

# Some perspectives on Islamic finance and investment funds

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“Unlocking the Middle East”

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# Shari'a Funds



# Investment Funds

- Investment funds are collective investment undertakings used for:
  - Collective investment, pooling
  - Risk spreading/diversification
  - Institutional investment (insurance, pensions)
  - Private investment, (hedge funds, private funds)
  - One of the world's largest growing industries
  - Total global assets under management c. USD25 trillion

# Investment Funds

- Impact of Global Credit Crisis
  - Credit crisis is largely a bank generated phenomenon
  - Funds and particularly hedge funds are more victims than perpetrators
  - As long as assets and wealth are accumulating, they will require a home, so funds will grow
  - Investors may seek more transparent less complicated structures

# Islamic Investment Funds

- What are they?
- What are the main principles?
- Recent developments?
- What are the possibilities/opportunities for Shari'a hedge funds

# Islamic Finance

“Le finance Islamique en plein boom”

*(Le Figaro, September 2006)*

# Islamic Finance

Term “Islamic economics” first appeared in 1950s.

Dubai Islamic Bank – 1971

Citigroup & HSBC offer

Shari’a compliant product - 1990

# Islamic Finance

UK	Gordon Brown announces plans to make London the “gateway for Islamic finance in Europe”
Japan	plans to issue shariah compliant bonds
Malaysia	2007 budget announces tax breaks for Islamic financial sector
Indonesia	2009 USD0.5bn. Rupiah sukuk & USD3bn. MTN & retail mkt.

# Islamic Finance

- Total global Islamic banking and finance market c. USD 1 trillion
- 265 banks and financial institutions in 40 countries dealing in Sharia compliant investments
- Growing at 15-20% per annum
- No. of Shariah compliant funds
  - 1990        15
  - 2000        97
  - 2006        350
  - 2008        500

*(KPMG, EY, WSJ, Business Week, Moodys)*

# Islamic Finance & the West

- Citigroup                      Malaysia                      2003
- Lloyds                              UK                              2007
- Nestle                              Sharia notes                      2005
- Sachsen-Anhalt                      Sharia FRNs                      2005

# Islamic Finance & the West

- Islamic Bank of Britain 2004
- European Islamic Investment Bank 2005
- Bank of London and Middle East 2005
- More than USD11bn. Sukuk bonds on London Stock Exchange

# Islamic Finance & the West

- Acquisition of Aston Martin by Kuwaiti investors using shari'a compliant finance



# Islamic Finance & the West

- Development of Chelsea Barracks by Qatari Diar, a real estate vehicle of the Qatari government for £1.3bn.



# Islamic Finance & Switzerland

- National Bank of Kuwait
- Planning an Islamic private bank in Switzerland (“F.T.” 31.3.08)
- Targeting high net worth individuals in Gulf Region

# Potential Size of Sharia Market

- Post 9/11 withdrawal of Arab monies from US
- USD1,000 billion in cash and Sharia compliant investments
- Of which USD200 – USD500 billion in Sharia compliant investments

*(UK FSA)*

# Potential Size of Sharia Market

- Combined GDP of Gulf Co-operation Council

	USDbn.
2002	375
2005	600
2007	800
2008	?

## Significance of Sharia

- In Dubai and Gulf jurisdictions, Sharia law dominant
- Saudi, UAE and Kuwait all have legislative provisions, which forbid the enforcement of acts and matters inconsistent with Sharia  
*(De La Rosa)*

## Significance of Sharia

- Increasing importance of Dubai as a financial centre
- Both Dubai (*DIFC*) and Bahrain have adopted trust legislation to facilitate the development of collective investment vehicles

## Sharia Finance outside Gulf

- 25% of investors in Malaysia, Indonesia also are strongly committed to seeking out and using shariah financial products
- 50% would prefer to use shariah funds as long as the return was not inferior to conventional products

*(McKinsey, October 2007)*

## Significance of Sharia

- However notwithstanding the new developments in Dubai and Bahrain:

*“The historical preference of many Muslim settlers for the haven of Swiss banks, or the security of other established offshore financial centres remains very strong”*

*(De La Rosa, June 2007)*

## Significance of Sharia

- “Many of our clients, who are Muslim are not always that devout. They are more interested in returns than religion”

*(Swiss private banker quoted in “F.T.” October 2007)*

# Schools of Sharia law

- Sharia is not a uniform immutable system of law, but over the centuries has become fragmented
- “Way, or path to the water”
- A life that is divinely ordained

# Schools of Sharia law

- Derived from:
  - The Koran
  - The Hadith (*sayings and conduct of the Prophet*)
  - Islamic jurisprudence over the centuries

