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The Shariah compliance challenge in Islamic bond markets

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ABSTRACT

This paper considers the interaction between Shariah advisors, regulators, Shariah conscious ethical investors and an Islamic bond issuing firm. The model shows that due to higher Islamic instrument cost, the Islamic bond industry's existence is contingent upon a Shariah conscious ethical investor base that can absorb the lower Shariah premium. The results also suggest that competition amongst Shariah advisors along with issuer fatwa shopping results in non-compliant (or less than fully compliant) Islamic financial instruments. This study contributes to Islamic finance theory by suggesting that apart from market incentives and stronger regulations, the Shariah compliance challenge is dependent on Shariah conscious ethical investors.

1. Introduction

The Islamic finance industry has experienced rapid growth in the last decade and is expected to reach \$1.8 trillion by 2013 (Nazim and Bennie, 2012). The concept of 'Shariah compliance' that defines and distinguishes the Islamic finance industry might also threaten its very existence. A stark reminder of this risk is the impact of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) February 2008 announcement regarding the illicit Shariah practices in the Islamic bond markets and the consequent decline in the demand for Sukuk[3] (Naim et al., 2013). This paper argues that the higher costs associated with Shariah compliance makes non-compliance an inherent risk in a system involving profit

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[3] Sukuk is an Islamic bond which represents a share in tangible assets, services or usufruct. Some of their types and characteristics are examined in Section 2.

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maximizing issuing firms. The problem becomes all the more complex with the possibility of fatwa shopping,[4] where the issuing firm can move away from the ethical advisor enabling them to issue less Shariah compliant but more profitable or low risk structures (Hegazy, 2005). The problem is much more severe in the bond market where the Shariah standards are lax and the Shariah advisors can be hired on a one-off basis. This paper argues that the presence of regulations and 'whistle blowing' by Shariah standard setting bodies should help to neutralize the moral hazard concern to some extent. A higher level of Shariah compliance, however, is only possible when one of the three parties (the issuing firm, advisor or investor) becomes more Shariah conscious. The focus here is on the investor to show that a higher preference for Shariah compliance can result in an equilibrium where it becomes optimal for the firm to issue Shariah compliant products. The results can be easily extended to show that similar equilibrium will be reached in the presence of a Shariah conscious firm.

The paper first builds a firm focused model and shows that due to higher Islamic instrument costs, the industry's existence is contingent upon a Shariah conscious ethical investor base that can absorb the lower Shariah premium. 'Fatwa' shopping is then incorporated to address the Shariah non-compliance problem. The model suggests that competition amongst Shariah advisors along with issuer's fatwa shopping results in non-compliant (or least compliant) Islamic financial instruments. These moral hazards are then partly neutralized by incorporating regulators in the model. Finally, Shariah conscious ethical investors complete the model by showing that high level of investor's aversion for non-compliance could result in an equilibrium situation where the firm's incentive for Shariah compliance exceeds that of non-compliance.

Previous Islamic finance studies have focussed more on the role played by Islamic financial institutions and their instrument structures and have not really addressed Shariah non-compliance and why it is an inherent feature of Islamic finance. This paper contributes to the Islamic finance theory by developing a model based on the work of Leland and Pyle (1977), Ueda (2004) and Bolton et al. (2012). The model captures the conflict between a profit maximizing firm, competing Shariah advisors by permitting fatwa shopping, an imperfect regulator and a Shariah conscious investor.

Our findings have implications for policymakers–regulators, Shariah boards, and investors. They suggest that the Shariah compliance challenge is not just dependent on the ethical nature of the firm or its' Shariah board but should also be addressed by the introduction of a proper mix of stronger regulations and by the development of more highly Shariah conscious investor base. The latter could perhaps be achieved through more education and enhancing investor awareness.

The remainder of the paper is organized as follows. Section 2 discusses some of the unique Islamic finance features that contribute towards their higher costs as compared to conventional finance. The relevant literature is examined in Section 3. The model is developed in Section 4 and the conclusions provided in Section 5.

2. Islamic finance characteristics

This section focusses on some of the unique features of Islamic bonds. Its primary focus is to identify the higher cost and risk associated with them compared to conventional instruments. It starts with explaining the basis of Islamic finance and then briefly discusses Musharkah, Ijarah and Murabaha Sukuk.

Islamic finance is governed by the Shariah or Islamic law. This precludes both the use of usury and interest. The financing of goods and services that contradict Islamic values is also prohibited (so no distilleries, casinos or piggeries) as are any financial structures that involve gambling (maysir) and uncertainty (gharar). It also encourages arrangements whereby the traditional borrower lender relationship common in conventional finance is transformed into one of a profit and loss sharing partnership.

Musharkah is an excellent example of such a profit sharing arrangement. It entails that both the bank or investor and the entrepreneur or entity running the project will share in its risk. If the project makes a profit, then both the investor (bank/depositor) and entrepreneur share the profits. Alternatively, any losses are also shared if the project is not successful. In conventional finance the financier will often have a fixed return for a given interest rate even when the project financed proves unsuccessful. When structured as bonds, Musharakah Sukuk possesses unique characteristics of both debt and equity. They allow their

[4] Fatwa shopping in relation to Islamic finance is where a firm contacts various Shariah advisors to find an affable opinion as to the Islamic nature of a transaction.

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