Where are Islamic finance indices pointing towards?

Lessons from experimental 'pockets' of Islamic financial regulation on international stock markets

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Abstract

Purpose – This paper aims to survey the screening practices and regulatory arrangements that can be gleaned from the experience of Islamic financial indices on international stock markets. Such indices can be regarded as experiments in the demarcation of "pockets" of *Sharīʿah*-compliant securities exchange, in the context of non-*Sharīʿah*-compliant stock markets. They offer valuable regulatory precedent, with a view to the development of a transnational domain of Islamic financial transactions.

Design/methodology/approach – The paper leverages the experience of Islamic financial indices for charting the fault lines between the foundational principles of Islamic finance, and those of interest-based investment commonly accepted on international financial markets. It subsequently reviews the most salient regulatory arrangements in place for discriminating between permissible and forbidden securities and modes of trading, as implemented on Islamic financial indices. These include selection criteria for index inclusion, and *Sharīʿah* committees with ex ante and ex post supervisory duties.

Findings – The paper makes a case for viewing Islamic finance indices on international capital markets as capacity-building experiments for the regulation of transnational Islamic financial flows.

Originality/value – The study rejuvenates the pragmatic approach towards the development of Islamic capital markets, by suggesting that incremental organisational innovations, as developed in connection with Islamic financial indices, can build institutional capacity towards an economy that abides by Islamic values.

Keywords Stock markets, Interest, Bonds, Islamic finance indices, *Sharīʿah*, Ribā

Paper type Technical paper

1. Introduction

After the onset of a dedicated commercial banking sector, the development of transnational Islamic capital markets has emerged as the next frontier of Islamic finance[1]. A notable example in this regard is Malaysia's two-tiered capital market, with an Islamic financial market running in parallel with a stock exchange functioning on conventional (e.g. interest-based) principles (Abdullah *et al.*, 2014). The Dubai Financial Market is another prominent centre of financial activity that aims to comply with the provisions of Islamic *Sharīʿah*

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(Fatwa and Shari'a Supervisory Board, 2018). While challenges remain towards the establishment of a frictionless transnational space for Islamic financial transactions (McMillen, 2006), Islamic financial markets are now acknowledged as a substantial economic reality, deserving deeper understanding in their relationship to conventional capital markets (Ajmi *et al.*, 2014).

This descriptive study contributes to the unfolding conversation by exploring how the implementation of Islamic indices on international stock markets helps clarify the fundamental differences between conventional and Islamic capital investment. Our study tries to map these qualitative differences onto possible forms of regulatory intervention, which would support the development of transnational Islamic capital markets. In so doing, this work tries to offer an alternative reading of the development of Islamic finance indices on conventional stock markets as a *regulatory experiment*, useful for drawing implications for the future trajectory of Islamic capital markets.

Stock markets are public venues for undertaking sale transactions (De Vauplane and Bornet, 2001, p. 377), and their emergence and development has historically occurred in the absence of a legal framework limiting the stipulation of interest. Because of this, the terms "capital markets" and "stock markets" are used in this paper to refer to those hubs for securities trade that have been established worldwide, independently of Islamic finance principles. Against the predominance of interest-based finance, however, Islamic financial engineering has gradually produced a collection of financial products and services suitable for investing money in accordance with the provisions of Islamic law. This has been the initial step, which has been followed by the availability of *Sharī'ah*-compliant investment opportunities on financial markets (El Khamlichi, 2012, p. 5).

The question of *Sharī'ah* compliance originates in the prohibition of *ribā* (literally "excess" or "increase") found in Islamic law, and specifically in the Holy Qur'ān and in the *Sunna* – its two chief sources[2]. While a detailed discussion of the legal basis for Islamic finance is beyond the scope of this paper, a brief *excursus* will be of use to readers less familiar with this rather technical branch of Islamic law. The prohibition of *ribā* embraces two sets of practices. The first, called *ribā al-jāhiliyya*, consists in an increase of the debt principal in exchange for a payment delay[3]. The second concerns two specific types of trading arrangement (Fadel, 2008): first, the like-for-like, spot trading of goods normally sold by weight or quantity, based on differences in quality (e.g. one measure of high-quality dates against two measures of low-quality dates) – this is called *ribā* of excess; second, commodity trading undertaken on credit, unless the counter-values are equivalent and belong to different genera – this is called *ribā* of delay. Egyptian comparatist al-Sanhuri (1953/1954, pp. 218-19) opined to locate the principle of law (*asl*) applying to financial transactions in the prohibition on *ribā al-jāhiliyya*, whilst viewing the other two types of *ribā* prohibitions as prophylactic measures (*sadd al-dhari'a*) that did not embody a self-standing regulatory principle. So, if the contemporary prohibition of interest-based finance originates in the prohibition of *ribā al-jāhiliyya* (Phull, 2011, p. 407)[4], this suggests that the original ban on ex post extraction of rent was extended, on social justice grounds, also to ex ante stipulations of interest. Hence, Islamic finance carries an implicit promise of actualising an alternative political economy based on such motives as the refusal of the exploitation of persons (Ahmad and Hassan, 2007, pp. 4-5; Rahman, 1985, p. 5). At the same time, it is confronted with the risk of an excessively permissive approach that "adjust[*s*] the interpretation of financial principles in Islamic law to accommodate and provide the same type of services and investment mechanisms as the dominant system" (Furqani and Wahid, 2013, p. 12). This paper treads a middle ground between those positions, suggesting that incremental regulatory experiments can act as stepping stones towards the establishment of a transnational space of Islamic financial investment, which would secure a supply of financial resources with which to nurture an economy based on Islamic values (Ismail and Kamarudin, 2012; Dar, 2003).

