds.

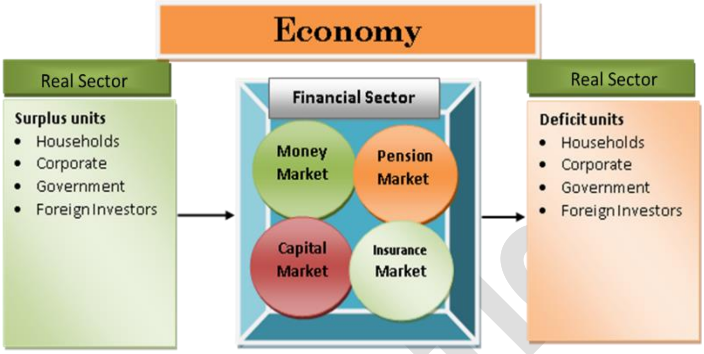


Figure 1

What is Islamic Finance?

The Islamic financial system is similar to the conventional financial system in certain aspects. However, its operations are guided by a set of principles that are determined by the Islamic code of ethics, thus, Islamic finance refers to financial market transactions, operations and services that comply with the principles of Islamic Commercial law.

Principles of Islamic Finance

Islamic Finance is built upon a number of distinctive and unique characteristics. Some of the prominent elements include the following:

i. **Riba** (interest) simply means any excess, increase or additional compensation that is not in exchange for a due consideration. The most common kind is ordinary commercial interest, where the borrower compensates the lender with an interest payment for the right to use a sum of capital over a period of time.[1]

ii. **Gharar** refers to uncertainty or ambiguity that may lead to dispute between contracting parties. For instance, executing a contract before the price, subject matter, or transacting parties are definitively known.[2]

iii. **Mysir** means:

1) The act of gambling or playing games of chance with the intention of making an easy profit;
2) The element of speculation in a contract;
3) Chance or uncertainty with respect to an outcome.

iv. Others are the prohibition of conducting economic or investment activities, which are ethically and socially unacceptable albeit being profitable (such as pornography, prostitution, alcohol and nuclear weapons).

Islamic Capital Market

The capital market is the segment of the financial sector where medium to long-term securities are issued to raise funds for the financing of productive activities.

The Islamic Capital Market (ICM) is a sub-sector of the Capital Market that promotes shariah-compliant securities/instruments as alternatives to conventional ones, and provides investment opportunities for a wide range of investors. ICM is an integral part of the Islamic financial system, complementing the investment role of the Islamic banking sector. Due to the Islamic economy's emphasis on equity and asset-based transactions, ICM plays a vital role in serving the needs of investors to diversify their investment.

Figure 2

[1] www.ethicainstitute.com
[2] www.ethicainstitute.com

Players in the ICM

1) **Issuers**: These are government (federal, state or local), government agencies, supra-national bodies or corporate entities who issue products such as Sukuk for raising capital/funds to finance projects or expand businesses.

2) **Investors**: These include retail/high net-worth individuals, corporate bodies and government/government agencies who provide funds for the purpose of investment and in exchange for some income.

3) **Regulators**: These are agencies statutorily empowered by law and charged with responsibility of ensuring market fairness and investor protection. One of such regulators is the Securities and Exchange Commission (SEC).

4) **Intermediaries:** These are firms registered by the Securities and Exchange Commission to provide specific market functions. Examples of market intermediaries include issuing houses, brokers, dealers, trustees, solicitors etc.

5) **Advisory/Certification Board:** This is a unique market participant that provides a critical role under the ICM sector. Typically, they are registered individuals or corporate entities with expertise in Islamic commercial jurisprudence. The certification of an advisory/certification board is essential for any product issued in the ICM to be acceptable.

Contracts relating to ICM

The development of Shariah-compliant financial products has remained a landmark under Islamic Finance Industry. To ensure that products meet this specification, they make use of commercial contracts acceptable under traditional Islamic legal principle and adapt conventional financial contracts so that they comply with the tenets of

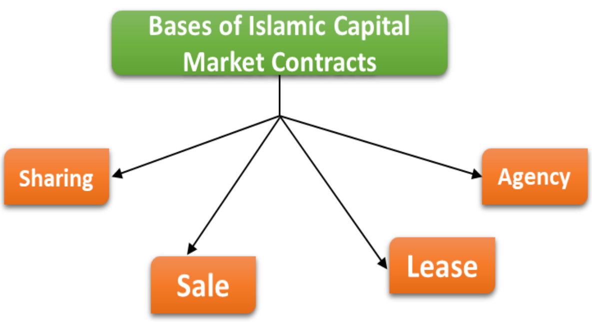


Figure 3

Shariah[3]. Thus, due to the distinctive nature of the contracts, the mode of operations of ICM products differ from that of conventional instruments. Find below and on Figure 3 the bases of ICM contracts.

