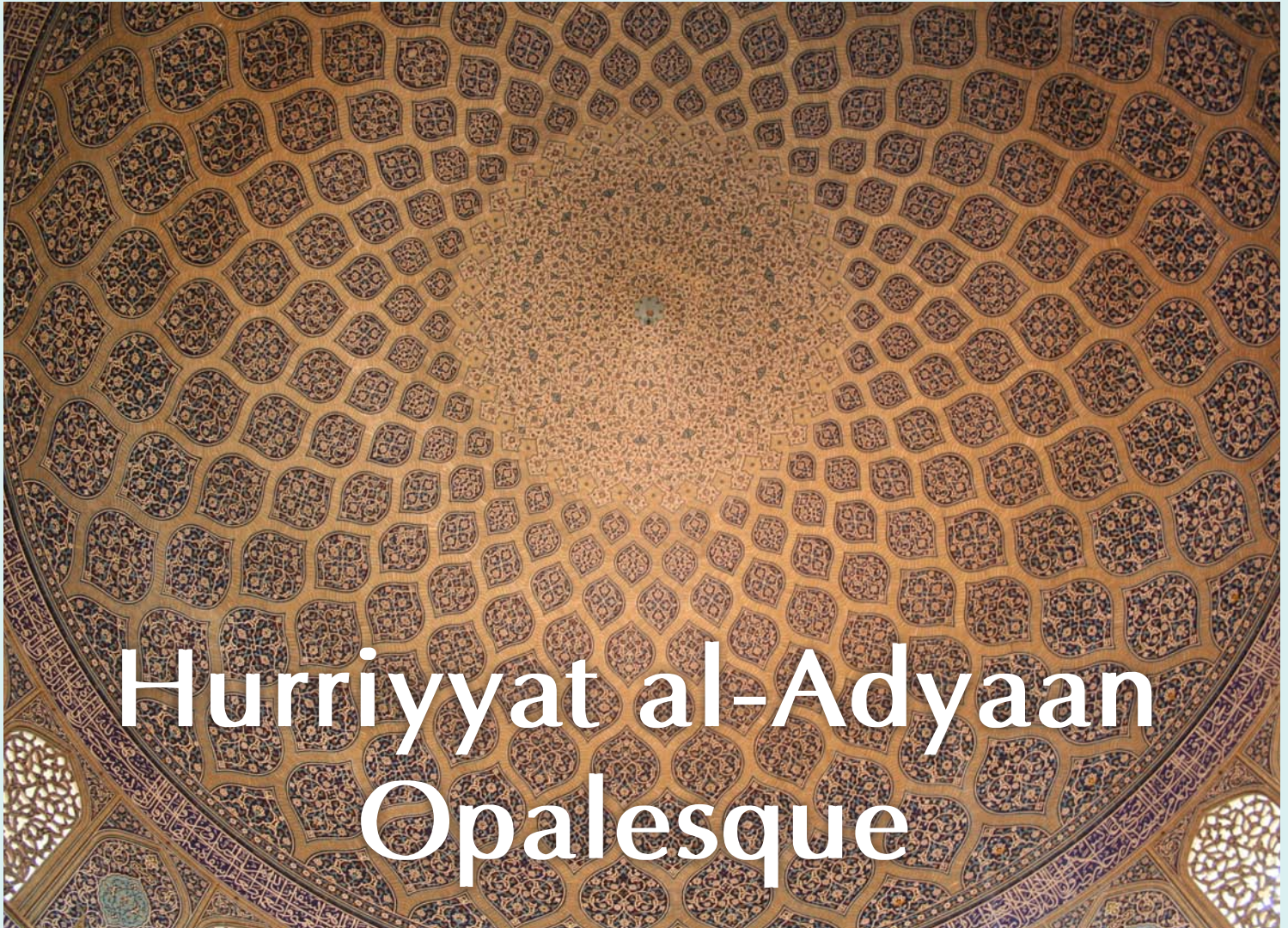


OPALESQUE

ISLAMIC FINANCE

INTELLIGENCE



Hurriyyat al-Adyaan

Opalesque

Featured Structure

Shariah Compliant Structured
Product: Consecutive or Rolled
Murabaha
Nikan Firoozye, PhD

Lex Islamicus

When Sukuk Default - Asset Priority of
Certificate-holders vis a vis Creditors
Mohammed Khnifer

Allocator Interview

Gold Bullion and Islamic Private
Equity: Protection and Production
Shahzad Siddiqui & Toby Birch

Welcome to the eleventh issue of Opalesque Islamic Finance Intelligence, we bring together a wide range of content that we hope you will find both timely and relevant. This month's edition explores a recurring theme, that of crossovers and frictions that are generated between the worlds of Islamic finance and traditional finance. Recent events have only reminded us of this delicate balance. We might be tempted to think that Islamic finance operates on a standalone basis, alien to the mechanics of mainstream finance (and media) and immune to the ebbs and flows of capital markets (and public perception). However, the reality is that every bank, product and service in the former exists (and co-exists) in the realm of the latter. We explore the implications across this issue.