In view of the foregoing, this paper attempts to chart the qualitative difference between conventional and Islamic capital investment, as it is encountered in practice. It does so by looking carefully at the experience of Islamic financial indices, because they directly face the task of crafting rules to distinguish *Sharī'ah*-compliant investment opportunities from conventional alternatives. Hence, they can be of help in understanding where the differences between the two systems actually lie. By functioning as miniature regulated exchanges, indices can be regarded as a useful precedent to figure out the regulatory architecture that independent Islamic capital markets would need to adopt. In this respect, the experience of Islamic finance indices shows that questions of *Sharī'ah* compliance dominate over profitability alone, for instance when it comes to determining which companies might be listed on an Islamic stock exchange. Further, Islamic financial indices also reveal the possibility of borrowing regulatory solutions from conventional capital markets.

Our exploration of Islamic financial indices begins in Section 2, in which we undertake a review of the legal and economic differences between Islamic and conventional forms of financial investment. Subsequently, Section 3 locates those differences in the practical arrangements that have been tested out on Islamic financial indices, to consolidate pockets of *Sharī'ah*-compliant financial transactions at the heart of conventional stock markets. By way of conclusion, Section 4 summarises our inquiry by laying out the most relevant distinctions between the two forms of financial investment, as charted through the experience of Islamic indices.

2. Reviewing the gap between Islamic law and conventional stock market practices

One of the constant challenges in Islamic financial markets development has to do with differentiating *Sharī'ah*-compliant transactions from conventional ones. To understand the purpose of the regulatory arrangements that Islamic financial indices have put in place to tackle this, it is first of all necessary to chart the gap between the two domains (Islamic and conventional) of financial transacting. Only then does it become possible to motivate the specific arrangements that Islamic financial indices have adopted, for the purpose of implementing "pockets" of Islamic financial regulation at the heart of international stock markets.

2.1 Interest-based transactions on conventional stock markets

Interest is normally understood as the price of time and risk (Piedelièvre, 2013, p. 2), and specifically as the price that a borrower pays as consideration for being able to benefit from present availability of the loan principal (Sousi-Roubi, 2001, p. 142). The loan, in fact, deprives the borrower of the opportunity to take advantage of his/her capital for a stipulated time; thus, interest is provided to him/her and computed as a percentage of capital. While interest payments need not necessarily be settled in cash, and may be undertaken in other movables, cash remains the preferred means of settlement (Piedelièvre, 2013, p. 2).

The development of conventional financial markets has occurred outside of a legal framework, prohibiting the extraction of interest. This has favoured the development of practices, customary on conventional stock markets, which are problematic under Islamic law. Those practices present a challenge for distinguishing pockets of Islamic financial transactions amidst a sea of non-*Sharī'ah*-compliant forms of investment – which describes precisely the conundrum faced by Islamic financial indices. The sub-sections that follow hone in on two domains, with respect to which the greatest distance exists.

2.1.1 Tradable securities. Conventionally, stock market access is not in principle restricted only to certain types of legal entity (Ohl, 2008). For instance, it is not limited to companies offering marketable shares, but might also include entities that issue listed bonds (Ohl, 2008).

