



Islamic/Shariah Fund Administration Gap Assessment

Introduction

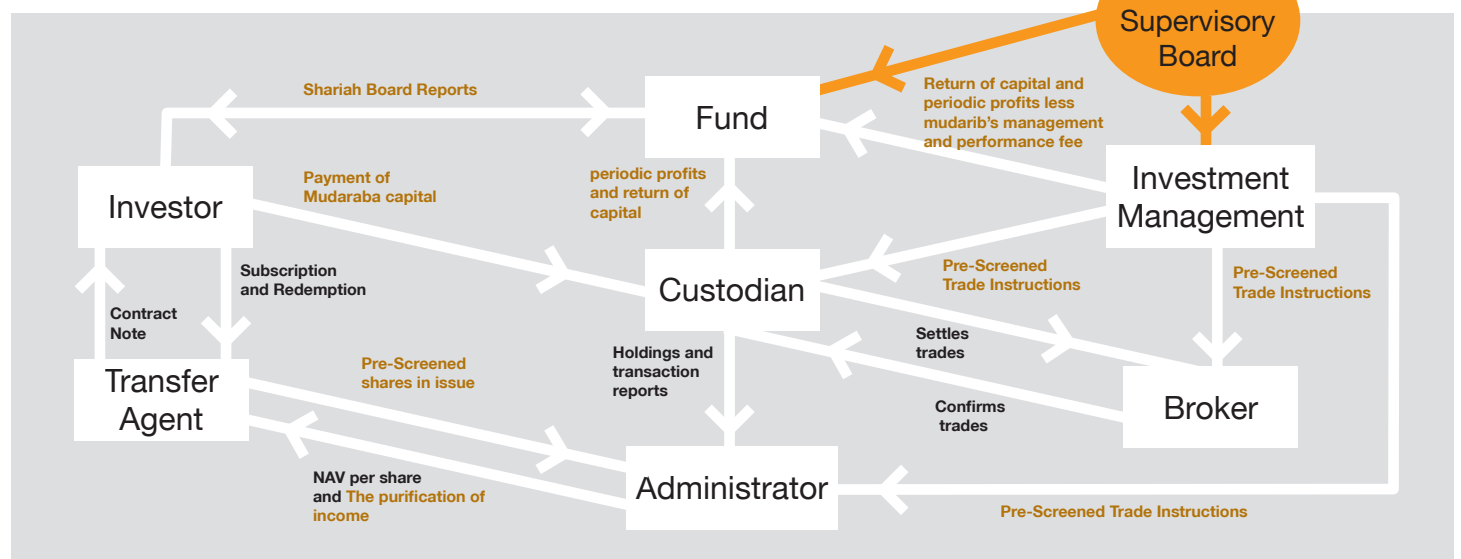
Shariah compliant finance is emerging as a significant and growing part of the global financial services market. The abundance of wealth and liquidity in the region, fuelled by high commodity prices and coupled with strong economic fundamentals has significantly increased the new opportunities for those looking to the Middle East and Islamic Finance. The growth is most notable in the success of Sukuks, the most popular Islamic Financial Instrument, they are becoming a global phenomenon, attracting more issuers from a larger pool of countries than ever before. According to a recent report by Standards & Poor's, the global Sukuk market more than doubled in 2007 exceeding \$60 billion and is set to hit the \$100 billion mark in the next few years. Shariah Equity funds are also very popular and as the industry evolves Sukuk and Murabaha funds are emerging as well.

The term "Shariah" refers to practices in Islam, which is also the legal framework for many countries with a majority Muslim population. It is not a single text or set of rules and is better understood as a system of devising laws. From a financial point of view, several central tenets of Shariah rule are important. The most obvious and well known requirement of Islamic finance is that investments can have no exposure to certain type of entities engaging in gambling, pornography, alcohol, tobacco or armaments activity. But the two most crucial things to understand are the concepts of riba and gharar.

Riba refers to interest. In Islam money cannot be turned to more money without serving some purpose first. Money on money (i.e. interest) is contrary to Shariah principles.

Gharar refers to the inappropriate uncertainty. Gambling is an example of excessive uncertainty as is speculation although Shariah does accept that there is an element of risk in any investment.

A typical Shariah compliant transaction



Irish legal and regulatory framework for Shariah Funds

1. The appointment of a Shariah Board

Shariah funds are set up similarly to other Irish funds. They can avail of any of the legal structures available for the establishment of investment funds in Ireland. The main difference with Shariah funds is the necessity for these types of funds to appoint a Shariah board.

The Shariah board should consist of experts on matters of Islamic law and practice. The Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI), has stated that a Shariah board consist of at least three Shariah scholars. The Shariah board provides guidance on whether the proposed investments of the fund are Shariah compliant.

2. Investment in Shariah compliant products

A Shariah fund must ensure that the underlying business in which it holds securities is Shariah compliant. The list below outlines some of the businesses that the Fund may not invest in:

- Businesses which manufacture sell or offer alcohol or pork-related products
- Gambling establishments
- Businesses which provide interest based financial services
- Nightclubs or businesses which are involved in pornography or adult orientated material.

In addition a Shariah fund may not invest in interest-bearing instruments and may not sell short.

3. The purification of income

Income generated by a Shariah-compliant fund must also be 'purified' as it is often unavoidable that some of the income generated by the underlying companies in which a Shariah fund invests will include some form of interest.

The Shariah board's input is again necessary in determining the types



of income that need to be purified. The amounts purified should, under Islamic principles, be donated to charity.

