

OPALESQUE

# ISLAMIC FINANCE

## INTELLIGENCE



# Rihla Opalesque

### Featured Resource

Country & Regulatory  
Perspectives on Islamic Finance

### Featured Structure

Islamic REITs - An Unfinished  
Journey

### Lex Islamicus

Enforcing Arbitral Awards in Islamic  
Finance Contracts

## Rihla Opalesque

We are back after a month filled with journey (the OIFI team has been travelling of late: Malaysia, Jordan, UK, UAE and more to come) and correspondingly our fourth installment incorporates content from all corners of the globe. We begin by exploring the potential synergies available across the industry (and whether it is in need of a catalyst to spur further growth and collaboration) in our editorial piece.

Complementing this is our Featured Resource section which outlines a variety of country and regulatory perspectives on Islamic finance, exhibiting how approaches can differ widely from one country to another. While some of it is positioning, they are testament to the importance being placed on Islamic banking and how regulators are hard at work trying to address and incorporate it into their existing financial architecture.

Nevertheless this is not just a case of mere talk--what is transpiring beyond the boardrooms of IFIs is in fact very energetic discourse that is gradually developing into a tangible initiative. There is great expectation that this can take the shape of an industry-wide effort (resilient to commercial interests) and one which we look forward to reporting in the near future. Indeed we explore the roots of this initiative in our Discussion Board as we borrow the topic from our online forum: 'Does Islamic Finance Need a Voice'.

In this edition OIFI dives deep into multiple asset classes: The Featured Structured section tackles Islamic REITs and the apparent underutilization of liquid real estate products. Khalil Khoury of KIPCO Asset Management Co. provides his perspective on the investable universe of Shariah compliant products in the Allocator Interview section. We further investigate what might be in store for indexation products in our fund manager interview, as we converse with Saeid Hamedanchi of Florentez Investment Management. To round it out, our Industry Snapshot profiles the latest research undertaken on Islamic equity funds, as we hear from the team of Andreas Hoepner, Hussain Rammal and Michael Rezec.

Further expanding on his Lex Islamicus column, Khalil tackles arbitration and enforcement in Islamic contracts - with particular relevance on the revitalized sukuk market. On the other hand, Nikan surveys the various currents of thought on existentialism in Islamic finance under the Opinion Column - with a compendium of views that are not only contrary to the mainstream but possibly test the resolve of Islamic Bankers. But what doesn't kill us makes us stronger. As always, we welcome your comments & suggestions (you can also feedback directly to the authors), and we remind our registered readers that you have free access to the entire archive of Opalesque Islamic Finance Intelligence (including back issues) and Opalesque Islamic Finance Briefing (our daily news summary), an ever-growing historical data bank of industry news and articles.

Thanks & Regards,

Bernardo

Editor, Opalesque Islamic Finance Intelligence

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## In This Issue

### Editor's Note

Revisiting Ibn Battuta  
Bernardo Vizcaino, CAIA ..... 3

### Featured Resource

Country & Regulatory Perspectives  
on Islamic Finance ..... 4

### Featured Structure

Islamic REITs - An Unfinished  
Journey  
Bernardo Vizcaino, CAIA and Nikan  
Firoozye, Ph.D. .... 5

### Fund Manager Interview

Saeid Hamedanchi, President & CEO,  
Florentez Investment  
Management ..... 7

### Allocator Interview

Khalil Khoury, Senior Vice President  
Head of Investments and Product  
Development  
KIPCO Asset Management Co  
(KAMCO) ..... 10

### Lex Islamicus

Enforcing Arbitral Awards in Islamic  
Finance Contracts  
Khalil Jarrar, J.D. .... 12

### Discussion Board

Does Islamic Finance Need a Voice?  
..... 14

### Opinion Column

Existential Risk to Islamic finance  
Nikan Firoozye, Ph.D. .... 17

### Industry Snapshot

Islamic Mutual Funds: Reviewing  
their Financial Performance and  
Investment Style Around the World  
Andreas G. F. Hoepner, Hussain G.  
Rammal & Michael Rezec ..... 20

Photography by: Kelly Lemon

# Revisiting Ibn Battuta

By Bernardo Vizcaino, CAIA

Among the vast literature of the Muslim world – be that mathematics, poetry, economics or most-recently banking & finance – the *Rihla* (or Journey) of Ibn Battuta stands out for many. This is a revealing account of life in the 14th century and a significant exploration of the world as seen by this Moroccan judge and legal scholar. Ibn Battuta would set out on his first hajj pilgrimage at the age of 21 and his travels would take him to almost every corner of the Muslim world and beyond. He would set out from Morocco, into Egypt, Syria and Saudi Arabia. Thereafter expanding his travels to Persia, Turkey and several years in the Maldives and India. His travels would stretch as far as China and Spain, finally seeing him back in Morocco after almost three decades on the road. Needless to say, his travels were extensive and the full title of the *Rihla* (written by scholar Ibn Juzzay) reflects on this vast undertaking: “A Gift to Those Who Contemplate the Wonders of Cities and the Marvels of Travelling”.

One can find several parallels between his journey and that of Islamic finance, both are witness to how different and diverse the world can be. This pilgrim could have returned home to Tangier after his first hajj in 1325, but he chose to forge ahead. We can speculate over his motives but certainly his inquisitive nature gave him sufficient courage to face pirates, storms, illness as well as the impetus to interact with a wide range of rulers, courts and territories. The Islamic finance industry has been equally adventurous perhaps without the pirates but certainly able to navigate rough seas, resilient to malaise, and embedding itself into a wide range of jurisdictions. Oddly enough Ibn Battuta would bear witness to the ravages of the bubonic plague (reporting on how it practically wiped out Marrakech) just as the Islamic finance industry has observed the global financial meltdown (which in turn practically wiped out other trader-towns). He would recount multiple conflicts, rebellions, and occasional brushes with despotic rulers, just as the industry has toiled through verdicts, court rulings and misconception in ‘far away’ lands.

What kept him going (we speculate) was the vast opportunity that lay not in each single territory but in the cross-border interaction between them all. A fragmented world perhaps – but one holding great promise (if only he might have had the communication tools that we have today). He often expressed striking observations of local cultures but this in itself gives his accounts a personal touch that the diplomatic Marco Polo rarely exhibited.

Despite being a close contemporary to Marco Polo, Ibn Battuta has remained on the sidelines of history. Perhaps his adventures are chronologically imperfect (he never kept a diary that we know of, instead dictating to Ibn Juzzay mostly by memory) and current historians debate whether he indeed traveled to every place that is

claimed (nevermind that Marco Polo failed to mention chopsticks after years in China). Then again, Islamic finance might have been on the sidelines of finance for quite some time. It hasn't followed a ‘chronological’ growth either as it has yet to fully explore the gamut of vanilla products at its disposal, albeit some feel comfortable dabbling in exotics anyway. On the other hand the industry has yet to be fully tested in a hostile financial territory of its own, although it has learned much from the cracks exposed in conventional markets. Perhaps the main difference is that Ibn Battuta's journey ended several centuries ago, while Shariah compliant finance keep finding new territories to explore.