Listing bonds on capital markets constitutes one broad chunk of financial activity that conflicts with the prohibition of *ribā*. Al Sebaey (2004) reports that the laws applicable to many conventional stock markets specifically contemplate debt securities, the nominal value of which is equal to the principal being lent from the bondholder to the bond issuer. In terms of their marketability, these cater for savers looking for the guaranteed restitution of their principal, increased by the stipulated amount of interest. This is highly problematic in the light of Islamic law, because it guarantees a return to the lender, regardless of the issuing company's financial position, and of the profits or losses that were realised from the investment of borrowed funds (Al Sebaey, 2004). For all practical purposes, loan bonds are extremely close to conventional bank loans, as lenders hold rights to certain monetary flows, such as restitution of the principal and payment of an interest margin, that are stipulated in the bond agreement (Lecourt, 2013). At the same time, there are some differences, such that bondholders are allowed, under certain conditions, to take part in the corporate life of the issuing company (e.g. to attend and intervene in shareholders' meetings, albeit without being able to cast a vote) (Ohl, 2014). This notwithstanding, trade in loan bonds, is spite of being allowed on conventional stock markets, is not acceptable according to the tenets of Islamic financial regulation. This interpretation has been affirmed in Resolution No. 60 (11/6) of the International Islamic *Fiqh* Academy, affiliated to the Organisation of Islamic Cooperation ("OIC *Fiqh* Academy") (Islamic Development Bank, 2000, p. 119)[5].

Company shares, whether listed on a stock market or not, do not attract the same prohibition. Abdullah (2007, p. 66) aptly summarises the reason for this difference of treatment in comparison to bonds:

> A share, in the *Sharī'ah*, is understood as a portion of the company capital, which is used in developing the project. As long as it is a part of the company capital, it is subject to gain or loss; thus, it is not in contradiction with the concept of *mudarabah*, which forms the basis of all kinds of Islamic company undertakings. Purchasing commercial shares in such form is lawful (*halāl*), whenever it is made through methods permissible in the *Sharī'ah*.

This general rule suffers an exception, however. In fact, considering shares are a portion of a company's assets, if those assets include interest-bearing loans and similar transactions, then shareholding might effectively amount to indirect participation in interest-based financial transactions. Hence, for the purchase of listed shares to be *Sharī'ah*-compliant, an additional scrutiny is necessary as to the degree of implication of the listed company in interest-based financial dealings – a view that has also been endorsed by the OIC *Fiqh* Academy in Resolution No. 87 (4/9)[6].

This has implications for the purpose of demarcating a space of *Sharī"*ah compliant financial investment. While conventional market regulators might not demand a detailed breakdown of a company's business, at least for the purpose of authorising its listing, the same disclosure would instead be necessary for the purpose of inclusion in an Islamic financial index, or for listing on an Islamic stock market.

2.1.2 Speculative trading. Financial speculation is trading undertaken with a view to benefit from market fluctuations in asset prices (Cornu, 2011, p. 120). This includes any transaction that reaps a monetary profit by anticipating contingent fluctuations in prices

(Hamel *et al.*, 1980, p. 224). It is advantageous for carrying out speculative trading successfully, to possess a degree of expertise and professional acumen in connection with the sale and purchase of listed securities. Consequently, there exists a class of market operators whose professional specialism consists in speculative trading on listed securities, and whose main source of income are the gains from this kind of trade. This has posed a question for market regulators, concerning the legitimacy of such speculative trading (Hamel *et al.*, 1980, p. 224). In conventional stock markets, speculative trading is not *per se* prohibited. By exploiting price differences between supply and demand, speculators have been considered instrumental in price discovery, facilitating the circulation of information. Still, De Vauplane and Bornet (2001, p. 476) also acknowledge that speculation can interfere with price formation mechanisms, leading to booms and busts and subsequent financial crises.

The Islamic perspective on speculative trading takes a different starting point. Speculative trading in listed securities is suspicious on a number of grounds: for amounting to simulated exchange or to gambling (*qimar*) or for exploiting invalid transactions. Concerning the first point, the reason for prohibiting speculation is that the circulation of securities on secondary markets – when undertaken for speculative reasons – can simulate price increases in a manner that detaches their fluctuations from underlying changes in the valuation of a company's assets. As for the second point, profiting from speculation has its basis in risk, which can fall foul of the *Sharī'ah* prohibitions on gambling. Lastly, professional speculators may sometimes undertake forms of market manipulation to inflate the price of securities, thereby leading to trades based on deception and therefore marred by grounds for invalidity (Al Omrany, 2010; Khorshid, 2006).

Notwithstanding these considerations, a careful position has been articulated by the OIC *Fiqh* Academy, in Resolution No. 46 (8/5):

> [G]overnment officials in Muslim countries [. . .] must not leave those who speculate with prices, free to do whatever they want to do. They should make it mandatory for them to follow the lawful means and methods in respect of the deals that are concluded on stock market. They must prohibit the deals which are not permissible in the Islamic *Sharī'ah*, and prevent the speculation that causes financial disasters and destroys the public economy, inflicting losses on so many people[7].