# Schools of Sharia law

- **Sunni**      *(85% of Muslim World)*
- *Hanafi*      *Middle East, Pakistan, Turkey, Sudan*
- *Maliki*      *North and West Africa, Kuwait*
- *Shafii*      *Malaysia, Indonesia, parts of middle east*
- *Hanbali*      *Principally Saudi Arabia, basis of Wahabbi sect*
  
- **Shia**      *(largest minority – Iraq, Iran, Bahrain, eastern Saudi Arabia)*

# Schools of Sharia law

- Each Sharia school borrows ideas from other schools
- Makes it difficult to predict how an issue of Sharia law not precisely covered by the Koran will be dealt with
- Consultation with Sharia law boards often no guarantee of certainty

*(De La Rosa)*

# Fatwah

- Islam is a complete code for living of which the legal principles are an inseparable part
- Therefore, Islamic clergy have an important role in the day to day interpretation and application of legal rules
- A “Fatwah” issued by such clergy is a pronouncement on a matter of religious principle, which determines legal rights and obligations

# Islamic Investment Funds

“ A joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profits in strict conformity with the precepts of Islamic Shariah”

*(Mufti Taqi Usmani)*

# Islamic Investment Funds

Subscribers to the fund receive a document certifying the subscription and entitling them to pro-rated profits actually accruing to the fund

Instead of a fixed rate of return, the investments must carry a pro-rated profit

The amounts pooled must be invested in a business acceptable to Shariah

# Islamic Investment Funds

Financial products must satisfy Shariah criteria and must not involve:

- Riba (*usury*)
- Riswah (*corruption*)
- Maysir (*gambling*)
- Gharar (*unnecessary risk*)
- Jahl (*ignorance*)

# Islamic Investment Funds

Shariah screening of investments includes industry exclusions, e.g. alcohol, banks and observance of certain financial ratios to identify Riba income and avoid impermissible trading of debts.

*Shariah Standards 2004-5 of the Accounting and Auditing  
Organization for Islamic Financial Institutions, (AAOIFI)*

# Equity Funds

If main business of a company not lawful under Shariah, Islamic fund can't buy stock

Difficult if the company has money on deposit in which it earns interest

Shareholder in a company must not be a partner (*sharik*) as every sharik is an agent for each other partner in the enterprise

# Equity Funds

However, decisions in a joint stock company are taken by majority

If shareholder is not agreeable to interest transactions, debt, or deposits, but overruled by majority, not fair to conclude that he has given his consent

Equally, assets purchased in exchange for borrowed principal are not unlawful

# Equity Funds

Dealing permissible subject to following conditions:

1. Main business not in violation (*Screening required*)
2. If main business halal, but interest involved, investor must raise objection
3. Proportion of dividend arising from interest must be given to charity
4. Company must own non-liquid assets

# Equity Funds

- Interesting aside to this is that recent moves by SEC and EU, (via pressure from Germany), on shareholder activism have the potential to negatively impact on Sharia equity funds
- In US, SRI and significantly Catholic Funds, such as CBIS, have actively lobbied to retain shareholder activist rights

# Purification

Purification is required to actively monitor the activities of investee companies to ensure that they remain compliant

Purification also applies to the % of any dividend to be given to charity

Interest element of any capital gain?

Purification software has been developed and is used by fund administrators

# Other Islamic Funds

Ijarah Fund

Leasing

Sukuk certificates

Commodity Fund

Murabahah Fund

Islamic financing

# Ijarah Funds

Ijarah funds must conform to Sharia, which differs from a normal finance lease, as follows:

- Leased assets must have usufruct
- Leased assets must be halal
- Lessor must undertake all responsibilities consequent to ownership of the assets
- Rental must be fixed and known to the parties at the start

# Ijarah Funds

Subscription amounts are used to purchase assets, e.g. real estate, vehicles, equipment

Ownership of the assets remains with the fund and rentals are received from the users

Each subscriber is given a certificate to ensure his pro rata entitlement to the underlying rentals

The certificates, called “Sukuk” may then be traded

# Commodity Funds

- Commodity must be owned by seller before sale (no short sale)
- Forward sale not allowed
- Commodity must be halal
- Seller must have physical, or constructive possession of the commodity
- Price must be certain

# Murabahah Funds

- Commodity sold on a cost-plus basis
- Murabahah is the mode of finance used frequently by Islamic banks and financial institutions as a mode of financing
- The fund purchases the commodity for the benefit of the client and then sells it to them for a deferred payment at an agreed profit added to the cost
- Fund must be closed ended and units may not be sold in secondary market (as asset is either cash, or debt)

# Murabahah

- Murabahah was devised by Islamic banks to replace earlier unreliable equity financing
- The flexibility of Murabahah is that there is no minimum period during which the bank must own the asset before passing it on to its client for deferred payment
- The banks ownership can be for a millisecond
- The deferred payment is also usually secured on the asset as collateral