Ironically, the *Rihla* and Ibn Battuta were destined to oblivion if it not were by chance and the efforts of some western academics. In fact, the scarce manuscripts of the *Rihla* remained unnoticed until the early 19th century and even then it isn't until the mid-19th century that European translations arrive (notably the work from Charles Defermery and Beniamino Sanguinetti) thus popularizing his exploits to a wider audience. One must wonder if Islamic finance has been equally under-reported and whether insufficient market data has contributed to its obscurity. Moreover, it seems that western bankers have only recently (and gradually) began to decipher this financial manuscript. Some might argue that it is in need to be rediscovered by a global audience – perhaps requiring a new ‘translation’ for digestion by a readership of conventional bankers.

One must wonder if we would be talking about participatory banking if it not were for the contrast provided by fractional banking. Curiously the *Rihla* was initially translated to English, German and French and so it seems that the same countries are finding it equally appealing to study and analyze the journey of Islamic finance.

Whatever drove Ibn Battuta on his travels is lost in time, but we can certainly ask what is driving Islamic finance today. What are the intentions of its participants? Why not just return to Tangier and retire? The signs for the industry are quite promising: we are witnessing reinvigorated frameworks and structural changes aimed as accelerating cross-border collaboration and unification of efforts. The discourse surrounding the need for standardisation (with many detractors) is evolving into the need for industry coordination (undeniably necessary). Efforts to market the industry and its products – while important – are giving way to efforts aimed at enhancing the communication between market participants. Most importantly, Islamic finance is being rediscovered by a wider audience and this financial journey is proving to be as intriguing as that of the 14th century legal scholar.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

# Country & Regulatory Perspectives on Islamic Finance

 **Blogger™** [As featured in the Islamic Finance Resources Blog](#)

An overview of various policy statements, speeches and initiatives from jurisdictions across the globe (directly addressing Islamic finance). Featured below are some of the most pertinent texts as they relate to each country and/or region:

Bahrain Central Bank  
[Challenges for Islamic Finance](#)

Central Bank of Kuwait  
[Development & Integration of Islamic Finance](#)

Dubai Financial Services Authority  
[The DFSA's Islamic Finance Regulatory Regime](#)

Financial Services Authority (UK)  
[Islamic Finance in the UK: Regulation and Challenges](#)

Hong Kong Monetary Authority  
[The Natural Gateway to Islamic Finance in Asia](#)

Monetary Authority of Singapore  
[Singapore's Perspective on Islamic Finance](#)

Malaysia Islamic Finance Centre  
[A Primer on the MIFC Initiative](#)

Qatar Financial Centre  
[Business Case : Islamic Finance](#)

State Bank of Pakistan  
[Pakistan Islamic Banking: Past, Present and Future Outlook](#)

US Federal Reserve  
[Islamic Finance 101 \(The Bush version - May 8, 2004\)](#)

[Islamic Finance 101 \(The Obama version - November 6, 2008\)](#)





# Islamic REITs - An Unfinished Journey

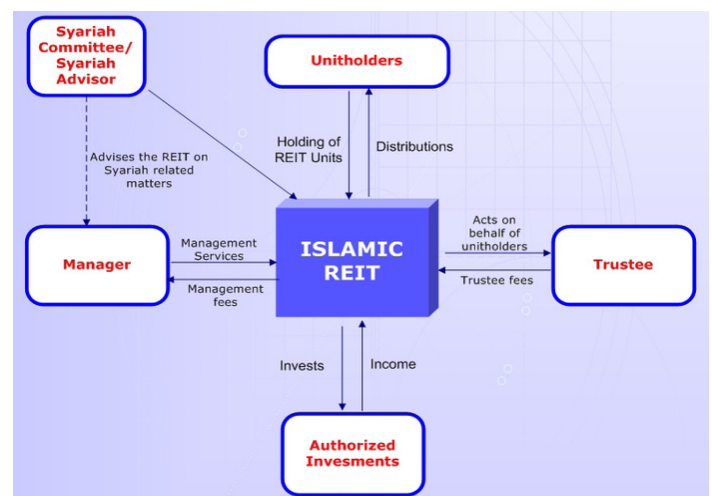
By Bernardo Vizcaino, CAIA and Nikan Firoozye, PhD

Standardization seems to be the recent keyword in Islamic finance - exemplified by the ISDA IIFM ta'hawwut hedging master agreement, the recent release by BNM of the Murabaha Contract Parameters (and upcoming release of similar standards for Ijara, Istisnaa, etc), and the Bursa Malaysia CFM trading platform (not so much the release of a standard as the correct implementation of one), we see that the move has been one of consolidation and/or unification. The search for contract clarity and trading volume is very much alive, but other vanilla structures have not found as much reception as one might imagine, this is very much exemplified by Shariah compliant Real Estate Investment Trusts (or rather the lack of them).

A great starting point has to be the existing guidelines on Islamic REITs as provided by the Malaysian Securities Commission ([see reference link](#)), which were issued back in 2005 and only had to wait a few months until the first such vehicle was eventually launched. Thus it was in June 2006 that the Al-'Aqar KPJ REIT was listed ([see reference link](#)) followed a half-year later by the Al-Hadharah Boustead REIT in February 2007 ([see reference link](#)). It was clear from these two offerings that the initial forays into Islamic REITs seemed to be seeking very specific underlying assets. In the case of Al-'Aqar it focused on hospital and healthcare facilities, whereas Al-Hadharah was much more concentrated as it involved palm oil plantations. It wasn't until December 2008 that a more diversified offering came to the market in the shape of AXIS REIT ([see reference link](#)) which incorporated both office and industrial assets, and quite interestingly it was also converted from an existing conventional structure. Defining a REIT is straight forward - a collective investment scheme that pools funds to allocate across a portfolio of real estate assets. The investments can take the form of buying, managing, administering, leasing and eventually selling these various assets. As a listed vehicle a REIT provides investors with various benefits: asset accessibility, liquidity, diversification, and exposure to real estate that would otherwise be prohibitive for individual consumer or small retail investors. Much academic and industry literature

has been devoted to the risks and the advantages of REITs - from low correlation to equity markets, active management, to even serving as a hedge against inflation. Furthermore, the generic structure remains similar for a conventional REIT as it does for a Shariah compliant REIT, although there are very clear specifics that differentiate the two.

Most noticeably of all the underlying properties (and related businesses operating out of these properties) must not be categorized as being involved in non-permissible activities (such as a gambling enterprise or a tobacco factory). If a business indeed contains non-permissible income this must remain below a stipulated level (the SC guidelines outline a level of 20% of total turnover). Crucially, the financing, investments and deposits of an Islamic REIT are required to be maintained in accordance to Shariah principles. Similarly, insurance must be sought under a Takaful structure (unless such coverage is not available or prohibitively more expensive in the market where the REIT operates). Similar guidance is given to the use of risk management tools such as forward sales.