This mandates a cautious approach, based on a case-by-case discernment between legitimate trading on listed securities, i.e. trading which does not formally occur through *ribā* means, and other trading schemes that fall foul of *Sharī'ah* prohibitions such as those on *qimar*, mentioned above[8].

2.2 Centrality of the link to real assets in Islamic financial transactions

Financial activity under *Sharī'ah* is to be subservient to transactions taking place in the real economy; the chief means of ensuring this remains the case is by channelling funding in the form of partnerships. This arrangement ensures that financing is tied to the exchange of commodities and services, thereby maintaining a connection with wealth-producing activity (Al Wardy, 2013, p. 71). In this respect, conventional stock markets allow for a higher degree of separation from the real economy than is acceptable on the Islamic view (Abdullah, 2007).

To preserve this connection of financial operations to economic exchange, the *Sharī'ah* subjects stock market transactions to a number of rules and procedures meant to accrue their stability. These include: controls to enforce free competition and correct information disclosure; prohibitions against gambling (*qimar*), spreading market rumours (*najash*), monopoly and simulated trades; and procedures for ensuring contractual freedom and correcting overly formalistic legal solutions through equity (*istihsān*) and consideration of public interest (*istislāh*) and of the common good (*al-maslaha mursala*) (Rejal, 2013). Moreover, while conventional financial market regulation contemplates rules to protect savings and investors, these do not directly address the interest-based character of financial transactions. This gap is precisely what has prompted the demand for *Sharī'ah*-compliant financial products (Ahmed, 2010, pp. 310-313). The most notable innovation in this field is represented by the Islamic finance alternative to interest-bearing bonds, namely, the *sukūk*. This implements one of the ground rules of Islamic financial architecture, whereby "money is capital, people trade thereby not therein" (Al Aany, 2007, p. 11). A second principle underlying the structure of *sukūk* securities is the sharing of profits and losses ("PLS"), based on the *Sharī'ah* maxim "damage and benefit go together" (*al-ghurm bi al-ghunm*), meaning that whoever is bound to profit from a particular venture ought not to be able to insulate him-/herself from the losses or damages that may flow therefrom (Al Wardy, 2013).

Conventional bonds fare poorly from an Islamic perspective also under the PLS principle, as they can prove an added burden when a company is facing losses, because interest will need to be paid even when the balance sheet records a loss (Ripert and Roblot, 2003; Le Cannu and Dondero, 2010). This is why excessive reliance on debt financing may lead a company to tip over into insolvency (Guyon, 2001). At the same time, bonds also fulfil a useful function whenever they provide issuing companies with the means to finance their investments (Lecourt, 2013).

This is the background behind the development of *sukūk* securities – or "Islamic bonds" (Hassoun, 2009, p. 18). With *sukūk* securities, buyers receive an individual claim to indivisible assets (Conseil Déontologique des Valeurs Mobilières, 2012). In other words, *sukūk* securities provide title to underlying assets, with the aim of granting a claim to their holders on the assets themselves, for the purpose of sharing the profits (and risk) from the investment: this is how the financial performance of the underlying assets will return to the investor, without there being a direct stipulation of interest payments (Dupichot, 2010). While *sukūk* investors are akin to conventional bondholders, in that they have a right to reap a portion of the benefits from the revenues flowing from their investment, they also remain subject to bearing losses, in proportion to the size of their investment (Conseil Déontologique des Valeurs Mobilières, 2012). In this sense, *sukūk* securities allow to mobilise savings for the sake of promoting investment (Toloba, 2013), whilst conforming to the PLS principle, which leaves an investment exposed to losses. Because of this feature, *sukūk* investors are justified in indirectly enforcing their rights in the underlying assets, particularly when the issuer has run into financial hardship (Lienhard, 2009, p. 2412).

In sum, Islamic financial trading does not simply require conformity to the *ribā* prohibitions (which place limits on the types of securities that may be bought and sold, on the basis of their interest-bearing features). Instead, it also suggests the development of instruments offering specific guarantees about profit-and-loss sharing and about retaining a connection to underlying assets.

2.3 A review of economic differences between Islamic and conventional capital markets

Principles such as PLS and the connection to economic fundamentals might account for the long-run correlation between Islamic securities markets development and economic growth, which does not appear to hold in the same way with respect to conventional markets (Abbes and Trichilli, 2015).

