

## A greater understanding brings new opportunities

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**Managers and administrators looking to enter the Shariah funds market need to understand the differences between Shariah funds and conventional funds in order to capitalise on this growing market.**



### A global awakening

In the 2008 report, "Shariah Investing: Market Sizing and Analysis", Cerulli Associates ("Cerulli") reported that the size of the Shariah compliant mutual fund industry is US\$35bn-US\$65bn if institutional or discretionary mandates are included. While this figure represents a great increase in recent years, the value of these funds compared to market capitalisation in the region is still far lower than elsewhere in the world and is expected to increase at a rapid pace for many years to come.

The recent growth in interest in establishing and servicing Shariah compliant investment funds is therefore no surprise. Despite the recent market turmoil there is a steady increase in the number of new funds being established for sale into the Middle East region and an increasing number of these are Shariah compliant. These funds are being established both by international asset managers keen to tap into the wealth in the region and by asset managers and banks from the region. The types of funds being established is also changing. Historically it was mostly Shariah compliant equity funds being established. Today the range of funds being established compares favourably to the range of conventional funds available and includes exchange traded funds, money market funds, fund of funds and even hedge funds.

A number of new centres for the domiciliation and servicing of Shariah funds have begun to emerge in Europe. Ireland is one such domicile which is experiencing a rapidly growing interest in servicing Shariah funds as evidenced by the significant attendance at a recent industry seminar organised by the Irish Funds Industry Association. Recognising the need to respond in an appropriate way to this new stream of business, the Irish Financial Regulator has established an experienced regulatory authorisation team specialising in the authorisation of Shariah funds. The Irish Financial Regulator has also confirmed that it is proactively engaged with its regulatory counterparts in MENA countries and other jurisdictions with a view to sharing an understanding of the regulatory systems in the

respective jurisdictions for the purposes of facilitating investment managers and promoters based in such jurisdictions to obtain approval to use Ireland as the domicile for their international investment funds. A memorandum of understanding has been signed with the regulatory authorities in Bahrain.

### Emerging and popular Islamic investment funds

#### Shariah UCITS funds

It should come as no great surprise that the UCITS fund structure is proving to be a popular structure for the establishment of Shariah compliant funds.

The aim of the EU's UCITS Directive was to create a pan-European funds market as part of the EU's financial services action plan, the objective of which, to allow for open-ended funds investing in transferable securities to be subject to the same regulation in every Member State. It was hoped that once such legislative uniformity was established throughout Europe, funds authorised in one Member State could be sold to the public in each Member State without the requirement for further authorisation, thereby furthering the EU's goal of a single market for financial services in Europe. This is commonly referred to as a "European Passport" and is available only to funds under the UCITS regime. Once a UCITS fund is approved in one EU country, application may be made to have the fund registered for marketing to the public in any other EU country. There are now over 30,000 UCITS funds in existence with assets, according to EFAMA's Quarter 4 Statistical Release, in excess of €4.5 trillion as at December 31, 2008.

However the success of the UCITS structure has extended beyond the borders of the EU and the UCITS brand is now recognised globally as a well regulated investment products. UCITS funds are distributed heavily in Asia, the Middle East and South America as well as in Europe.

According to data compiled from the Lipper Hindsight database in February 2009, 43% of Irish UCITS funds distribute into the Middle East to

countries such as Bahrain, Qatar and the United Arab Emirates. This research focused on fund groups in Ireland where the number of countries which they distribute to was greater than 10 countries.

**Shariah-compliant ETFs**

The exchange traded funds (“ETFs”) sector seems to have been less troubled by the recent global financial crisis than many other sectors. Although assets are down as a result of falling markets, new money continues to pour in. This is mainly due to the fact that exchange traded funds have high transparency, low costs, high liquidity and high risk diversification. They are also tax efficient and require no minimum investment, other than the market price of one share.