i. **Sharing Contracts**: Sharing (or equity) based-contracts are structured based on partnership. Investors and originators/issuers are partners in a commercial business venture and have the right to share in any profit (or loss) generated by the venture. Types of partnership contracts are:

   a. ***Mudarabah*** - A form of partnership where one party provides the funds while the other provides expertise and management. While the fund provider is called Rabul-mal, the fund manager is referred to as the Mudarib. Any profit accrued is shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.[4]

   b. ***Musharakah*** - Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. Profits are shared on a pre-agreed basis while loss is apportioned based on the ratio of capital contributed.[5]

ii. **Sale/Exchange Contracts**: ICM products could be structured based on trade contracts. Under the sale/exchange contract, investors and issuers are in a buyer-seller relationship. The holders of this type of instrument are sellers of commodities or assets to the issuer. They receive cost plus mark-up at a pre-determined future date. Types of sales contracts are:

   a. ***Murabahah*** – This literally, means a sale based on mutually agreed profit margin. Technically, it is a contract of sale in which the seller discloses his cost and the profit to the buyer.

   b. ***Salam*** – Salam (forward sale) contract refers to a sale contract whereby the seller undertakes to sell some specific fungible commodities to the buyer at an agreed future date in exchange for a price fully paid in advance on spot basis.[6]

[3] www.islamicfinance.com
[4] Muhammad Azhar, J., (2010). Islamic Capital Market: Sukuk and its Risk Management in the Current Scenario
[5] Same source as number 4
[6] Same source as number 4

c. **Istisna** – It is a contractual agreement for building projects or manufacturing equipment, allowing cash payment in advance and future delivery or a future payment and future delivery.[7]

iii. **Lease Contract** – under this contract the instruments are structured based on lease transactions, i.e. lessor and lessee relationship. In this structure, the investors lease an asset to the originator[8] /issuer in return for rental amount from the use of the asset for a determined tenure. The asset can be tangible (existing and to be provided) or intangible (services). A type of this kind of contract is known as ***Ijarah*** – the sale of a definite usufruct (benefit) of an asset in exchange of definite reward.

iv. **Agency Contract** – under the agency contract, the products are structured based on agency transactions i.e. principal and agent relationship. Normally, originator/issuer acts as an agent to inventors in a commercially viable business venture for agency fees. An example of agency contract is what is known as ***Wakalah*** – a contract where a muwakkil (principal) authorizes a party as his wakil (agent) to perform tasks on his behalf. The agent may commence the task authorized to him voluntarily or fee-paying basis.

Benefits of ICM

ICM, just like the conventional capital market, plays the important role of efficient and effective mobilization of resources for optimal allocation within an economy. Therefore, developing this alternative source of financing will benefit economic activities in a number of ways including:

1. Increasing access to funding for government and other institutions for infrastructure development and business expansion. This in return will lead to job creation and poverty reduction.
2. Playing a complementary role to the non-interest money market and takaful (Islamic insurance) market thus enabling a comprehensive and integrated financial system.
3. Enhancing financial inclusion and financial deepening through encouraging ethical investors to participate in the capital market.

[7] Same source as number 4
[8] **Originator** – *An entity that initiated the need to raise fund from ICM and may not necessarily be the issuer*

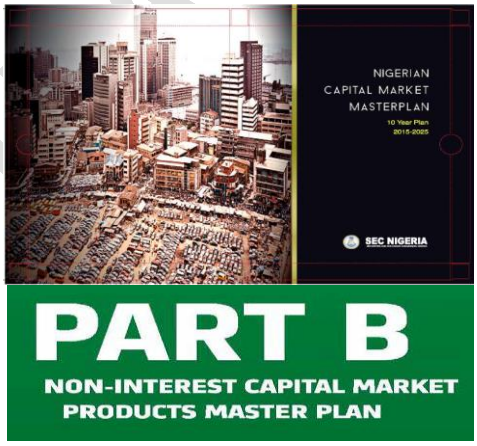
This will enable the public and private sectors to access a previously untapped investor base.

4. Providing alternative sources for issuers (public and private) to diversify their sources of capital raising and in the process, enhance capital market depth. The availability of ICM products as an asset class enables investors to diversify their investment portfolios.

Regulatory Initiatives to develop the ICM

SEC has introduced several important initiatives to maintain the growth momentum of the ICM in Nigeria. These significant initiatives include:

1) The formulation of regulation for Sukuk offerings, which facilitated the first Sukuk issuance in the market; Osun Sukuk in October 2013.



2) Development of a 10-year (2015 – 2025) ICM Masterplan that contains a number of strategic recommendations to ensure ICM sector of the market contributes 25% to total capital market capitalization.
3) Enabling regulations to guide operations of Islamic Fund Management and facilitated the registration of the first Islamic Fund Management firm in 2008. This led to the birth of similar firms in the sector. As at November, 2019, about 5 Non-interest/ethical Funds exist with total assets under management of N4.37 billion. This is another significant step in increasing the depth and breadth of the ICM segment.
4) Convened roundtable enlightenment programmes for public awareness on ICM products in conjunction with Kano and Sokoto State Governments in 2015 and 2016 respectively. Plans are underway for similar programmes across the six geopolitical zones of the nation.
5) Collaboration with Debt Management Office on the issuance of the first Nigeria Sovereign Sukuk in 2017.
6) Continuous collaborations with other relevant stakeholders to further deepen the ICM.

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