A significant economic difference in the functioning of conventional and Islamic capital markets can be found with respect to the institutional concepts of information and allocative efficiency. Conventional markets allow arbitrage trading in view of its contribution to price discovery, with arbitrageurs being able to borrow stock (short selling) to enact trades from which they will reap a profit. This is not the case with Islamic markets, which are less concerned with the achievement of allocative efficiency through trading and more with the correct selection of suitable investments. This explains their conservative attitude towards short selling, as well as the ubiquity of partnership contracts, where capital providers and investors share risks and returns (Saiti and Khaliq, 2017). Following on from this, credit also plays a negligible role in Islamic financial transactions (Askari and Krichene, 2014; Saiti and Abdullah, 2015).

The legal concerns outlined earlier in the section distinctively shape the functioning of Islamic financial markets, putting ethical questions before the concern for market efficiency (Obaidullah, 2001). For instance, not every kind of goods or services is tradable, as the subject matter of a contract (*mahal al-aqd*) must first of all be permissible (*halāl*) (Saiti and Abdullah, 2016).

An upside of religion-based restrictions in Islamic finance is that they mitigate elements of risk habitually found on conventional stock markets. In this sense, Islamic capital markets might even act as models for ameliorating regulation on conventional markets (Bouoiyour *et al.*, 2016).

With specific reference to Islamic financial indices, these have been regarded favourably also in the context of conventional stock markets, as a way to attract new capital and increase the volume of transactions. For instance, in France, where Muslims total 6 million, or 10 per cent of the population, proposals to create Islamic indices highlight such advantages as increased international competitiveness (Peillex and Ureche-Rangau, 2012), as well as robust performance in the face of conventional counterparts (El Khamlichi and Viallefont, 2015).

3. Islamic finance indices on international stock markets: an expanding frontier of regulatory development

Over the years, indices listing Islamic financial products have become commonplace in many of the most important international stock markets. The earliest index for *Sharī'ah*-compatible equity purchases has been the Dow Jones Islamic Market Index. Other prominent equity indices are the FTSE Global Islamic Index at the London Stock Exchange and Standard and Poor's Global Benchmark Shariah (El Khamlichi *et al.*, 2014). Indices also exist, which list *sukūk* securities, such as the FTSE Sukuk Index (for USD-denominated securities). These indices provide global visibility to investment opportunities that are available for funds that would otherwise be endangered by dealing in *ribā*.

In addition, they constitute an interesting capacity-building experiment in financial regulation, for enabling the raising of *Sharī'ah*-compliant funds on an international scale. This is because Islamic finance indices confront the unusual challenge of having to elaborate detailed criteria to discriminate between the *Sharī'ah* permissibility (*halāl*) and prohibition (*harām*) of different types of investment options. In this respect, they are facing, on a small scale, many of the regulatory issues that would equally have to be tackled in the context of full-fledged, independent Islamic capital markets.

3.1 Regulatory challenges raised by the use of indices for relaying Islamic investment opportunities

Generally speaking, "index" means a numerical account that tracks changes in the value of a particular asset (Guillien and Vincent, 2001, p. 301). Stock market indices broadcast the daily value of securities they are meant to track, coupled with their percentage variation on a daily, monthly or yearly basis (Mishkin *et al.*, 2010, p. 44). Indices on international stock markets work as aggregators of information, working in tandem with electronic trading systems that greatly accelerate the performance of trades. Together, they enhance the capacity to carry out cross-border trades (De Vauplane and Bornet, 2001)[9], and in general to clear demand and supply of funds in relation to the indexed securities.

Islamic finance indices can list either "original" Islamic securities (such as *sukūk*) or investments that have been vetted from the mass of conventional securities because they conform to the requirements for *Sharī'ah* compliance. However, the fact that indices were originally born to aggregate the "essential features" of *conventional* financial products, irrespective of Islamic law distinctions between *halāl* and *harām* investments, poses the question of the extent to which this channel of information dissemination might be congruent with the principles of Islamic finance.

Indeed, there are some ways in which indices of Islamic financial investments clearly differ from their conventional counterparts:

- Islamic equity indices only list companies that comply with the principles of Islamic law, particularly in connection with their involvement in economic activities that are clearly proscribed in the *Sharī'ah* (El Khamlichi, 2012, p. 88), which include such goods and services as wine, gambling, pork products and interest-based banking.
- Moreover, Islamic indices presuppose quantitative filters of "financial purification", which serve to exclude companies whose involvement in the interest-based economy (as a debtor or creditor) exceeds a threshold, below which it is deemed exceptional or accessory to their principal line of business (El Khamlichi, 2012, p. 91). In connection with this assessment, the role of a *Sharī'ah* committee, consulted by the compiler of the index, takes centre stage (El Khamlichi, 2012, p. 88).