Our editorial note discusses the interactions between Muslims and non-Muslims in the Islamic finance industry, an often taboo subject but a blatantly obvious one. We also showcase the various published standards from the Islamic Financial Services Board (IFSB) in the Featured Resource segment, arguably the most transparent and comprehensive set of prudential documentation available for the industry.

The Featured Structure section sees Nikan scrutinizing structured products as they make the journey from the turbulent waters of traditional finance to the shores of Islamic finance, with a specific focus on rolled Murabaha contracts. Lex Islamicus profiles the study by Mohammed Khnifer on the bankruptcy proceedings relating to the East Cameron Gas sukuk and the sukuk-holders priority claim on the underlying assets post-default. In addition, Toby Birch and Shahzad Siddiqui share their analysis of integrating Islamic private equity with a physical commodity component in our Allocator Interview.

The Opinion Column welcomes Rushdi Siddiqui as he shares his point of view on the proposed Muslim community center in lower Manhattan. Furthermore, the Industry Snapshot section hears from Mobasher Zein as he has explores Islamic mutual funds and recent trends as the industry awakens from the aftermath of the global financial crisis.

As always, we are keen to hear your comments & suggestions and remember that you can visit our online archive ([see reference link](#)) for access to our ever-growing databank of Opalesque Islamic Finance Briefing as well as all of the back issues of Opalesque Islamic Finance Intelligence.

Best Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

Please contact us, we would love to hear from you:
Publisher: Matthias Knab - knab@opalesque.com
Editor: Bernardo Vizcaino - bernardo@opalesque.com
Advertising Director: Denice Galicia - dgalicia@opalesque.com

In This Issue

Editor's Note

The Conquest of Kafirstan
Bernardo Vizcaino, CAIA 3

Featured Resource

IFSB - Published Standards 5

Featured Structure

Shariah Compliant Structured
Product: Consecutive or Rolled
Murabaha
Nikan Firoozye, PhD 6

Lex Islamicus

When Sukuk Default - Asset Priority
of Certificate-holders vis a vis
Creditors
Mohammed Khnifer 9

Allocator Interview

Gold Bullion and Islamic Private
Equity: Protection and Production
Shahzad Siddiqui & Toby Birch .. 15

Opinion Column

From a Mosque to a Museum
Rushdi Siddiqui 23

Industry Snapshot

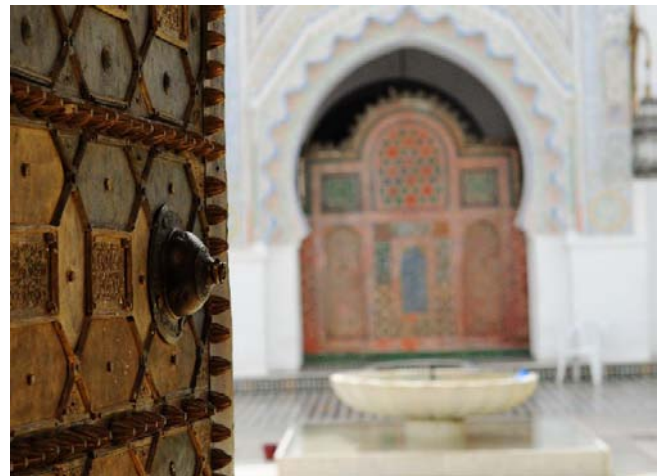
A Study of Islamic Mutual Funds
Mobasher Zein Kazmi 26

Photography by: Kelly Lemon, Robert Seabrook

The Conquest of Kafiristan

By Bernardo Vizcaino, CAIA

It was in the year 1896 that the ruler of what is now present-day Afghanistan launched a final attempt at conquering a stubborn northern province in the Hindukush, one that was known for its predominantly non-Muslim inhabitants. Hence the name given to this region was that of Kafiristan, the land of the unbelievers. It was a small expansionary endeavour in the late 19th century, a far cry from the large scale Ottoman challenges to Christendom (such as the one that ended under the walls of Vienna in the year 1683), but it provides us with an interesting backdrop for discussing Islamic finance. This is an industry that has developed with contributions from both Muslims and non-Muslims alike. Furthermore, the products & services are not only offered within the historical boundaries of the Muslim world, but across jurisdictions from all over.