Source: Al-'Aqar KPJ REIT

# Featured Structure

6

Hence an Islamic REIT provides us with a clear framework to work with, very beautiful in its simplicity. From a product manufacturing point of view the additional issues to be addressed would include:

- the establishment of a Shariah Advisory Board/Committee in order to oversee the various aspects of the REIT operation (such as the tenants underlying business activity, etc)
- the specific model to be used for establishing the REIT management company (such as the Al-Wakalah fee-based model or Al-Mudarabah profit-sharing model)
- determining the source and the level of financing for the REIT itself
- taxation, stamp duty and other contractual considerations

Notwithstanding these clear stipulations, it has been four years since the issuance of the SC guidelines and it seems that the overall market (whether inside or outside of Malaysia) has failed to build on this. The momentum generated seems to have been short-lived, to the dismay of many. Some arguments have been made as to the slow takeup of Islamic REITs: high distribution rates (and hence lower reinvestment) allowing for slow growth rates; non-permissible restrictions limiting the investment universe; the cyclical nature of real estate markets; and the ability (or inability) to source quality underlying assets. Here are some other considerations:

**Leverage:** Surprisingly, one of the various benefits attributed to conventional REITs is that of low leverage, according to NAREIT the average debt ratio for REITs in North America remaining below 55% over the past decade. The latest figures from NAREIT actually put the debt ratio for Equity REITs at 52.8% and 60.7% for All REITs. While the SSB will need to determine the appropriate level and type of financing that is allowed, it is evident that the development of a REIT solution doesn't have to be limited by the degree of financing (whether the pricing of such financing is on par with that available in conventional markets is less clear cut).

**Volatility & Liquidity:** The latest dive in global property markets has certainly had an impact on the financial performance of REITs, but what has been less obvious is the strain this has placed on management of capital reserves and the sourcing of funding for short term requirements. In fact regulatory authorities have sought to alleviate some of the impact from the global financial crisis, whether it is by relaxing the limit on aggregate borrowings (such as in Hong Kong) or by allowing dividends to be paid out in stock as opposed to cash distributions (such as in the US). Nevertheless, most jurisdictions have been able to provide sufficient and prompt support to the REIT marketplace (with perhaps the UK as an exception).

**Sector Concentration:** While it is evident that hospitals and plantations provide very focused investments (as in the case of the two Islamic REITs discussed earlier), this does not mean that conventional REITs have to be fully diversified either. In fact if one looks at the global REIT marketplace, one can find several industry

or sector-specific REITs (including healthcare, industrial and even self-storage). In the UK for instance, one can find a healthcare REIT (Primary Health Properties) with a market capitalization of GBP 173 million. This certainly remains small compared to British Land (the largest UK REIT) which commands a market capitalization of more than GBP 4 billion (investing across a diversified commercial property portfolio), but it proves that thematic REITs are viable. Similarly, both the UK and US have self-storage REITs (Big Yellow and U-Store-It Trust respectively). The US market alone is home to 11 healthcare REITs (out of a total of 138 which comprise the FTSE NAREIT All REITs Index).

**Market Access:** While some real estate markets have been favored by Islamic finance (namely UK and US markets), this type of exposure has often been achieved through private real estate funds (often close-ended) and not through any type of liquid offering. With Asian real estate having exhibited stellar returns over the past five years (posting rolling 5 year returns of 23%) the argument for accessing this and other markets (frontier, BRIC, etc) is ever increasing. With markets such as China planning to launch REIT structures this year it is clear that gaining access to specific geographies is not necessarily exclusive to private/institutional vehicles.

Here we have opted to avoid a detailed discussion of the REIT structure per-se, as it seems that it is not the structuring that is a limiting factor. Instead it seems that the deficiency lies in a lack of local market knowledge, both for identifying quality assets as well as for navigating local regulatory regimes (minus Malaysia, which has proven once again as a friendly venue). While this might be construed as a critique we rather see it as a call for revitalizing this under-utilized structure. It is evident that as much government and/or regulatory support is given, it is up to the private sector to identify and capitalize on market opportunities. Once again we see a wide range of products/markets that are not being offered in a Shariah compliant manner, but this is certainly not because of costs, complexity, product immaturity or any other 'classic' excuse. Whether the journey of Islamic REITs is destined to be counted in the single digits remains to be seen.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

# Florentez Investment Management

## Interview with Saeid Hamedanchi, President & CEO

*"Florentez Investment Management (ShariahShares ETF), based in Irvine, California, is a newly established Exchange Traded Funds (ETF) sponsor that will be offering complete line of Shariah compliant ETFs on the New York Stock Exchange upon obtaining approval from the US Securities and Exchange Commission (US Regulator). Florentez Investment Management was founded by Saeid Hamedanchi, CFA and James Altenbach, CFA."*

**Q1. Regarding the product range you are developing, it seems indexation products have not been widely developed in the Islamic finance space. What is your take on this?**

This is absolutely correct. Indexation and passively managed mutual funds and ETF have not been widely developed in the Islamic Finance arena. There are several reasons for that:

- The fees charged by industry participants are substantially higher in actively managed products rather than Indexing. Actively managed mutual funds have higher expense ratio than their passively managed counterparts in both conventional and Islamic Finance markets. The typical Shariah compliant mutual fund in GCC charges total expense ratio of 1.5%-2%. Shariah compliant ETFs are typical charging between 0.50%- 0.70% globally.
- Lack of education of the investing public on passively managed products. Investors need to be educated by the industry about the benefits of passively managed product. Passive managers in the US spent a lot of money and effort to educate the retail and institutional investors on the benefit of Indexing strategy.

However studies have consistently shown that Index funds outperform active managers on regular basis due to lower total expense ratio. Lower fees lead to greater returns for investors in an extended time period. In fact most Active Shariah mutual funds underperform FTSE All World Shariah index and other similar

indexes on consistent basis due to higher fees charged by the managers.

**Q2. Why has the industry been slow in taking up these products? Is this a case of a business-as-usual approach that delays product development or precludes product innovation?**

The Islamic Finance industry is accustomed to actively managed products where high fees can be charged from the investors. The typical Shariah compliant mutual fund charges expense ratio of at least over 1.5% per year. Unfortunately most active managers underperform the index funds due to factors cited above. There are currently very few Shariah compliant passive ETF or mutual fund products available worldwide.

**Q3. Can you describe your product pipeline, how do these fit in the current universe of Islamic investment products?**

We are planning to offer complete family of Shariah Compliant Equity ETFs covering both developed and emerging markets. These products will be passively managed with low total expense ratio. We will be using world class index providers to create our products. (i.e: FTSE Shariah Global Indexes Series). In addition, we are partnering with world class service providers to manage our products.

# Fund Manager Interview

8

We will also be offering non equity Shariah compliant ETF that would be very unique in the near future. We are also in the process of developing commodity ETFs that would be Shariah compliant. By offering these products, our investor base will have ability to do a complete asset allocation strategy according to their investment criteria and constraints. We believe this will be well received by our investors.

## **Q4. What other products are you planning to develop under your umbrella? What is the investor appetite for actively managed solutions, and how would you incorporate these into your offering?**

We are planning to focus on Indexation as we are a firm believer that Index products provide better return to investors due to lower management fee and trading expenses over an extended time period than actively managed products. As discussed earlier, very few managers outperform the index over an extended period. In fact, the managers that outperformed in the past do not necessarily outperform in the future. This is the biggest challenge in identifying the best managers who will outperform in the future.

## **Q5. You have undertaken extensive market research on Shariah Compliant ETF industry, in your view what are the key drivers of growth for ETFs and specifically for Shariah compliant ETFs?**

There are three areas the investors benefit greatly by using the ETF structure versus the traditional mutual funds structure.