What the above shows is that, at the very least, alongside displaying the information that is customarily expected of conventional stock market indices (trade values, reports on whether certain securities have ceased trading, variations in the value of securities), Islamic finance indices *also* face the issue of disseminating adequate information concerning the compatibility of the listed products and securities with Islamic law.

At the same time, the presence of Islamic indices alongside conventional ones on international markets makes it easier to compare the performance of conventional investments with that of *Sharī'ah*-compliant investments. This raises a question as to whether such vicinity may not, on occasion, trigger the prohibition of financial dealings based on interest remuneration (*ribā*). Take, for instance, the inclusion of *sukūk* instruments in an index, enabling comparison (and/or other forms of benchmarking) of their returns to those of interest-bearing bonds featured in competing conventional indices[10]. Another issue arises when the securities of one company are included in an Islamic index, when those of the latter's parent company, traded on the same stock exchange, haven't qualified for inclusion. These points raise the question of when compliance with the *Sharī'ah* may be reduced to a mere formality through the presentation of Islamic investment opportunities via indices, featuring alongside indices that list conventional securities. This, in turn, revives the ongoing challenge of devising safeguards to ensure that form fully aligns with substance (Agha, 2009, pp. 129-130).

3.2 Modelling Sharī'ah supervision after financial markets regulatory authorities

Because stock markets are venues where savers are invited to invest their funds, they are normally surrounded by legal safeguards to protect holders of securities listed on those markets. Typically, this function is undertaken through the imposition of specific duties upon market operators, such as brokerage firms, while tasking a public agency with proposing appropriate regulation and controlling its implementation. As an example, the French Capital Markets Authority is equipped with:

- the authority to formulate rules and suggest their interpretation, for the sake of ensuring their correct application;
- the power to take decisions in individual cases and issue orders to market participants; and
- the means to conduct inspections and monitor market operations, administer penalties and facilitate the amicable settlement of minor disputes (Paclot, 2013, p. 66).

Also relevant for our purposes is the regulatory authority's power to approve the information that companies will be issuing to interested investors when they undertake an initial public offering of their securities (François, 2013). Moreover, the same authorities are often entrusted with the capacity to establish monitoring procedures and impose compliance duties upon market participants, as is the case again with the French Capital Markets Authority and the Moroccan Capital Markets Authority (Boujeka, 2014). Finally, market regulatory authorities are typically set up by law in a manner that guarantees independence in carrying out their tasks, namely sufficient distance *vis-à-vis* market operators, as a guarantee of neutrality.

These regulatory arrangements in connection with financial markets reveal a changing pattern of state intervention, signalling a move from a traditional role as direct provider of goods or services, to regulator of private actors' activities in delivering the same. Institutionally, this shift becomes visible precisely through the establishment of the just mentioned "market authorities" or "regulation authorities" (De Vauplane and Bornet, 2001).

This approach requires further qualification when it comes to Islamic capital markets. In this case, in fact, a committee that verifies the *Sharīʻah* compliance of securities offered for trading is necessary, and has become commonplace in the major Islamic financial trading centres, such as the Dubai Financial Market[11]. This is required because, as it has been shown earlier, *Sharīʻah* law restricts the stipulations that may be included in individual securities (which might fall foul of the *ribā* prohibition). It also demands close scrutiny of trading practices – even when they occur in connection to formally permitted securities – when they might nonetheless amount to dealing in *ribā* (as in the case of shares of companies heavily involved in interest-based financing) or elude the PLS principle to extract a rent from risk, disconnected from economic fundamentals.

Historically, Islamic banks have been the first to introduce internal *Sharīʻah* committees, also in light of the lack of incorporation of Islamic financial prescriptions into some national legal systems (making it necessary to set up private forms of regulation and monitoring). Similar committees have also started to play a significant role, in connection to checking the *Sharīʻah* compliance of the different types of securities listed on an Islamic finance index or financial market.

