



A Reference for
Islamic Finance
Practice.

ISLAMIC INVESTING: CHALLENGES & OPPORTUNITIES

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Outline

- I. Main types of Islamic Capital Market instruments and Investors' objectives
- II. Islamic Funds Overview
- III. Main challenges for Islamic Institutional Investors
- IV. Future of Islamic Finance

I. Main Types of Islamic Capital Market Instruments

- Listed Equities that are meeting Industry and financial screening criteria
- Listed mutual funds and collective investment schemes that are meeting screening criteria
- Islamic Real Estate Investment Trusts (REITs)
- Listed Sukuk

Investors' Objectives

Common Objectives for all investors:

- Capital preservation
- Maximization of yields
- Ensuring a balance of liquidity and profitability

Additional Objectives for Sharia-compliant investments:

Incorporate Sharia principles and behavioral ethics in the investments process

Islamic Funds: Background

- First Islamic investment fund was established during the late 1980s.
- Real catalyst to the development of these funds was a ruling by the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC), whereby shares in a company were defined as being an 'undivided portion of the company's assets'.
- Prior to this, there had been much debate about whether investing in shares (or equities) was allowed under Sharia law.

Islamic Funds: Role of SSB

The role of the Sharia Supervisory Board (SSB) varies from a fund to another. In addition to the critical investment approval role, other roles may include the following:

- ❑ Studying the fund's offering memorandum, constitutional documents and any major agreements governing the relationship between the functionaries of the fund.
- ❑ Giving general advice to the Manager or Investment Adviser regarding compliance with Islamic Sharia.
- ❑ Determining the selection criteria of companies where funds may be invested at.

Islamic Funds: Role of SSB (2)

- ❑ Advising on the use of instruments and techniques for hedging and efficient portfolio management, and their compliance with the principles of Islamic Sharia.
- ❑ Preparing an annual Sharia Audit and Review concerning the fund's activities and issuing a report to investors in the fund.

II. Islamic Funds Performance

- The performance of Islamic funds – depending on the year of their launch – has as much to do with the overall industry growth as any other factor. Clearly the demand for these products increases after the performance metrics validate the initial investment decision.
- This rate has not been constant though. While strong years are catalysts for growth it is the combination of track records and new mandates that have established the right conditions for the industry.

Islamic funds performance (2)

- Due to restrictions imposed on certain financial instruments for not being Sharia-compliant (namely derivatives and short-selling) the argument is often made that Islamic funds are long-only vehicles, that will merely be closely correlated to overall stock markets.
- This has been debunked due to the expansion of fixed income markets (e.g., Sukuk) increased trade in structured products (e.g., Ijara/Leasing contracts), and the introduction of additional exposures (e.g., Listed Real Estate).