- **Lower Expenses:** Exchange Traded Funds are offering the lowest expense ratio's compared to Index and active mutual funds. Shariah ETF are charging between 0.50-0.75% where as the mutual funds are charging between 1.5-2.00% per annum.
- **Greater Transparency:** ETF sponsors are required to disclose their holdings on daily basis to market participants where as the mutual funds disclose their holdings on a semiannual basis. In today's market, Investors value transparency especially after the events of 2008.
- **Speedy Execution:** ETFs offer speedy execution during the market hours where as mutual funds can only be redeemed or purchased at the close of the trading day. ETF investors are able to purchase the ETF early in the day and redeem later in the day.

These three drivers have fueled the growth of the ETF industry. In fact, ETF industry has had a very rapid growth since its inception in 1993. Today, assets under management exceed \$900 Billion globally. Shariah compliant ETF are the newest addition to the ETF

family of products. The first Shariah compliant ETF was introduced in 2006 on Istanbul Stock Exchange and there are still very few Shariah compliant ETFs around the globe. We believe the above benefits will apply to Shariah compliant ETF as the investors will be seeking lower expenses, greater transparency and speedy execution.

The other benefit of ETF is to equitize cash for active managers. If an active manager has excess cash, he can invest in Shariah compliant ETF until he decides what securities to purchase. By using this strategy, the active manager will minimize cash drag in the rising markets. In addition, Shariah ETF can be effectively employed as an asset allocation tool to gain exposure to various regions, sectors and market capitalizations.

## **Q6. Considering the competitive landscape, and increasing interest of ETF investments, how do you plan to position yourselves in the market and what are your differentiating factors?**

We are planning to be a low cost provider of Investment Management products in the Islamic Finance Arena. In the ETF industry, we can be a niche player who focuses exclusively on Islamic Finance products. Other players just offer Shariah compliant window in addition to their other products (i.e: Deutsche X-tracker).

By having this objective, we will be offering quality Shariah compliant ETF and will have better understanding and expertise in the space

## **Q7. What regions and investor segments do you intend to target first? What particular challenges do you see in efficiently accessing these?**

We are planning to target GCC and South East Asian countries initially as these are the largest markets in the world for Islamic Finance. We will initially reach out to Institutional Investors as well as high net worth investors to introduce our ETF. One of the particular challenges in the GCC & Southeast Asia has been the lack of knowledge by investors regarding ETF and their application. We will need to invest in educating all investors on the various applications of ETF such as Asset Allocation, using it to minimize cash drag and other applications.

Exchange Traded Fund products are being used extensively by both institutional investors as well as retail investors in the USA. In fact the split is around 50/50. However even in Europe, ETF are mostly used by Institutional investors (90%) and only 10% employed by retail investors. In Asia except Japan, ETF are in their very early stages of development in the conventional arena.



# Fund Manager Interview

9

## **Q8. Marketing and distribution are often underestimated by fund managers, what strategies are you considering for disseminating your products?**

We will be partnering with world class financial institutions who are interested in distributing our products in the various regions. We will be working with these financial institutions to help their marketing teams understand our products in greater detail and be able to provide them as solutions to their client's investment needs and requirements.

We are interested in joint ventures with financial institutions who are interested in developing ETF based on the various regions of the world to be distributed in the US market. We are particularly interested in regions with strong fundamentals such as GCC, South East Asia. . Furthermore, we are interested in cross listing our ETF in various exchanges.

## **Q9. Innovation has become a bad word lately; does this present a challenge when the industry is trying to develop fresh new solutions for investors?**

ETF industry has seen rapid growth due to its ability to innovate constantly create new and exciting products. Inverse, Ultra Short and Highly leveraged ETF were recently introduced by ProShares and Direxion in the US. These products have witnessed very rapid growth due to their innovative ability to solve investors needs and requirements.

We must realize that the Islamic Finance is very young industry. The first Islamic Banks were crested in 1970's. There are many products that can be created in Islamic Financial Arena that are available in the conventional Finance space. We believe that the Islamic Finance industry needs to continuously innovate to meet the needs and requirements of its investor base. We believe Index based ETF provide cost effective way for investors to invest in Shariah compliant portfolios.

# KIPCO Asset Management Co (KAMCO)

## Interview with Khalil Khoury, Senior Vice President Head of Investments and Product Development

### Q1. What are the key challenges faced by conventional investment companies in developing comprehensive and diversified Shariah compliant products?

For a conventional company it takes twice the effort to develop shariaa' compliant product especially when you are up against prominent institutions like KFH in Kuwait for example.

The challenges faced are similar to any product development process in order to ensure its success mainly summarized in 3 major points:

- A good understanding of the requirements of shariaa' compliance in relation to the product being developed
- The setting up the structure for screening shariaa' compliance
- Ensure acceptance of the product by the shariaa' compliant investors

### Q2. Do you observe any significant differences between building conventional and Shariah compliant Products? Do you follow similar allocation methodologies or are there any stark distinctions?

The philosophy if well understood and implemented goes in line with the conventional investment philosophy with the main difference such in the case of the Modaraba for example where "Rab-ul-mal" or the provider of the financing is perceived as a provider of capital or a partner or and not as a lender.

That is to say that the major difference comes at the level of the financing structure assuming that the underlying activity is shariaa' compliant de facto. Take the example of the "Ijarah" that resembles leasing as it is practiced in today's commercial world. In a nutshell

the distinction appears at the level of the structure and not the concept.

### Q3. The scope of Shariah compliant investment products now spans the entire globe, however do you find any specific areas (i.e. geographies, asset classes, currencies, etc) which are still not properly covered?

Asia mainly Malaysia, Pakistan and the GCC are considered to be the hub that is hosting and enticing the development and the perfection of the shariaa' investment and compliance philosophy and implementation. The fact that the Islamic world and specifically the GCC holds a substantial amount of sovereign wealth and due to the major increase in the pool of Islamic funds seeking shariaa' compliant investment opportunities, has raised the awareness on the necessity of such products within the major financial economies such as the US, UK and Europe. Education on Islamic investment is now available in major universities in the US and the UK.

### Q4. Would you maintain that this universe of compliant investments carries a problem of quantity (more funds needed) or quality (better managers needed)? Or both?

I think it's both as more products are definitely needed with enhanced liquidity and hedging features and I believe this is the main challenge that the Islamic investment is facing, especially in today's Investment environment where minimizing risk has become a major portion of the investment equation through hedging possibilities and enhanced liquidity, I am not sure that there is a consensus amongst shariaa' scholars on the compliance to the injunctions of Islam of some the instruments used for hedging.

# Allocator Interview

11

**Q5. With your experience managing both conventional and Shariah compliant products side by side (such as your Shariah compliant Kamco Energy Services Fund), do you see a distinct client preference for either one?**

Feels like hitting two birds in one stone at first sight when you structure a Shariaa' compliant product under the assumption that a shariaa' compliant product would be appealing to shariaa' compliant and conventional investors, our experience shows that this is not always the case especially when you realize that there are two levels of Islamic investments the shariaa' compliant and the shariaa' compliant by articles of association thus another layer of distinction in Islamic investment.

**Q6. Much has been said about real estate and/or illiquid investment products in Islamic finance, to what extent do you mitigate any potential issues of concentration, liquidity, idiosyncratic risk, etc on your portfolios?**

Mainly through diversification when and where possible, we have to remember that the Islamic financing is still at its infancy however things have been improving as we speak and we believe that there is a tendency especially after the global crisis to lower the risk within the Islamic product structures but again we are nowhere near the level of conventional products, I can think of the example of derivatives, or hedge funds products that are being sold under the shariaa' compliance banner by major financial institutions but this does not mean that these products are being fully accepted by the Islamic investment community.