4. Types of Shariah financial instruments

There are a number of different Shariah financial instruments which can be used individually or in combination including:

- Mudarabah
- Musharaka
- Ijara
- Murabaha
- Salam
- Sukuk

5. Irish Fund Structures

There are a number of different fund structures available in Ireland; UCITS, non-UCITS, PIFs, QIFs, hedge funds, FOHFs etc. The most popular structures are UCITS and the QIF.

UCITS

The UCITS brand is recognised globally and UCITS funds are distributed heavily in Asia, the Middle East and South America as well as in Europe.

Ireland as one of main locations for UCITS funds has an abundance of experience and expertise with these types of funds. The UCITS structure is one of the commonly used structures for retail Islamic Equity Funds.

Qualifying Investor Funds (QIFs)

Qualifying Investor Funds (QIFs) are designed for high-net worth individuals or institutional investors, borrowing and investment restrictions do not apply. The basis for QIFs is that the investor must have a high degree of knowledge and experience in the relevant markets along with a detailed understanding of the investment risks involved. QIFs can now be authorised by the Irish Financial Regulator within 24 hours of the submission of relevant documentation to the Financial Regulator. As the range of assets eligible for the QIF is very flexible, it is an ideal structure for structuring funds for the Islamic market.

6. Taxation of Irish funds

All Irish regulated investment funds available to the public are exempt from tax on their income and gain, irrespective of where their investors are resident. Taxation of Irish funds is very favourable and is considered to be one of the key areas of competitive advantage.



What is the objective of Gap Assessment?

The objective is to identify the gaps for the service elements between the current fund administrations offering to non-Shariah funds against the requirements for servicing Shariah funds.

One of the main differences with Shariah funds is the necessity for these types of funds to appoint a Shariah board which provides guidance to the board of directors of the Fund and to the investment manager on matters of Shariah law and in particular whether the proposed investments of the fund are Shariah compliant.

Drawing from our wealth of experience in the Shariah fund area, Gap Assessment will help your business make the smooth transition from servicing traditional investment funds only to the inclusion of Shariah investment funds. It will identify the gaps for the service elements between the current fund administrations offering to non-Shariah funds against the requirements for servicing Shariah funds.

A gap analysis includes an impact assessment, which provides a summary of key findings and the extent to which the particular administrator's proposed offering to Shariah compliant funds is likely to meet Shariah principles. It is developed based on a detailed assessment of current asset servicing

arrangements of the administrator against our understanding of Shariah principles.

Approach

1. Workshops with key stakeholders,
2. One-to-one interviews with relevant staff
3. Review available operational documentation and sample reports
4. Review process and controls documentation

Service Areas Covered

The general product/service areas covered during the assessment relate to:

- Custody;
- Cash management as it relates to custody;
- Fund administration and fund accounting;
- Trustee/fiduciary oversight;
- Transfer agency, institutional and retail;
- And on a more limited basis: Ancillary services which may arise in the course of providing custody, such as foreign exchange and securities lending.

Process Map, Gap analysis

- Carry out an analysis of which activities are impacted by specific Shariah requirements
- Perform 'current' to 'proposed'

analysis against Shariah principles

- Conduct on site meetings with key staff in order to further drive out the impacts of Shariah, their potential consequences and relative priority
- Accumulate our initial thoughts on likely impact
- Organise and conduct confirmation meetings where needed
- Refine and confirm gap analysis cross-referenced to the Shariah Requirements with potential next steps
- Prepare our findings following the interviews and produce Gap analysis,
- Devise a plan to work with administrator to produce a project framework which can be used to enter the next phase of implementation
- Closeout presentation to Senior Management, helping to identify strategic overview of risk and opportunities
- Kick off the implementation programme with the business

Other PwC Islamic Services

- Staff training on Shariah Principles
- Advice on set up of various Islamic fund structures in Ireland
- Guidance in relation to eligible investments under Islamic principles

- Shariah Compliance Function Effectiveness, advice on involvement of Shariah board etc
- Provision of advice on: Purification of non Islamic Income, Islamic Instruments support from accounting and classification perspective, Investment restriction monitoring, Cash Management & Custody of Assets
- Assistance with Promoter & Fund authorisation
- Taxation Services

- There are now over 4,400 funds and sub-funds listed on the Irish Stock Exchange, making it the largest exchange in the world for funds listing
- 24 hour approval process available for Qualifying Investor Funds (QIFs)
- Flexible, proactive regulatory environment
- Market driven alternative investment product solutions
- Extensive industry experience and expertise
- Location – optimum time zone to ensure global coverage, English speaking, Euro currency
- Corporate tax rate of 12.5 per cent, one of the lowest in Europe for administrators
- Fund activities are exempt from Irish taxation

announcement of a dedicated Shariah regulatory team demonstrates Ireland's flexible and proactive regulatory environment and further cements Ireland's attractiveness as a domicile of choice for Shariah investment funds.

With Ireland's experience within the funds industry and the receptive attitude of the Irish Financial Regulator to new entrants to the market, the Irish regulatory framework provides a favourable environment for the establishment of Shariah compliant funds.

Why Ireland?

- In Ireland today there are over 11,000 people employed directly in the investment fund industry
- Ireland is the leading global hedge fund administration centre, servicing 37 per cent of the total global industry
- Seven of the top ten hedge fund administrators in the recent HedgeFund.net survey on administrators have operations in Ireland, additionally there are more than 340 international fund promoters

In light of the significant activity within Shariah investment funds in Ireland the Irish Financial Services Regulatory Authority (the "Financial Regulator") has recently confirmed the establishment of a dedicated regulatory team for the authorisation of Shariah funds in Ireland. This

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