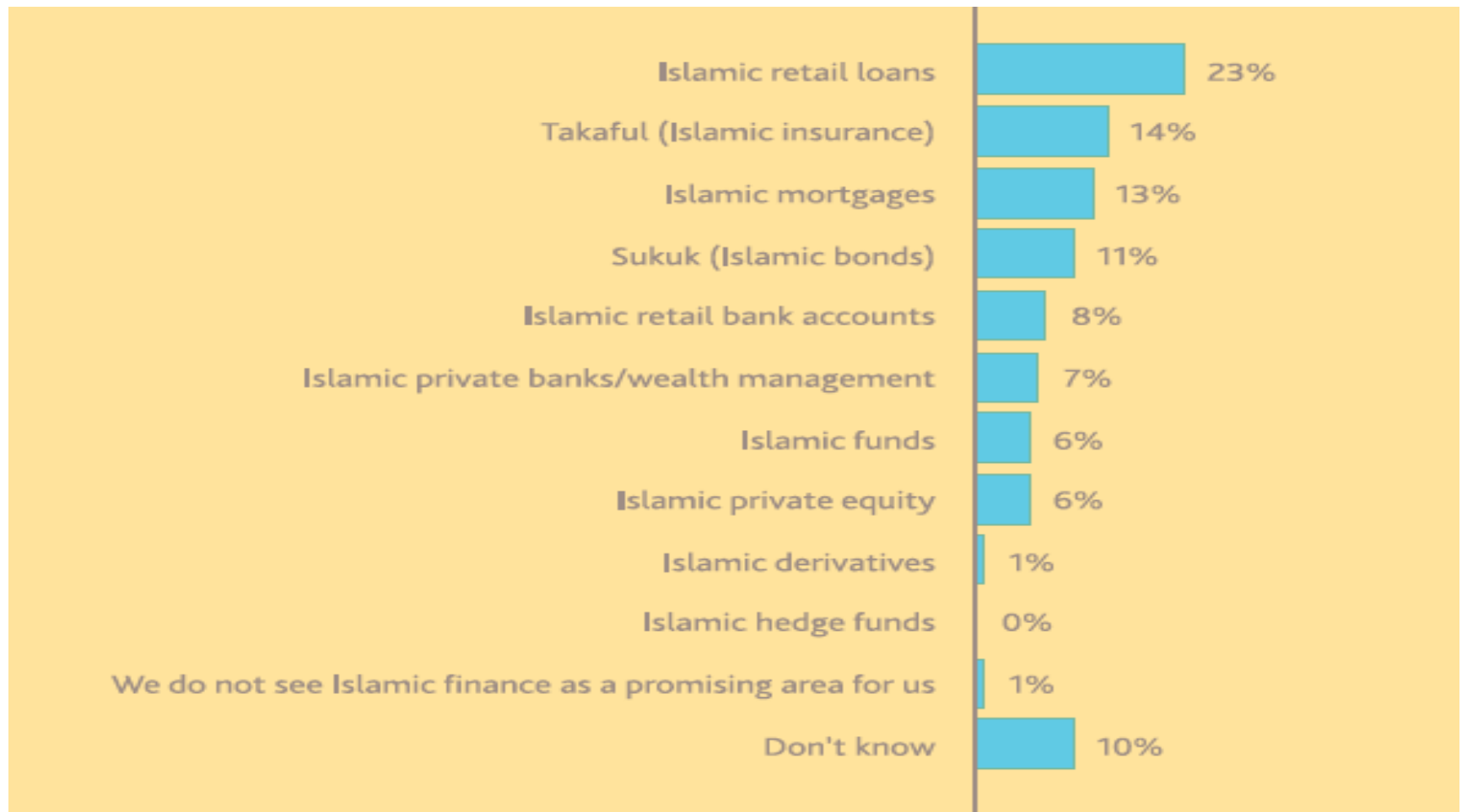
Source: EurekaHedge, 2008

PERFORMANCE OF THE DOW JONES ISLAMIC MARKET INDEX

Dow Jones Islamic GCC Index vs. Dow Jones GCC Index
Percent Change



Survey: Products Offering Most Potential Source of Revenue



An Advantage

Islamic finance falls within the “ethical investments” assets class which comprises also other Social Responsible Investments (SRI)