**Q7. Do you manage all of your mandates internally (using in-house fund managers) or have you sought to utilize external managers as well? Would this be relevant for specific products such as a high-conviction strategy or an allocation into a specific geography?**

In some cases we use external managers especially when we are targeting shariaa' compliant equities in the US and Europe such in the case of our Energy services fund where we are using the advice of a prominent international investment bank and their equities research capabilities to help us determine the shariaa' compliant universe within the alternative energy and energy services sectors. Also the need for a shariaa' advisory board is required for periodic compliance screening.

**Q8. What are some of the key trends that you are monitoring in the industry (with regards to new products, new markets, etc)? Which would you argue hold more opportunity and where is the greater potential for growth?**

Modaraba is one area that we are seriously contemplating, the beauty of Modaraba is that it is similar to the project financing concept as far as the recourse to the financial status of the main company is concerned i.e. if for example if an Islamic investor wants to invest in a sector where the leading company is not Shariaa' compliant because of its leverage the Modaraba offers the opportunity to the Islamic investor to venture with the company on a specific project through the establishment of Modaraba Management Company (MMC) regardless of the compliance status of the main company assuming that the contemplated activity or sector is shariaa' compliant.

We believe that the Modaraba is a bridge between the conventional and Islamic investment world offering the possibility of a venture between both worlds.

# Enforcing Arbitral Awards in Islamic Finance Contracts

By Khalil Jarrar, J.D.

Having recently moved from California to Amman Jordan, I found myself contemplating writing this article and in search for an hour of solitude and I hastily made plans to follow up on my previous article outlining preventative and remedial measures protecting Sukuk investment account holders. This of course was derailed by a call from my mother to pay her rent-to-own payment at a local Islamic Bank. My first impression took the intellect out of intellectual debate, what would seem to be a simple transaction in a conventional bank requires: getting an approval from a bank officer, standing in line to get the payment endorsed, and then finally pay at a cashier's window. My inquisitive nature took the better of me and soon I was interrogating the bank officer. Soon I realized that most debates we read and articles we write are aimed at the wrong audience. The consumers at large are unaware of the different modes of obtaining funds to support their financial needs.



This is not entirely surprising, since bank officers at Islamic banks come from a finance background that – most often than not – is heavily laden with conventional banking experience (and corresponding perspective/notions). I took the liberty of examining a copy of a contract that was written in English, finding a major discrepancy in its contractual terms. While it is universally known in the legal field that arbitration is binding and final, the finality of arbitration seems to be arbitrary to say the least. The line that follows arbitration, states that if the terms are not satisfactory to the disputing parties then they will resort to the court of law (?). To add insult to injury the contract never states a jurisdiction nor does it state a venue, leaving ambiguity in the details to put it mildly.

Having encountered this major issue, I decided to address remedial measures, arbitration, in advance of preventative measures (meaning corporate governance) hoping to introduce this issue in a simple format with the risk of insulting the more educated audience but hoping that the benefit to the reader community at large outweighs the risk.

So what is Arbitration? Arbitration is a form of alternative dispute resolution (ADR), a legal technique for the resolution of disputes outside the courts, wherein the parties to a dispute refer it to one or more persons (the “arbitrators”, “arbiters” or “arbitral tribunal”), by whose decision (the “award”) they agree to be bound. It is a settlement technique in which a third party reviews the case and imposes a decision that is legally binding for both sides, and arbitration has recently gained traction in resolving various International disputes. Not surprisingly the New York Convention of 1958 is one of the most important and successful United Nations’ sponsored commercial law treaties. As of January 1, 2009, 143 states, out of 192 member States, have adopted the New York Convention including all the major players in the Sukuk bonds market: Bahrain, Malaysia, Qatar and the UAE. As Sukuk issuance have gained global acceptance, arbitration can be an effective tool in resolving international disputes arising under provisions of Sukuk contracts. The Convention has indeed seen an increasing number of accessions by Gulf States over the past few years – Kuwait led the way (1978), followed by Bahrain (1988), Saudi Arabia (1994) and Oman (1999). The most recent Gulf State to accede is Qatar, where the New York Convention entered into force on March 2003.

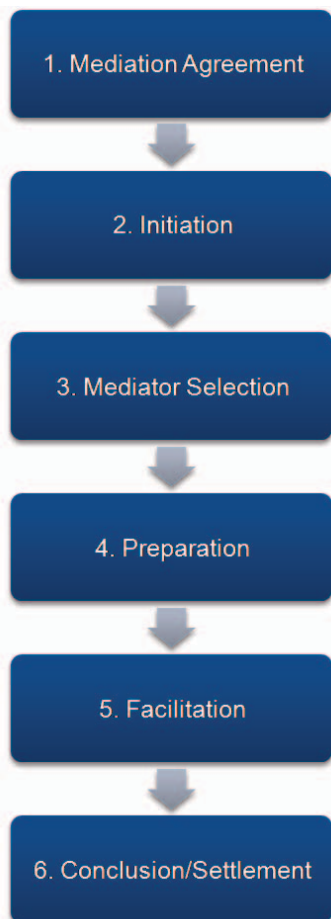
Moreover, the cross-border nature of sukuk issuance and the increasing international dynamic that has been observed provide further motivation for expanding on the use of arbitration. As a matter of fact the New York Convention is not the only treaty dealing with cross-border enforcement of arbitration awards. The earlier Geneva Convention on the Execution of Foreign Arbitral Awards 1927 remains in force, but the success of the New York Convention means that the Geneva Convention is rarely utilized in practice. Arbitration is an invaluable tool for the average investor in any foreign investment dispute (Islamic finance included). In most cases, an average investor

does not have the financial resources to litigate. Even if the legal expertise were available and supported by the financial ability, dealing with conflicts of laws in foreign disputes and the lack of uniformity of remedies regarding litigation cost and lawyer fees creates enough hardship in getting an equitable relief for the adversely affected party.

The aforementioned reasons, inter alia, makes arbitration the most effective tool in getting the needed relief for a Sukuk investment account holders whether in a domestic court or in a cross border dispute .

One of the reasons that arbitration is so popular in international trade as a means of dispute resolution, is that it is often easier to enforce an arbitration award in a foreign country than it is to enforce a judgment of the court.

Under the New York Convention 1958, an award issued to a contracting state can generally be freely enforced in any other contracting state, only subject to certain, limited defenses.



Source: National Arbitration Forum

So how are arbitral awards enforced in Islamic countries that are parties to the New York Convention?

In an article written by the law firm Abdul Razzaq outlining the enforcement of Arbitral awards in Kuwait (for both domestic and foreign judgments) the author asserts that “in an era of globalization with so many investors entering and establishing themselves in the Muslim world a sound knowledge of how Muslim laws operate would be crucial for anyone involved in banking, insurance, syndicated loan agreements, agency contracts and distributorships”.

They proceed to outline the mechanisms of enforcing arbitral awards in Kuwait in accordance with Judicial Arbitration Law No. 11 for the year 1995 that establishes the procedure whereby a panel of arbitrators may be formed in the Court of Appeals. Article 1 of the said law states that one arbitration board or more shall be formed in the house of the court of Appeal, consisting of three judges and two arbitrators, each of the disputing parties can choose from the arbitrators enrolled, from the tables prepared in this regard in the arbitration department of the court of Appeal. Article two of the said Law confirms that the five-member panel shall decide on the following matters: Any arbitration matter that the parties agree to refer to the panel arising under a disputed contractual matter either between ministries and governmental authorities or other commercial disputes between individuals , corporations or governmental entities.