It is hardly surprising then with all the above benefits that the demand for Shariah-compliant ETFs has grown significantly. Some of the largest global providers of ETFs are expanding their range of ETFs and actively pursuing Islamic markets and investors. iShares, Daiwa and db-xtrackers have all launched Shariah compliant ETFs as Muslim investors look to invest in these types of products without any exposure to alcohol, tobacco and other Haram items.

Ireland is a recognised key centre for the domiciliation and servicing of ETF products. It also has the added benefit of being a tax efficient location for ETFs. Aside from the usual tax exemptions

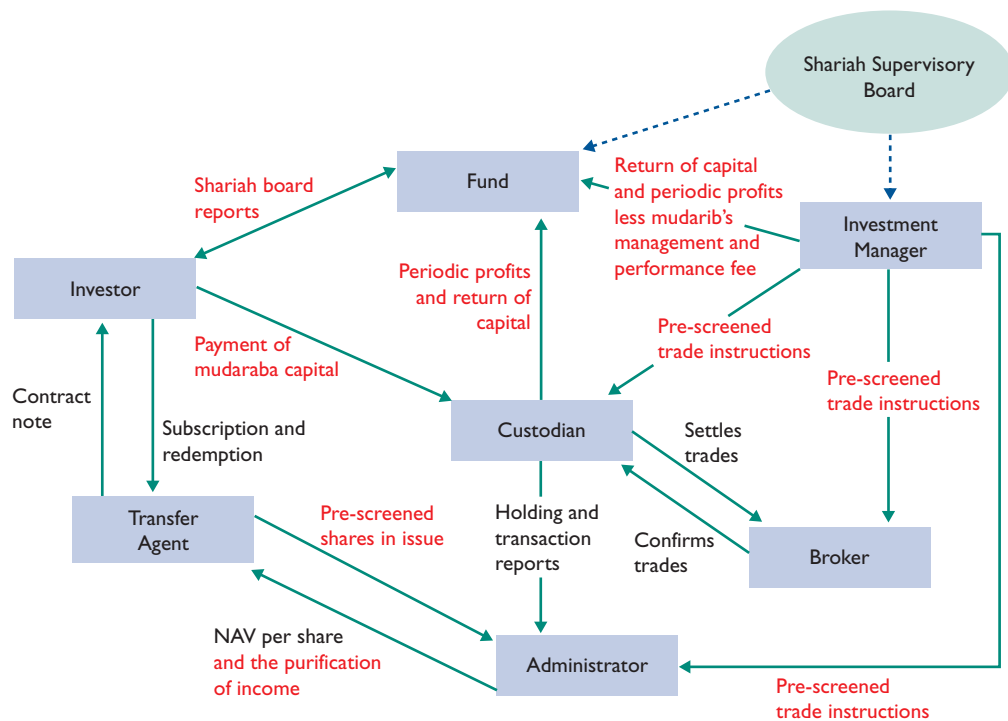
applicable to investment funds and, by way of classification and definition for tax purposes, Irish ETFs may avail of reduced withholding tax rates with the US under the Ireland/US tax treaty.