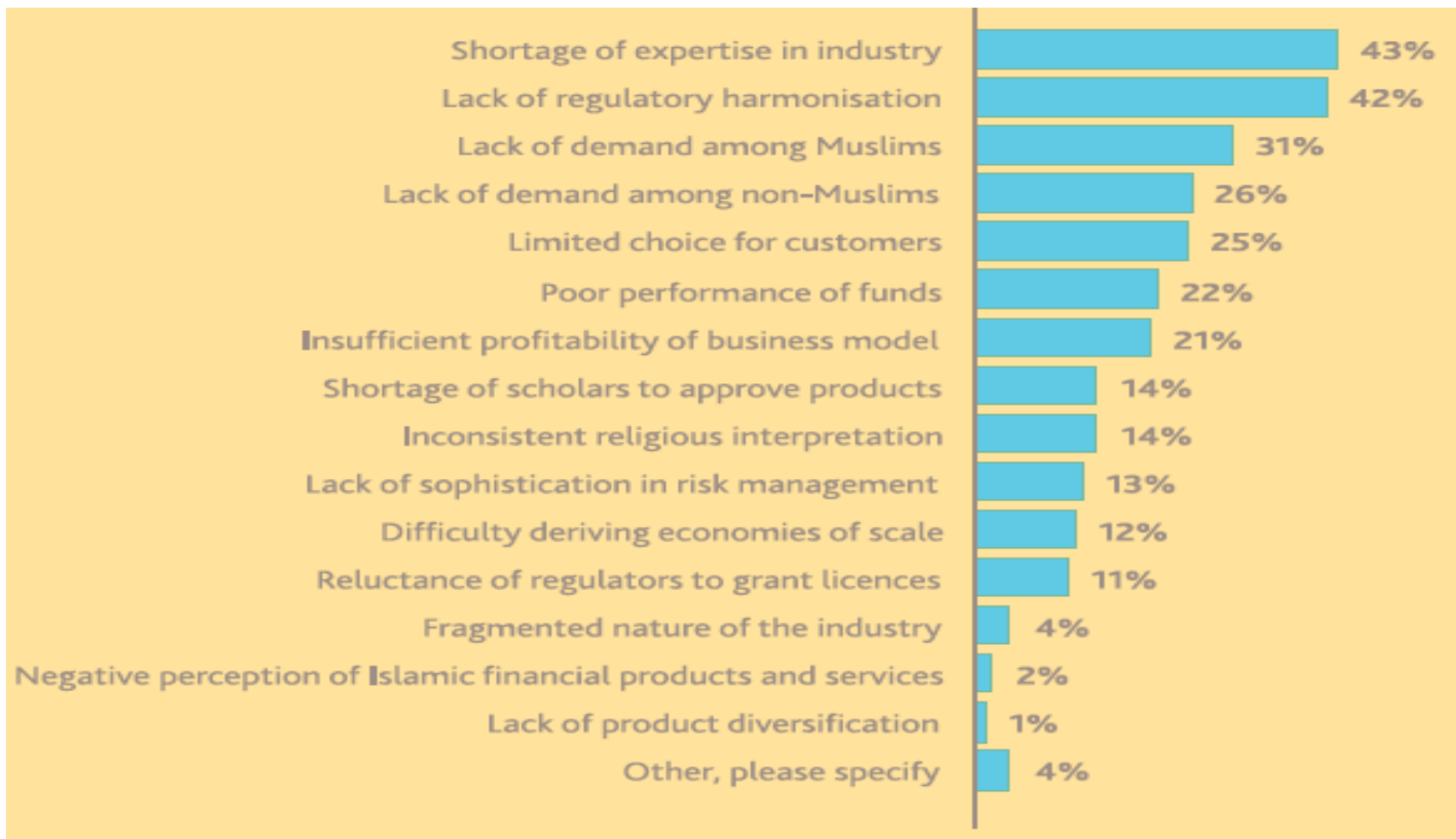
The Sukuk Investors Base is Widening

Investor description	Type of Investor	Sukuk investors before 2005	Sukuk investors after 2005	Conventional bonds
Western	Retail	✗	✗	✓
	Banks	✗	✓	✓
	Pension funds	✗	✓	✓
	Mutual funds	✗	✓	✓
	Hedge funds	✗	✓	✓
	Investment Trusts	✗	✗	✓
Regional, indifferent to Shariah compliance	Retail	✗	✗	✗
	Banks	✓	✓	✓
	Pension funds	✓	✓	✓
	Mutual funds	✓	✓	✓
	Hedge funds	✓	✓	✓
	Investment Trusts	✓	✓	✓
Regional with preference for Shariah compliance	Retail	✗	✗	✗
	Banks	✓	✓	✗
	Pension funds	✗	✓	✗

Sukuk : New Developments

- The early 2009 announcement of the establishment of the Tadawul Sukuk platform in Saudi Arabia, a market for the trading and pricing of Sukuk, was a noteworthy development that should, over the longer term, create an active and regulated secondary market in the Kingdom.
- Issuers are expected to be willing to tap the market for new issuances, as transfer of ownership, tradability and market liquidity which can be facilitated at minimum transactional cost.
- This legislative development is a positive step towards strengthening the longer-term sustainability of the Sukuk market. This would attract a larger segment of investors into the market, including institutional investors.