The individuals and corporate entities can choose either to proceed to the court or force the government entity to submit to judicial arbitration as long as the same dispute is not already being litigated in the courts in violation of the principles of Lis pendens (pronounced “Lay penden”) or any parallel or pending judgments. The rationale behind barring parallel proceedings is to avoid forum shopping as articulated by the landmark case of Piper v. Reyno where one party seeks to either double the awards or shop for higher awards (such as punitive awards under the American legal system).

As for conformance with Shari’a law, the author states: “an arbitral award has a jurisdictional character and is binding and enforceable. According to the Maliki, Hanbali, Hanafi and the majority of the Shafi’ School an arbitral award is as enforceable as a court order. As to the enforcement of

foreign arbitral awards, the attitude of Sharia is dependant on the bilateral and international conventions and treaties to which the party states have entered. Moreover, the Muslim judge may set aside a foreign award or refuse enforcement if the award violates the general principles of Sharia law”.

Reality on the ground might state otherwise, as for the example of the aforementioned contract with contradicting terms deeming arbitration non-binding in a jurisdiction. Also, leaving a judgment of enforcing a contract to a judge gives a very wide discretionary power to the local judiciary if it is decided to violate the principles of Islamic law. In closing, seeking an arbitral award in a country member to the New York convention is a far better alternative for an average individual than a traditional judicial award. In future articles , we will explore more examples of different jurisdictions of the major market players in Islamic finance, both challenges and mechanism of enforcing such awards.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).



# Does Islamic Finance Need a Voice?



*"Does the industry (by this we mean investors, consumers and practitioners) need a communication channel to interact with other industry bodies (such as AAOIFI, IFSB, IIFM) as well as with regulatory bodies? Could this serve a positive role in lobbying for improvements and supporting industry-wide initiatives? Does it risk being a weak voice among the marketing noise of the industry?"*

The industry should have a voice with the regulators. Here in Pakistan we have a channel where the consumer/customer has a communication access to the regulators where he can report his grievances. This arrangement has ample benefits and the most momentous aspect is that the institutions have an apprehension that their wrong practices and mis-commitments can be reported to the regulators that can draw disciplinary actions. This acts as a watch and vigilance control over the institutions.

Such communication also brings harmony within the industry. The customer and the public will explore the system and Islamic Finance in detail. Ultimately they will be more aware of the practices, the principles and the system.

However communication with other bodies such as AAOIFI, IFSB or IIFM will need a lot of background knowledge as a pre-requisite for their understanding. At a very elementary stage it will be confusing for the general public to understand and time-consuming for the institutions to entertain them all.

Of course arranging seminars, conferences and awareness programs is very effective in disseminating knowledge and communicating message across the prospective community, which can amplify the voice in a polluted ambiance.

Islamic finance does need a voice or body that promotes the development of Shariah compliant finance as a whole, and is not just representative of one particular narrow interest group. The problem we have is that not everyone has the same collective vision or ambition, and there are already a number of bodies in Islamic banking such as AAOIFI, IFSB, IIFM etc which play a key role in accounting and other standards, but with the differing interpretation of Shariah, having common standards usually means moving to the most conservative stance. In addition, within the Islamic institutions, there are some who take a very active role in trying to drive Islamic finance to a new level, whilst others are happy to give next to nothing towards the industry's development. However, the key point in all this is that these bodies are all driven either by, or for the industry, and there are few bodies outside of the industry that have a voice loud enough to be heard.

There is a perception in my view that the Islamic finance industry is not listening to where the end users, especially the retail market, want the industry to develop. To be able to build, therefore, a group that represented all the interested parties that had an interest in the markets development would be an excellent idea. It would need to be very focused to ensure that it became more than a talking shop only, it should include members (individuals or institutions) from the Islamic finance industry who shared such interests, and should probably pick one or two key initiatives that could be delivered to ensure that the group gained credibility.

Geographic spread is also important, to include all those centres where Islamic finance is on the agenda, whether because predominantly Muslim countries, or where there is the vision that the growth of Islamic finance is going to be one of the major trends in the coming decades, as alternatives to the conventional finance become more main stream.

## Ehsan Ahmad

Member Shariah Committee  
Emirates Global Islamic Bank

## Simon Eedle

Global Head Islamic Banking  
Calyon

Islamic finance is still embryonic and at the same time growing with a rapid pace. These two are distinct features and require extra care. While on one hand Islamic financial products are getting popularity for providing an alternate source of funding, on the other hand there is criticism regarding its effectiveness. Moreover, there are some differences among scholars as well on few products. None other than open communication among relevant parties could serve as an effective tool to discuss and resolve industry issues.

### Mudassir Amray

Head of Islamic Banking - Asia Pacific  
Citigroup

I believe strongly that as long as there is no global trade association representing Islamic Finance, this nascent industry will not be able to realise its true potential. A common body made up of major financial institutions and corporates (buy side) comprising both international and regional players having interests in Islamic products and services, would provide the industry with the cement it badly needs and with the accreditation it is due. At present, as each country has its own sets of rules and regulations, Islamic Finance appears very fragmented indeed. A common voice would ensure financial institutions, corporates and service providers interact with the AAOIFI, the ISFB and other regulatory and industry bodies in a consistent way.

### Sohail Jaffer

Partner and CIO  
FWU Group

A voice is an essential part of any debate. Islamic Finance (IF) is a young industry possessing vibrant, committed, passionate, intelligent, experienced and knowledgeable stakeholders and practitioners whose contribution at this stage of its development is the life blood of its future. The more engagement between the various parties from regulators, standard-setting bodies, institutions both educational and financial, the better the offering for the utilizers. In any industry the matters are usually best resolved discussed around a table. IF has much to offer, it is conservative, socially responsible, ethical and has an approval and oversight function built-in to address any violation of preset Shariah criteria. If all the stakeholders contribute together to establish it as a true alternate offering to the global finance space, then the best way to achieve this is through dialogue and engagement. The customers need to be informed of the mechanisms of IF and how it is different from conventional finance in order to be comfortable with the offering. Presently there is much misunderstanding that needs to be addressed for IF to become acceptable on a critical mass basis. IF has developed from the top down and needs a broad base from the grass roots to become a serious alternative to conventional finance and currently only represents 1% of global finance. The recent economic crisis bringing misery globally provides an unique opportunity to IF to establish a foothold in the global finance space as it is attractive to those who feel that the excesses of the unregulated and unmonitored sector of conventional finance need to be reined in and leverage and short selling should be discouraged. All of this can be achieved through dialogue and solution searching among the IF stakeholders from all parts of it and also engagement with the conventional finance counterparts.

In my view, there is a tremendous need to establish channels between the various stakeholders, such as Scholars, practitioners, regulators, customers, lawyers and auditors on a regular basis to avoid reaching decisions in a vacuum. This is an industry which affects all the stakeholders and so bodies to include the voice of all stakeholders is a must. It may not seem effective, but a platform for airing the issue and getting the feedback is an important part of the development of the IF industry.

