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The role of the stock market in the provision of Islamic development finance: Evidence from Sudan

Bruce Hearn [a,*], Jenifer Piesse [b,c], Roger Strange [d]

[a] School of Management, University of Leicester, Leicester LE1 7RH, United Kingdom
[b] Department of Management, King's College London, 150 Stamford St., London SE1 9NH, United Kingdom
[c] University of Stellenbosch, South Africa
[d] School of Business, Management and Economics, University of Sussex, Mantell Building, Brighton BN1 9RH, United Kingdom

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ABSTRACT

This paper assesses the impact of stock exchange funding in the Shari'ya compliant Islamic economy of Sudan. Evidence suggests that while Islamic financial instruments have considerable potential in facilitating development finance through their emphasis on partnership this is better achieved by the banking system rather than the Khartoum Stock Exchange. A case study of the Sudan Telecommunications company shows that larger firms able to cross-list elsewhere are likely to choose regional markets in preference to their domestic one thus benefiting from lower costs of equity. However, governance preferences are likely to favour block shareholders following the Islamic finance partnership concept.

1. Introduction

Islamic finance is one of the fastest growing sectors of the global banking industry and has risen to prominence recently through its distinctive adherence to the concept of partnership embodied within its profit–loss–sharing (PLS) paradigm. While many well known international institutions such as HSBC, Citigroup and Societe Generale have recently established shari'ya compliant banking arms there has been a considerable proliferation of Islamic Equity Funds (IEFs) between major financial centres such as London and New York as well as in Malaysia and the Arabian Gulf markets of Bahrain and Dubai (Fayyad and Daly, 2011; Hayat and Kraeussi, 2011). In contrast Islamic development banks have a longer history with the first institutions being established in Kuwait and Egypt during the 1960's and 1970's while the Islamic Development Bank was created in 1975 (Rowey et al., 2006). This paper considers the impact of the stock

* Corresponding author. Tel.: +44 1162525141.
E-mail addresses: bruce.hearn@le.ac.uk (B. Hearn), jenifer.piesse@kcl.ac.uk (J. Piesse), r.n.strange@sussex.ac.uk (R. Strange)

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exchange as opposed to banking sector in the provision of cost effective Islamic development finance. Furthermore it considers the implications arising from full shari'ya compliance in terms of market segmentation and the cost of equity experienced by listed firms. As such we extend the literature which is largely based on the normative prescriptions of Islamic finance as a discipline (see El-Din and El-Din (2002) and Naughton and Naughton (2000) for an extended discussion) in considering the practical implications on listed firms arising from full shari'ya compliance with a case study on the Sudan Telecommunications company (Sudatel) that has been able to list on regional exchanges away from its home market.

In particular we find evidence that full shari'ya compliance leads to higher costs of equity experienced by listed firms that can be mitigated through cross-listing. Furthermore we highlight that the significant relationship orientated nature of Islamic finance infers that the often well developed banking sector in many developing countries is better placed to administer shari'ya compliant financial products alongside microcredit institutions as opposed to stock market institutions.

The paper is structured as follows. Section 2 presents the theoretical aspects of Islamic economics and finance as a sub-discipline before introducing the principle factors governing regulation and product design in this context. Section 3 reviews the prominent Middle East and North African (MENA) regional stock exchanges and the institutions defining the Khartoum Stock Market (KSE). Section 4 studies the role of the KSE in the financing strategy of the Sudan Telecommunications company, an example of a prominent multinational enterprise in a developing Islamic economy. Section 5 concludes and suggests policy implications.

2. Theoretical background to Islamic financial markets

The relatively recent emergence of Islamic economic institutions in the MENA region is largely due to the reassertion of Islamic values following the post-colonial period during which Western and Marxist principles dominated (Kuran, 1995) as countries aligned themselves to the capitalist or socialist orders of the Cold War (Chapra, 1993).

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 form 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, as Pryor (2007) notes, Muslim policy makers are faced with considerable dilemmas over omissions from canonical texts, as well as differing translations and contradictory interpretation of these doctrinal sources by the various schools of Muslim jurisprudence (Pryor, 2007; El-Din and El-Din, 2002).

But while the political economy aspects of the Islamic system encompasses all component 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). Therefore, the Islamic order can be viewed as providing "the economic system with its basis and objectives on one hand, and with its axioms and principles on the other" (Kahf, 2003). Consequently the normative prescriptions of Islamic economics are operationalised through axioms, or fundamental principles, which provide a basis for rationalising and verifying knowledge (Asutey, 2007).

2.1. Islamic finance

The Islamic financial system is founded and regulated on the same Shari'ya principles as the overall economy and society (Iqbal, 1997). These dictate the nature of contracts traded and the design of institutions to support the market and regulation of participants' behaviour. Individuals within an Islamic financial system will be subject to behavioural norms, which give rise to very different assumptions to