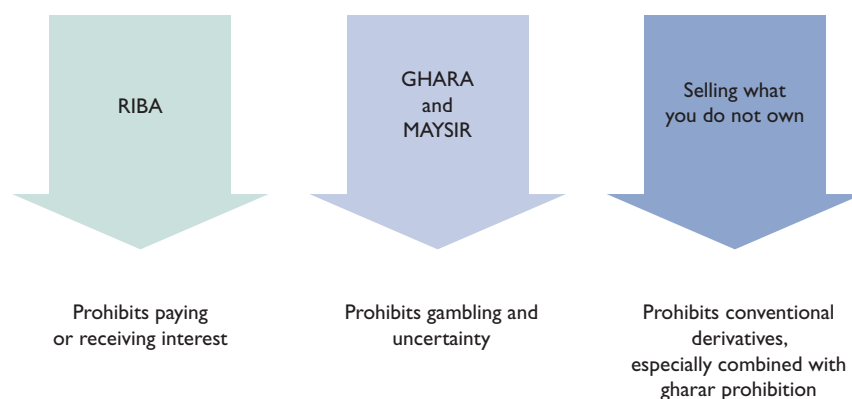
**Shariah-compliant hedge funds**

Hedge funds are a relatively new concept in Islamic finance and some Shariah scholars hold reservations about the compliance of certain hedge fund products. Hedge funds are a particularly complex field because some investment techniques widely employed by hedge funds, including the use of leverage and short selling of stocks, are generally incompatible with the principles of Shariah law. However, using constructive thinking a number of promoters have been able to develop funds in partnership with Shariah scholars that offer effective investment techniques while abiding by Shariah law. There are various ways of structuring hedge funds in order to ensure their compliance with the requirements of Islam while creating transactions and structures that have similar economic effects to the use of conventional derivatives.

The number of Islamic hedge funds in the market is growing. In early March the first Islamic fund of long/short hedge funds was launched which will be marketed in the Middle East. In the current market conventional hedge funds have received a lot of bad press including being portrayed as the scapegoat for the global financial crisis. This has led to a call for

**Figure 1: A typical Shariah compliant transaction flow**



**Figure 2: What Shariah prohibits**

greater regulation and transparency in the hedge fund industry. In contrast to conventional hedge funds, Shariah compliant hedge funds are expected to be substantially transparent.

Demand for hedge funds is likely to continue to expand in the future as Islamic investors increasingly recognise the benefits that these types of investments can bring to an investment portfolio. While some Muslims may continue to hold reservations about the compliance of certain hedge fund products, the growth of the market is likely to bring greater consensus among Islamic scholars on techniques that are acceptable under Shariah law and greater certainty for fund promoters and investors alike.

### Differences between Shariah funds and conventional funds

For those looking to establish Shariah compliant funds or those looking to get into the business of servicing Shariah compliant funds it is important to understand the main similarities and differences between a conventional fund and a Shariah fund. The transaction flow in Figure 1 is very similar to the transaction flow for a conventional fund. The items highlighted in red indicate the differences that pertain to a Shariah compliant fund.

#### Appointment of a Shariah board

The main difference with Shariah funds is the necessity for these types of funds to appoint a Shariah board which provides guidance to the 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.

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

should consist of at least three Shariah scholars.

The board is also empowered to issue fatwas which are religious rulings issued after an examination of fund rules and investments made by a fund which in effect certifies that the fund is "Shariah compliant". The fatwa is an important precondition in order for a fund to be marketed to prospective investors as Shariah compliant.

The Shariah board's role is purely advisory; it has no discretionary powers whatsoever.

#### Annual Shariah audit

Shariah compliant funds may also be audited on an annual basis to ensure that their investment policies etc are adhering to the Shariah principles. This is to ensure that the fund is indeed still a Shariah compliant fund.

#### Investment restrictions – no interest, etc.

A Shariah fund must ensure that the underlying businesses in which it holds securities are Shariah compliant. A Shariah fund's offering document will spell out the Islamic-based investment restrictions. The fund may not invest in any businesses whose underlying activities are involved in any Haram items. The investment manager of a Shariah fund will therefore not include any companies involved in the following sectors from its universe of investible entities:

- Alcohol
- Tobacco
- Pork
- Adult entertainment industry
- Gambling
- Weapons
- Conventional banks and insurance companies

The Shariah fund's investment manager will also employ a financial screening process to ensure that the companies do not employ excess levels of leverage or generate or pay significant amounts of

interest. There are a number of financial index providers that publish Shariah compliant indices that can be used by investment managers for the screening process.

In addition a Shariah fund may not invest in interest-bearing instruments. It may not invest in conventional derivatives and may not sell short. These restrictions have in the past been seen to rule out Shariah compliant hedge funds. However, due to recent developments this may now be achievable.

#### **Purification of non-Islamic 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 Haram income such as 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.