### Majid Dawood

Chief Executive Officer  
Yasaar Limited

# Discussion Board

16

The rapid and recent growth of the Islamic Banking industry has certainly highlighted the fact it has been difficult to coordinate all the key stakeholders in an efficient manner. The stakeholders include:- Islamic Financial Institutions, regulators, scholars, consumers, who naturally have their own agendas. Currently there is no constructive platform to ensure these interests are reconciled for the industry to develop in a uniform manner. Compounding this is the fact that each country already active in, or recently entering, Islamic banking, has a desire to promote its own agenda, which makes cross border, international cooperation difficult. The industry is becoming very large, both across the number of new and “innovative” products being delivered to the market, and the ever increasing number of entrants into the market.

All appears well, growth is certainly good, and the industry needs to develop a framework for effective administration and management of this growth.

It is also clearly evident that independent and objective analysis highlights key issues that are not being addressed in any noticeable manner by the industry. Issues such as the fact that all financing (as opposed to investing) is benchmarked to Interest rates, assets introduced into Islamic transactions typically serve just to facilitate cash flows (again often priced on or benchmarked to interest where deferred cash flows are involved) rather than serve to make the transaction truly asset based, and that in many fundamental areas, Islamic banking is seen to be practicing sophistry in how it presents itself.

These issues go to the heart of the industry and any growth achieved whilst these and other key issues remain unaddressed only further serves to undermine and erode the deep principles underlying the philosophy of Islamic banking. This view is expressed by several within the industry, and also by Muslim as well as non-Muslim observers. However, the race to be a part of this growing and lucrative industry is blurring these considerations.

The most beneficial role that could be played by an independent body or entity would be to ensure that the industry does not further diverge from its founding principles, and that the competition for market share, growth, products and revenue do not override these principles. The industry and its stakeholders would benefit from such an impartial and objective body, and should also expect advice on concrete and realistic policy and strategy on how growth can still be sustained without sacrificing their key tenets.

## Safdar Alam

Head of Islamic Structuring  
JP Morgan

My fundamental answer is a “yes”. However, we do need to understand what it is we need to achieve before prescribing a set of solutions. A welcome first step would be pulling together a list of issues and gradually turning that into a blueprint with corresponding action items that require attention and follow-up.

I have been particularly critical at a number of conferences in the recent past – and while the debate has been interesting it has only been that. This “voice” can document these issues but simultaneously it needs to be empowered with the right tools to be able to follow up on these action items and ultimately enact positive change. Those individuals and institutions involved will have an onus to do that, hence it requires arms and legs to do the heavy lifting.

The regulatory bodies have their own agendas and are challenged enough in trying to formulate guidelines and promote buy-in. Perhaps People Power is the currency required at the initial stage so that this initiative can build momentum and gain acceptance across the industry.

There is not a moment to lose.

## David (Daud) Vicary (Abdullah)

Managing Director, DVA Consulting  
Global Leader, Global Islamic Finance Group, Deloitte

# Existential Risk to Islamic Finance

By Nikan Firoozye, Ph.D.



Paul Tillich, the theologian, in his seminal book, *The Dynamics of Faith*, claimed that faith was an essential component of life, and that this faith was underpinned by doubt; doubt was an essential component of faith and that doubt, overcome, was something that made believers firmer in their belief. While his main claims that faith was essential to life were in some ways completely contradictory to the basic tenets of existentialism (i.e., existence precedes essence, so in essence it may be possible to have life utterly meaningless), we present here what we consider to be existentialist risks to Islamic Finance.

These risks (expressed in different ways in the papers and authors listed below) have at times questioned the fundamental core of Islamic Finance and its current practice, although it is more in the

spirit of Tillich that we hope to present these existential risks as something to lead to deeper introspection. Indeed it is through this questioning that hopefully leads to strengthening our resolve to pursue the core philosophy of Islamic Finance – characterized by the bans on *riba*, *gharar* and *maysir*.

## Risk 1: “Conventional Derivatives are Better”

[On the pareto-optimality of futures contracts over Islamic forward contracts: implications for the emerging Muslim economies](#)

M. Shahid Ebrahima, Shafiqur Rahmanb

Journal of Economic Behavior & Organization, vol 56, 2005

A general equilibrium approach is used to demonstrate that: (i) futures contracting (on Islamically permissible commodities) is pareto-optimal over the Islamic forward contract of Bai' Salam; and (ii) both forms of contracting constitute a quasi-equity claim instead of debt (*dayn*) as construed by the majority of Islamic jurists. These results are of import as they: (i) remove a major hurdle against futures contracting by the Islamic jurists thereby enabling the renovation of the financial intermediation system of emerging Muslim economies; and (ii) demonstrate that the arbitrage principle needs to be re-examined under non-linear asset pricing.

## Risk 2: “Conventional Derivatives are Islamic”

[Islamic Commercial Law: An Analysis of Futures and Options](#)

Mohammad Hashim Kamali

The Islamic Text Society, pp 262, 2001

*Islamic Commercial Law: An Analysis of Futures and Options* focuses on options and futures as trading tools and explores their validity from an Islamic point of view. Futures and options are a completely new phenomenon which has no parallel in Islamic commercial law. After reviewing the existing rules of Islamic law of contract and verifying their relevance or otherwise to futures trading, the author,

Professor M H Kamali, advances a new perspective on the issue of futures and options based on an interpretation of the Qur'an and the Sunnah and referring to the principle of maslaha (consideration of public interest) as enshrined in the Shari'ah. Islamic Commercial Law consists of three parts. Part One is devoted to the description of futures trading and the understanding of operational procedures of futures and futures markets; Part Two investigates the issue of permissibility of futures trading in Islamic law and the underlying questions of risk-taking and speculation, which are of central concern to the topic. Part Three is devoted to an analysis of options. This work will be of use to anyone working on Islamic law, comparative law or working in Islamic banking.

### **Risk 3: "Simple Interest is Islamic"**

[Stipulation of Excess in Understanding and Misunderstanding Riba: The Al-Jassas Link](#)

Mohammad Omar Farooq

Arab Law Quarterly, Vol. 21, pp. 285-316, 2007

An essential condition in the orthodox definition of riba is stipulated excess in a loan or debt. This essential condition is traced to al-Jassas. Understanding this issue of stipulated excess is critical to understanding riba. In this paper the stipulated excess in connection with al-Jassas as well as its implication for defining riba and prohibition of interest is examined. A critical examination of the subject shows that pre-Jassas discourse about riba did not include stipulated excess as an essential condition and al-Jassas' changing of the conditions in defining riba is not corroborated by the textual evidences he used.

### **Risk 4: "Islamic Contracts are not Incentive Compatible"**

[Incentive Compatibility of Islamic Financing](#)

Humayon Dar

Handbook of Islamic Banking, Eds Kabir Hassan and Mervyn Lewis, 2007.

Islamic Contracts do not provide sufficient incentives – but no fear because the wa'd swap is here.

### **Risk 5: "Total Return Swaps (wa'd swaps) and Profit Return Swaps (murabaha swaps)"**

[Pioneering Innovative Shari'a Compliant Solutions](#)

Dr. Hussain Hamed Hassan

Deutsche Bank and Dar Al Istithmar

Completing the market for Islamic investors – the risk that non-permissible activities and financial ratio guidelines can be made trivial.