# Murabahah, Sukuk & Growth of Islamic Finance

- Murabahah and Sukuk comprise the majority of the Islamic wholesale finance market
- Estimates of size of global Sukuk market in structured notes around USD70 billion
- The % of Muslim investors in Sharia compliant product is predicted to grow from 20% at present to 60%
- S&P predicts a global Sharia market of USD4,000 billion

*(FT May 2007)*

# Islamic Mutual Funds

- |      |  |
|------|--|
| 2008 | Family Shari'ah Fund Limited listed on AIM   |
| 2007 | Citigroup/DWS retail "DWS Noor Islamic Funds"<br><br>Corecap Islamic Private Equity (USD150 million) |
| 2005 | Amana Growth Fund, Amana Income Fund, based in Washington State (USD600 million)                     |

# Islamic ETF Funds

Deutsche Bank listing of 4 Shari'a ETFs on the London Stock Exchange:

- db x-trackers S&P 500
- db x-trackers S&P Europe 350
- db x-trackers S&P Japan 500
- DJ Islamic Market Titans 100

*The Fund Business 29 July 2008*

# Islamic Hedge Funds

2008 Deutsche Bank announces Shari'a compliant hedge fund platform with Dar al Istithmar (55% DB holding)

*23 September 2008 Reuters*

2007 Barclays Capital– Newedge platform

# Islamic Hedge Funds

1997 Al Kharwarizmi Market Neutral Fund

2003 Crescent Capital, Chicago

*Logarithmic trading model*

2005 Alfamar, New York/Jeddah

*Salaam contracts*

# Islamic Hedge Funds

Gabelli Merger Arbitrage Fund

Algo Al-Qayyim Fund

Amiri Capital

Swiss-Asia Mashriq Alternative Fund

Deutsche Bank structured hedge fund index product

*([www.islamica-me.com](http://www.islamica-me.com))*

# Islamic Hedge Funds

FIMAT International (Société Générale)

USD60 million seeding from Middle Eastern Bank  
using a “salaam” strategy, Ratings Intelligence assisted  
in Shariah advice

4 funds from:

Old Mutual

Stark Al-Noor

Al Raed Emerging Markets

London based manager

*(FIMAT, 22 December 2006)*

# Islamic Hedge Funds

Shariah Capital Inc.

Shariah compliant managed account with GRT Capital Partners and Barclays Capital as prime broker

“Arboon structure incorporating hedging techniques and replicating short-sales, options and leverage”

*(Shariah Capital, 29 March 2007)*

# Islamic Hedge Funds

Al Safi Trust

Barclays Capital & Shariah Capital

DSAM Kauthar Commodity Fund

4 hedge funds each seeded with USD50 million  
by Dubai Multi Commodities Centre Auth.  
(DMCCA)

# Islamic Hedge Funds

Basis of new Dubai Shariah Hedge Fund Index

Index performance will be calculated and reported by Thompson Reuters

Arboon contracts

*Lipper, Hedgeworld Jan. 2009*

# Arboon – a shorting solution?

Arboon strategy rooted in “classical Islamic law”

“Earnest money”

A non-refundable down payment to prime broker

Down payment equal to standard margin call

# Islamic Funds

Future issues:

- Standardisation of strategies and approvals
- Lack of experienced professionals
- Shariah scholars vs. financial experts
- MBA programme in Islamic Finance

# Islamic Funds

## Future issues:

- Continuing liquidity in Gulf region from oil prices?
- Low competition in current interest environment
- Government commitment to one centre, Dubai?
- Skills deficit
- Fragmentation risk, Sharia consultants
- Costs of caveats and conditions
- Compromising of Islamic principles under pressure of new product

# Islamic Funds

Other issues:

- Iran's potential Islamic banking model
- Government social policy being dictated to Central Bank and commercial banks
- Implications for depositors of loss sharing on “micro-finance loans”

# Islamic Finance and the Credit Crisis

“Islamic banks have been largely shielded from the US mortgage crisis. In Islamic banking there is no black box that needs a genius to unwind it”

*(Rasheed al-Maraj, Governor Central Bank of Bahrain,  
4 February 2008, Reuters)*

# Islamic Finance and the Credit Crisis

UAE Meeting of 12 October 2008

Guarantee of bank deposits

Kuwait and Qatar inject liquidity/capital

\$40 per barrel cut off?

*Henry Azzam, Deutsche Bank, "FT" 20 October 2008*

# Islamic Finance and the Credit Crisis

Dubai refinancing by USD20 billion 5 year  
bond taken as to 50% by Central Bank of UAE

Second tranche in June 2009

Construction issues

*F.T. 24.2.09*

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