A close analysis of the tasks carried out by regulatory authorities, as they exist in connection to conventional stock exchanges, reveals a useful model for framing the role of *Sharīʻah* committees in connection to Islamic financial markets and indices. In general, the competence of *Sharīʻah* committees is to verify whether a given security is compatible with Islamic law, and therefore suitable for inclusion in investment portfolios and/or listing on an index (Cekici, 2010, p. 11). Another task is to ensure that securities listed on an Islamic stock exchange or index do not resort to investment strategies or techniques that are in contradiction with the *Sharīʻah* (El Khamlichi, 2012, p. 97). More specifically, just like mainstream market regulatory authorities wield both ex ante (regulatory) and ex post (supervision) competencies, a similar role could be predicated for *Sharīʿah* committees. Such committees are usually required to issue a legal ruling (*fatwā*, pl. *fatāwā*) to allow or proscribe certain categories of products according to Islamic law. Subsequent to the ex ante *fatwā*-issuing role, the same committees often retain an ex post supervisory role – akin to that of their counterparts in conventional stock markets – to ensure that aspects in the implementation of an approved product do not alter its substance in impermissible ways (Ahmeen, 2013, p. 367).

In the context of Islamic finance indices, if they are approached as experimental "pockets" of Islamic financial regulation on conventional stock markets, a further question arises as to which entity ought to exercise the ex ante and ex post *Sharīʿah*-compliance roles just outlined. To give but one example, while French legislation allows the emission of *sukūk* securities, and their listing on the French Stock Exchange, it does not contemplate a dedicated competence for the French Capital Markets Authority to verify these products' compatibility with Islamic law. Rather, what the French Capital Markets Authority will check is that the *sukūk*-issuing entity has sought advice in matters of *Sharīʿah* compliance, in connection to the offered product, from its internal consultants, which will have to be an internal *Sharīʿah* committee. The French Authority will then ensure that any information provided to potential subscribers is complete, including disclosure of aspects related to the Islamic legality of the product in question, to allow investors to form a complete picture for evaluating the *sukūk* (Storck, 2008, p. 808).

4. Conclusion

Our descriptive analysis in this paper has attempted to contextualise the legal and economic differences between conventional and Islamic capital markets, as they are encountered in the establishment of Islamic financial indices. Indeed, Islamic finance indices face the task of drawing distinctions between permissible and forbidden forms of investment on a highly concrete level. In this respect, they can be regarded as incubators of regulatory solutions that might enjoy a wider uptake in the event of establishment of full-fledged Islamic stock exchanges.

Based on our observations in the rest of the paper, a number of conclusions might be drawn. These are based on the regulatory challenges faced by Islamic indices on international stock markets, but they would equally apply – on a different scale – to independent Islamic stock markets. First, the *ribā* prohibitions underpinning Islamic finance mean that interest-based transactions or instruments must come under close scrutiny under Islamic investment principles. For this reason, transfers of ownership that preserve risk-sharing remain the preferred form that financial transactions ought to take in an Islamic framework. This fundamental difference has a direct impact on the possible modes of operation that would be allowed on Islamic capital markets. In connection with indices, this principle restricts permissible securities primarily to shares or *sukūk* instruments. Second, while the essential purpose of regulatory infrastructure in conventional stock exchanges is to oversee the correct functioning of market mechanisms, in Islamic stock exchanges the crux of regulation would concern the issuance of *fatāwā* and the follow-up *Sharīʿah* scrutiny of listed products and trading practices. In addition, while speculation plays an accepted role on conventional markets, as an aid to price-discovery, Islamic financial principles warrant a more sceptical outlook. This justifies close examination of speculative trades on a case-by-case basis. Third, while the purpose of information disclosure on conventional markets is chiefly to do with its impact on prices, in an Islamic regulatory framework *Sharīʿah* compliance forms another essential domain in which transparency is needed. Fourth, when

Islamic indices operate on international stock exchanges that lack a dedicated *Sharīʻah* supervisory authority as part of their governance structure, this generates uncertainty as to the *Sharīʻah* compliance status of securities listed on Islamic indices. For this reason, authorities charged with market oversight on international stock markets tend to demand disclosure of independent assessments concerning the *Sharīʻah* compliant features of indexed securities. Last, but not least, Islamic capital market transactions need to rely on the same electronic infrastructure that has been developed in connection with conventional stock exchanges. Here, however, the priority accorded to synthetic price and trading information constitutes a potential challenge to ensuring that financial transactions in Islamic securities do not become driven by profitability alone.

This descriptive study has used Islamic financial indices as a way to map the main discriminants between conventional and Islamic stock markets onto concrete regulatory arrangements. An overview of this sort can be helpful for appreciating the incremental nature of institutional change, as Islamic finance transitions from a "prohibition-driven" orientation (El Gamal, 2007, p. 187) towards the gradual development of an infrastructure fit to accommodate an economic space more deeply informed by *Sharīʻah* values. This can be achieved through a careful assessment of concrete regulatory arrangements, such as those adopted by Islamic financial indices. This approach finds its basis in the direction charted by the OIC *Fiqh* Academy in its Resolution No. 46 (8/5), which states that "is necessary to give a ruling on the cases and deals which take place in the stock market, each of them separately". In this way, it can guide incremental capacity building in Islamic financial infrastructure. It is on this basis that the experience of Islamic financial indices, with their developing ability to demarcate "pockets" of Islamic financial flows at the heart of conventional capital markets, can fruitfully be mined as a source of rich organisational potential.