III. Main Barriers to Growth in the Islamic Finance Market



How Should One Best Deal With:

1. Limited International Consensus on Sharia Compliance,
2. Reduced Investment Universe,
3. Limited Hedging Capabilities, and
4. Increased Product Complexity and Compliance Cost.

1. Limited International Consensus on Sharia Compliance

Enhancing the Fatwa issuance and monitoring process

- The fatwa issuance process must be clear and credible
 - Appropriately skilled professionals/scholars must be appointed
 - Transparency and disclosure of the fatwa should also be encouraged to preserve the credibility of the industry (The Securities Commission in Malaysia is working on a project to compile the fragmented global body of fatwa into a single source comprising three volumes)
- Ongoing fatwa monitoring should ensure that there is a thorough and robust monitoring, through sample testing of the application of the fatwa by both the scholars and regulators during audits.

2. Reduced Investment Universe

Limitations of Optimal Islamic Portfolio Diversification:

- Islamic portfolios have a higher technology, real estate gearing
- Some industries are completely eliminated (Banking, Insurance, Alcohol, Tobacco, Pork-related products, Weapons, select entertainment activities like Gambling, ...)
- Speculation and most hedging techniques cannot be used since they are not Sharia-compliant (Short selling, Put & Call Options & Other Derivatives ...)
- Liquidity Management Issues (what to do with cash ? What is the alternative to the Commodity Murabaha schemes)?

Towards a more efficient Asset Class Mix

Conventional investment portfolio	
Cash	5
Bonds	40
Equities	45
Alternatives (incl RE)	10
Total	100

Islamic investment portfolio (typical)	
Cash	45
Bonds	5
Equities	25
Alternatives (incl RE)	25
Total	100

Islamic investment portfolio (goal)	
Cash	5
Bonds	40
Equities	45
Alternatives (incl RE)	10
Total	100

Sukuk should and now can take on their true role as a key pillar of portfolio construction

Source: Ernst & Young, EFH, as at Jan 2009

3. Limited Hedging Capabilities

➤ **Acceptable hedging capabilities**

1. Economic Hedging

- a. Diversification
- b. Natural Hedge
- c. Dynamic Hedge

2. Cooperative Hedging : Non-profit arrangements

Characteristics:

- No legal guarantee
- Risk is shared by members
- Limited liability
- Appropriate for all kinds of risks

Limited Hedging Capabilities (2)

3. Contractual Hedging

Characteristics:

- Uses for-profit contracts
- Applied using Islamic instruments
- Integrates risk hedging with real transactions

- **In some jurisdictions, Urboun Contract is not allowed to replace a call option, as the sale of “what you do not have” is considered**
- **Unacceptable as to avoid “Gharar.”**

4. Increased Product Complexity and Compliance Cost

Islamic product providers charge premiums due to the added complexity of structures, added layers of screening, higher research costs, and scarcity of products.

- Average management fees of Islamic funds have gradually increased, in particular with regards to equity funds :
 - more active management approach (more analysts needed and greater trading turnover)
 - investments across multiple geographies (augmenting the need for internal and external equity research).

Source : Eurekaledge , 2008

Increased Product Complexity and Compliance Cost (2)

- Fees witnessed slight downward trend across money market funds, while fixed income and balanced products have kept relatively stable fee structures (across all geographies).

Source : Eurekaledge , 2008

IV. Future of Islamic Finance

“The trend for non-denominational ethical or moral products is being seen in the US and growing in interest across Europe.

*Noting that Islamic finance is no longer confined to Islamic jurisdictions, the success of Islamic finance in secular markets (including Islamic secular markets) may increase with the **rebranding of Islamic finance as ethical, social or moral finance**”.*

Source : *“Globalization and its impact on Islamic finance: a focus on the changing landscape for Islamic finance”*, Hari Bhambra, Praesidium LLP

Thank you