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Islamic finance and market segmentation: Implications for the cost of capital

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ABSTRACT

This paper considers the impact of full Islamic shari'ya compliance on developing stock exchanges in their effective provision of development capital. Evidence from a unique study focussing on the Sudan telecommunications company and its listings on the Khartoum as well as Arabian Gulf stock exchanges reveals that costs of capital are considerably higher in the former than latter markets. While there are firm governance benefits arising from Islamic finance monitoring costs are substantial and the banking system is better placed to administer financing arrangements. Larger firms are better placed to circumvent this segmentation through cross-listing on regional exchanges.

1. Introduction

Islamic finance is a fast-growing sector of the global banking industry, and is based on a range of distinctive financial products that are compliant with *shari'ya* law. There are many banks that supply Islamic financial products and services around the world, including well-known institutions such as Citigroup, Société Générale, HSBC and Lloyds TSB. But there are very few countries whose financial systems are explicitly and exclusively based on Islamic financial principles: Pakistan, Iran and Sudan are the only countries with fully-compliant banking systems, while only Iran and Sudan have fully-compliant stock markets (Pryor, 2007). This paper considers the impact of this compliance on the cost of equity capital for domestic firms, focusing on the experience of the Sudan Telecommunications Company. Most of the literature on Islamic finance largely focuses on either contrasting the structure and design of financial products with those in the West (Abdouli, 1991; Kamali, 2007) or on the Islamic banking system (Aggarwal & Yousef, 2000; Lewis & Algaoud, 2001). Further, the literature on the role and regulation of stock markets within Islamic economies focuses largely on the normative prescriptions of Islamic finance as a discipline – see El-Din and El-Din (2002) and Naughton and Naughton (2000) for extended discussions.

In particular, we argue that *shari'ya* compliance may lead to market segmentation in developing economies and thus to higher costs of equity capital, and we show that cross-listing may provide access to more cost effective finance.

The paper is structured as follows. Section 2 describes the main features of some of the distinctive products used in the Islamic financial system, and then compares the main principles and practices of Islamic finance with those undertaken in

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the West. In Section 3, we note the importance (or perhaps lack of) in many countries within the Middle East and North Africa (MENA) region, and outline some of the key features of the Khartoum Stock Exchange in the Sudan. We then discuss in Section 4 some of the methodological issues involved in estimating the cost of equity in Islamic financial markets, before using the dividend capitalisation method to estimate in Section 5 the cost of Sudatel stock listed on the Khartoum and the Abu Dhabi Stock Exchanges. We also examine the comparative abilities of the two major Sudatel listings to attract foreign portfolio investors. Section 6 concludes.

2. Islamic finance

Islam represents a system of beliefs based on the interpretation of passages from the Qu'ran and various Had'ith and Sunnah, which are short texts concerning customs of the Muslim community and relating experiences of the prophet Mohammed (Pryor, 2007). These forms the basis of Shari'ya law, which permeates all areas of the wider Islamic system, including economics, finance, law, politics and government as integral component parts, and which have common values of Islamic social justice (Asutey, 2007). However while the political economy aspects of the Islamic system encompasses all components of a social system the central belief of Islamic economics is that individuals are merely the trustees of wealth and capital owned by God (Asutey, 2007; Chapra, 1993). As Islamic economics is only one part of the wider system where individuals have common values and adhere to Shari'ya principles the ethical behavioural norms of Islam are fully integrated with economic motives. Thus, ethical actions of the individual within this system are not voluntary but rather defined as part of the revealed knowledge derived from the teachings of the Qu'ran. Shari'ya law is thus the binding set of principles that govern the economic, social, ethical and religious aspects of Islamic society (Iqbal, 1997). The Islamic financial system is itself founded and regulated on the same *shari'ya* principles as the overall economy and society (Iqbal, 1997). These dictate the nature of contracts traded, the design of institutions to support the market, and the regulation of participants' behaviour. Individuals within an Islamic financial system will be subject to behavioural norms, which give rise to very different assumptions to those that form the basis of regulation in western markets. This section describes the most commonly used products, and then compares the main principles and practices of Islamic finance with those undertaken in the West.

2.1. Islamic financial products

A critical feature of the Islamic financial system is that the proliferation of financial products and legal definitions of the firm, or partnership, are subject to validation by the various schools of Islamic jurisprudence (Mannan, 1993). While these are generally in agreement over common products such as *mudarabah*, *musharaka*, *murabaha* and *ijara*, as well as the less common *mugawla* and *salam*, there is considerable consternation over more recently developed products that bear a strong resemblance to western debt instruments. The prohibition of interest (*riba*), which is the major distinguishing features of Islamic finance, is controversial because of differing interpretations by the various schools of Islamic jurisprudence of the translation from the *Qu'ran* of the definition of usury (Noorzoy, 1982). Kuran (1995) also notes that the original prohibition of *riba* was due to the ancient "pre-Islamic Arabian practice of doubling the debt of a borrower unable to make restitution on schedule, including both the principal and accumulated interest". As this tended to push defaulters into enslavement it was the source of real tension and its ban was effectively a form of bankruptcy protection, reflecting the concept of social justice in Islam (Kuran, 1995). However, despite the ban on *riba*, or any products offering a fixed schedule of repayments, few countries have been able to prevent the use of debt-based instruments entirely (Pryor, 2007) because of the global nature of international finance (Aggarwal & Yousef, 2000) and the dominance of western financial principles within the system (Asad, 2008).

Central to Islamic financial product design is partnership and risk-sharing, which is commonly referred to as the profit-and-loss-sharing (PLS) paradigm (Aggarwal & Yousef, 2000; Presley & Sessions, 1994). The exact division of responsibilities, and the levels of risk and reward allocated to each partner, is defined in the contract. This contract is enforced by the common ethical standards and social values within the *shari'ya* system, which ensures mutual compliance by all parties in the transaction.

The *mudarabah* contract is a partnership between the entrepreneur (*mudarib*) and at least one investor (*rabb al-mal*) (Abdouli, 1991; Aggarwal & Yousef, 2000) where the latter provides the sole source of capital. This is considered by many schools of Islamic jurisprudence to be the equivalent of common equity in western financial markets (Mannan, 1993). However, the difference arises because the *mudarabah* contract implies a closer partnership than the more distant legally defined link between principal (investor) and agent (manager) in western finance. In the event of a loss associated with a *mudarabah* contract, the investor earns no return and equally the entrepreneur receives no compensation for effort. If the project is successful then the gains are split between the parties according to the pre-transaction negotiated conditions of the contract. This is closer to limited liability partnerships common to western markets than a share instrument and has the further distinction of being restricted or unrestricted depending on the nature of pre-agreed restrictions on the use of funds by the entrepreneur (Aggarwal & Yousef, 2000). One consequence of the emphasis on partnership and risk-sharing in *mudarabah* contracts and Islamic commercial jurisprudence is that the modern Middle Eastern business environment is dominated by small and family-owned firms while larger companies are either foreign Multinational Enterprises (MNEs), foreign joint ventures, or privatised state owned enterprises (Kuran, 2004). However, Badr El-Din (2003) notes there is a general perception in Sudan that *mudarabah* contracts are risky and consequently there is some reluctance to enter this type