What has not been attempted here, but which could form the subject of future research, is a production of models for statistical estimation of the impact of some of the *specific* restrictions highlighted in our paper, such as those on interest-based instruments or trades, or on arbitrage and speculation. Lastly, another problem area that has not been directly addressed here has to do with the private international law questions attached to the enforcement of *Sharīʻah* norms with respect to Islamic finance indices established in non-Islamic jurisdictions, or in connection to cross-border trading on Islamic capital markets.

Notes

1. The development of modern Islamic finance has come to maturity in the 1990s. Prior to that, the *Sharī'ah* had been marginalised as a regulatory framework for economic and financial transactions. The independence of the major Muslim states, coupled with the availability of oil wealth in the 1970s, provided an initial catalyst for a process of capacity development, which led to the entry of *Sharīʻah* experts into banking institutions. By the 1990s, this process ushered the combination of different nominate contracts known to Islamic law, developing the legal infrastructure to accommodate more complex types of economic transactions. It is at that point that the question of developing a *Sharīʻah*-compliant legal infrastructure for capital markets becomes actual. For further background, see McMillen (2006, pp. 144–147) and Ahmed (2010).

2. Islamic law has its source in the Holy Qur'ān, and in the sayings (*hadīth*) of the Prophet Muhammad, peace be upon him (PBUH), which form the *Sunna*. Additional sources of Islamic law, used to guide juristic reasoning (*ijtihād*) for discerning the will of God in cases not directly addressed by the first two sources, are *ijmā'* (juristic consensus) and *qiyās* (analogy). Differences in conceptualising and relying on these additional sources are one of the reasons why separate schools of Islamic jurisprudence have historically emerged (the Mālikī, Hanbalī, Shāfiʿī and

Hanaī). For accessible introductions to Islamic jurisprudence and its history, see Alarefi (2009) and Menski (2006).

3. The qur'ānic verses (*suras*) in which the mentioned prohibition has its basis are *al-Baqara* 2:275, 2:279 and 2:280.
4. A different view is put forth by Kamali (2012, p. 626), according to whom the prohibitions against the *ribā* of excess and the *ribā* of delay establish the principle that currency can never be traded like-for-like for a profit motive, being turned into an investment opportunity, but should remain in service of real exchange.
5. The International Islamic *Fiqh* Academy of the Organisation of Islamic Cooperation has been instrumental in the development of Islamic finance, through the organisation of seminars and the facilitation of debate, also concerning financial matters (McMillen, 2006).
6. Resolution No. 4 of the Council of the OIC *Fiqh* Academy, issued in its Ninth Session of 1415H/1995 AD, *Bulletin of the International Islamic Fiqh Academy*, 1995, n. 9, 351. For a partial English translation, see Islamic Development Bank (2000, p. 190).
7. Resolution No. 5 of the Council of the OIC *Fiqh* Academy, issued in its Eight Session of 1409H/1993AD, *Bulletin of the International Islamic Fiqh Academy*, 1996, no. 10, p. 317. For a partial English translation, see Islamic Development Bank (2000, pp. 93-94).
8. These would include short-selling (selling shares one does not own) or leveraged share purchase (buying shares with loaned money), as clarified by the OIC *Fiqh* Academy, in its Resolution No. 63 (1/7); see Islamic Development Bank (2000, p. 129).
9. The adoption of an electronic infrastructure for broadcasting investment opportunities and carrying out trades greatly expands the geographical remit of financial trading (Vivant, 2001). This opens the additional question, which will only be mentioned here, of whether *Sharī'ah* rules on admissible types of securities and their approved forms of trading will be enforceable internationally, according to the rules of private international law. For an overview of a range of attempted solutions to the question of transnational enforceability of *Sharī'ah*-based securities regulations, see McMillen (2006, pp. 157-163).
10. Formal or informal benchmarking of Islamic securities to the yields of conventional securities is a problem that has been raised in the important econometric study by Ajmi *et al.* (2014), on the degree of 'coupling' between Islamic and conventional stock markets.
11. For an overview of the role of national *Sharī'ah* supervisory bodies in the major Muslim countries, see Grassa (2015).

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