### **Risk 6: "Islamic Banking is Just Rent Seeking"**

[Mutuality as an Antidote to rent-seeking Shari'a Arbitrage in Islamic Finance](#)

Professor Mahmoud El-Gamal

Rice University, 2005

An extensive critique of the rent seeking and shariah arbitrage of modern practice. More of a traditionalist although one must admit he has a point. His idea of enacting change is certainly valid, although the proposed method is less than optimal. He would be much relieved to see the SSB model under each Central Bank (as in the Bank Negara Malaysia model) to counteract the conflict of interest inherent in the current SSB setup.

### **Risk 7: "Islamic Contracts are little different from Conventional ones"**

[In what ways does Islamic banking differ from conventional finance?](#)

Mervyn K. Lewis

Journal of Islamic Economics, Banking and Finance, Vol 4, No 3, 2008

A critical overview of how "the adaptation of classical merchandising sales contracts for financing using deferred pricing contractual forms



has changed the landscape” of Islamic finance. First in the critique is how risk is transferred between traders and bankers - resulting in an economic cost/benefit scenario that is no different from what happens in conventional contracts. Second in the analysis is how “banks’ profit rate comes from the charging of a difference between the deferred price and the spot price that can be ‘benchmarked’ to conventional interest rates”, which is the root source of many snide remarks from outsiders in that there is little “substantive difference” between conventional and Islamic finance.

### **Risk 8: “Islamic Finance is merely a shell game and serves only isolationism”**

[Islam and Mammon: The Economic Predicaments of Islamism](#)

Timur Kuran

Princeton University Press, 2005

Timur Kuran argues that the doctrine of Islamic economics is simplistic, incoherent, and largely irrelevant to present economic challenges. Observing that few Muslims take it seriously, he also finds that its practical applications have had no discernible effects on efficiency, growth, or poverty reduction. Why, then, has Islamic economics enjoyed any appeal at all? Kuran’s answer is that the real purpose of Islamic economics has not been economic improvement but cultivation of a distinct Islamic identity to resist cultural globalization.

We present these various opinions here because they raise some serious questions which could shake the core of Islamic finance if they were indeed true. We must satisfy ourselves that conventional derivatives are not better, that they should not be Islamic because of some supposed superiority, and that they are not really Islamic merely by interpreting the rules correctly like Prof Kamali claims (in his absolutely fascinating and deep study). Similarly we must come to the conclusion that simple interest is no different from compound interest and it can be through Hadith alone (and the Prophet’s abhorrence of even accepting favours from borrowers, lest they be riba, let alone explicit markups) which should show the fallacy of such argumentation. If conventional were truly better and through the wonderful guise of Shariah transformation we could all get access to the wonders of conventional finance without having to lose the comfort of being halal, then Islam would truly be a burden, something that keeps us from opening normal savings accounts, taking out credit cards and mortgaging our homes, and we must really be such a sorry lot to have to pay for wa’d swaps just to ease our consciences. I think we can easily put this on the rubbish heap as an academic advertisement for structured product or a product of post-colonial envy of the west.

The latter criticisms from Professor El-Gamal shows some subtlety since it is more a question about the practice of Islamic Finance rather than the undertaking. Finally by the mere growth of Islamic Finance as an industry, with its newly found international appeal should give us confidence that it is meant to engage, not isolate.

We sincerely hope that you will satisfy yourselves of the vacuousness of some of the arguments, the hidden assumptions underlying others, and the use of rules to evade Maqasid. But in each of these, we can see a hint of a warning, something we must beware. It is either a mental trap to make us believe that the aim of IF is entirely wrong-headed, or believing that conventional methods are necessarily better, since this inferiority complex is the root of our wanting to emulate rather than to create. Perhaps the most positive aspect from all these points of view is the healthy debate that has been generated and the notion that the industry is not static but in a constant journey towards bettering itself.

Sincere thanks to Sayd Farooq for initiating this topic and Mahadzir Ahmad for his deep knowledge of relevant Hadith.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#)

# Islamic Mutual Funds: Reviewing their Financial Performance and Investment Style Around the World

By Andreas G. F. Hoepner <sup>ab</sup>, Hussain G. Rammal <sup>c</sup> & Michael Rezec <sup>a</sup>

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Since its commercialisation in the 1970's, Islamic finance has rapidly gained acceptance worldwide. In particular, the Islamic investment sector has experienced exceptional growth with Dow Jones, FTSE, MSCI and S&P jointly offering hundreds of Islamic equity indices. The collapse of several conventional financial institutions during the infamous Global Financial Crisis has placed the spotlight on the Islamic financial sector which was able to demonstrate stability during the crisis. To better understand the reasons for performance differences between conventional and Islamic assets, one needs to understand the expectation of Islamic investments. Islamic funds managers are expected to invest in assets that comply with Shari'ah principles and are therefore halal. Islamic law prohibits investment in businesses that deal with interest-bearing financing organisations, produce or sell alcohol or pork-related products, and ammunition. Therefore, like socially responsible investment, Shari'ah compliant investment refuses to only pursue profits.

Very recently, a study by Hoepner, Rammal and Rezec (2009, [see reference link](#)) analysed the financial performance and investment style of Islamic equity funds from 20 countries in five regions (Africa, Asia-Pacific, Europe, Gulf Cooperation Council, and North America). The study sampled a period of two decades and is based on the performance of 262 equity funds, which makes it, by far, the largest analysis of Islamic funds to date. (Previous studies had at most investigated 60 funds). Specifically for the purpose of investigating and comparing the performance of Islamic funds around the world, the authors extend Carhart's famous four factor model (1997, Journal of Finance) and developed a three level Carhart model (12 factors). This model simultaneously assesses the financial performance of assets at the national, regional and global level and thereby allows to compare Islamic funds from different nations (e.g. Saudi Arabia and US) and different regions (e.g. GCC countries, North America) in their ability to deliver abnormal risk adjusted financial returns.

The findings of Hoepner et al 's (2009) study reveal that, in Western markets, Islamic equity funds appear to trail their equity market benchmark returns on average. Furthermore, Western Islamic funds are significantly exposed to a small stock preference. In contrast, Islamic funds from countries with a significant Muslim population neither underperform their equity market benchmarks nor experience a small cap preference. These results have some economic intuition for two reasons: First, Muslim countries have more Shari'ah compliant business activities and hence Islamic fund managers have fewer restrictions in terms of companies and industries they can invest in. Second, larger, more diversified companies have a higher risk of receiving intolerable degrees of revenue from prohibited activities especially in Western countries. This second explanation can fairly be expected to drive Islamic funds' preference for small cap stocks.

# Industry Snapshot

21

Finally, the study also finds some evidence that the pattern of investment in assets with a low debt to equity ratio may help explain the strong performance of the Islamic financial sector during economic downturns. As Islamic funds tend to avoid investing in high risk assets (due to uncertainty or gharar) they tend to be less affected during economic crises than investments in high risk/high return assets. This evidence is not only important for Islamic fund managers but also points conventional fund managers to the opportunities to hedge their portfolios against crises by investing in Islamic funds.

In summary, Hoepner et al. (2009) find evidence supporting the view that Islamic investors from predominantly Muslim countries (i.e. GCC countries and Malaysia) do not sacrifice financial returns by investing actively in line with their religious principles. Even more, they find some evidence that Islamic investors in some countries (e.g. Bahrain, Saudi Arabia) experience a superior protection against overall equity market losses.

## Acknowledgements:

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