There are a number of different ways to purify "tainted" income. One way that purification is achieved in the funds industry is where fund administrators calculate a Shariah compliant NAV, where the proportion of non-Shariah compliant income is determined at each valuation point. This non-compliant income is then disbursed to an Islamic charity which has been chosen by the investment manager and approved by the Shariah board.

One of the frequently asked questions regarding purification is how far down a transaction does one go to purify income. The answer to this question is that purification has no specific materiality threshold.

#### **Custody of assets and cash management**

Although the custodian of a Shariah compliant fund does not itself need to operate along the lines of an Islamic bank it must service the Shariah compliant fund without violating any Shariah principles. The prohibition of interest will prevent a fund lending or borrowing on interest and arrangements need to be put in place with the custodian to deal with overdrafts in a Shariah compliant manner. The custodian will also need to ensure that the assets of the Shariah fund are held in custody in compliance with Shariah principles.

### **Growing pains**

The Islamic finance industry has a number of issues that must be addressed if it is to sustain its future growth potential. Some of these issues are outlined below:

#### **Availability of Shariah scholars**

As the Islamic finance industry continues to expand at an exponential rate, one of the issues that could hinder the growth of the industry is a shortage of

Shariah scholars. There are said to be fewer than 100 scholars working in the financial services worldwide. Scholars must first study Islamic law or Shariah for many years, and then master finance. Globally, and especially in Europe and America, there is a shortage of scholars familiar with both fields. One of the main problems is languages, as many Middle Eastern scholars work solely in Arabic and the global marketplace need scholars fluent both in Arabic and languages such as English or French.

#### **Interpretation of Shariah boards and scholars**

Another issue is differences in interpretation amongst scholars, as Shariah is not a set of codified laws, but a set of interpretations based on the Quran. As a result there can be some divergence of views and opinions amongst Shariah boards and scholars regarding the interpretation of Shariah law, relating to products and structures. There are also five main schools of thought including four main schools of Sunni fiqh, which were created due to a division amongst the Muslim people regarding who should be the successor of the Prophet Mohammed (PBUH). These differ in details and are applicable to different countries:

- Hanafi (Turkey, Pakistan, the Balkans, Central Asia, Indian subcontinent, Afghanistan, China and Egypt).
- Maliki (North Africa, the Muslim areas of West Africa, and several of the Arab states of the Persian Gulf).
- Shafi'i (Arabia, Indonesia, Malaysia, Egypt, Somalia, Eritrea, Yemen and southern parts of India).
- Hanbali (Arabia).
- Shia (Iran, Lebanon).

### **What is next for Islamic finance?**

The Islamic finance industry, although still a relatively young industry has grown into a sizeable alternative financial management system. Islamic finance assets are set to reach US\$1.6 trillion by 2012 from US\$660bn of assets at the end of 2007, according to global management consulting firm Oliver Wyman.

Muslims account for 20%-25% of the world's population. Given the size of this demographic, surprisingly the percentage of overall global financial assets that are Shariah compliant is less than 1%. This percentage is expected to reach double figures over the coming years. As global trends change, there will be an increased focus on better economic management, improving the financial systems of many of the poorer countries in the world, including a number of which have large Muslim populations. It is expected that within the next decade, 50%-60% of

the total savings of the world's 1.2 billion Muslims will be in the form of Shariah compliant products.

Looking to the future, we expect to see continued growth in Islamic finance. The global financial crisis has highlighted a number of weaknesses and imbalances within the international financial system. The future global financial model is not expected to resume its former pattern and it has been suggested that there will be a shift in economic and political power towards the East.

With this expected continued growth of Islamic finance, leading fund centres such as Ireland will seek to capitalise on this growing demand by expanding as servicing centres for both conventional and Shariah funds alike. In order to be successful in this growing market, managers and administrators will need to familiarise themselves with the Shariah principles and above-mentioned differences between Shariah and conventional funds.

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