The N Word

Islamic finance presents us with a remarkable opportunity to promote dialogue and understanding, although it is rather unfortunate that we seldom hear about this particular aspect. Perhaps it is taboo to openly talk about religion (even in a faith-based environment) or perhaps the interactions between Muslims and non-Muslims have become so casual and 'normal' that they pass seemingly unnoticed. "People getting along just fine" is not an enticing headline, it doesn't sell newspapers. For whatever reasons, we rarely discuss this N word: Non-Muslims, and more specifically the role and the contributions that these non-Muslims have had or what role they play in it. Perhaps it is political correctness, indeed the term non-Muslim is much kinder compared to 'heretic', 'unbeliever' or the less apologetic 'infidel'. Even the use of the arabic term kafir (plural kuffar) has been discouraged (seen by some as derogatory).

Non-Muslims represent a significant component of the human capital in Islamic finance, many having brought extensive experience from the conventional financial world. At the same time, a new wave of young Muslim professionals are gradually filling the industry ranks as they seek to directly engage the industry (and their faith). Wait a minute, I've seen this movie before: Muslims and non-Muslims coming together and delving into issues of faith and God.... the perfect script for a summer blockbuster that likely involves conflict and dis-chord.

In practice though the outcome in Islamic finance is very much anti-climactic, we see a dynamic and peaceful integration of multiple backgrounds, cultures, races, and faiths.

The J Word

Of course it is no mystery that Islam has expanded throughout history, it has done this both peacefully and under the sword. It is no different to the other major religions of the world, although you would struggle to find an equivalent in Islam for the Spanish inquisition, for a Torquemada or the Encomienda. If you are rushing to Google allow me to save you some clicks of the mouse, the latter refers to the worker camps that transformed the Americas into a cultural wasteland. The inhabitants of Kafiristan might have been converted to Islam, but history has shown that this was not always a priority (or even a goal) of Muslim expansion, it responded more to political and economic requirements rather than the urge to indoctrinate neighbouring lands. The concept of freedom of religion is part of the teaching of Islam and while it might have been at the discretion of the Afghani ruler it has been exemplified in many different occasions across antiquity.

Editor's Note

Nonetheless some Western commentators have been more than eager to saturate any discussion about Islam with the J word: Jihad. There have also been plenty of attempts to demonize Islamic finance itself by labelling it as some sort of 'financial jihad'. This is rather ironic (if not very unintelligent) since the industry is an example of modern Islamic principles being put into practice, a transparent and pragmatic exposition of the values of Islam. Not only that but jihad is not a synonym for holy war, its meaning is multidimensional and by most observers it constitutes a prompt for internal self-discovery rather than an external directive. I wonder if those same commentators are familiar with any other concept beyond their narrow definition of jihad.

Some individuals assume that because a Muslim ruler declared a holy war sometime in the 16th century this somehow equates to Muslim society today. The same faulty logic would suggest that a modern day Christian would be an accessory to the Spanish inquisition or should answer for the cultural obliteration of the native Americans! Lets remind ourselves that we should learn and appreciate history, not be the slaves of it.

To Read or to Write, That is the Question

So what is the role and standing of non-Muslims in Islamic finance? Recently, a discussion in our online forum ([see reference link](#)) revolved around whether a non-Muslim could make inroads into the field of Shariah advisory. This raised the additional question of whether a non-Muslim could become a Shariah scholar (as well as whether a scholar can be a man or a woman). While I am not aware of any precedent for a non-Muslim scholar I doubt this would be possible. However, the short debate did highlight an area where frictions could arise even though they rarely did as reason and understanding prevailed.

This might be a sensitive issue, but it boils down to a very simple distinction: having the ability to issue/write a fatwa is different from having the knowledge to read/understand a fatwa. In other words, the focus should not be on Shariah scholars but rather on compliance officers. Our attention seems to be geared towards the knowledge and intention of the individual that wrote the fatwa for the financial product. However, lets also focus on the knowledge of the individual

that is tasked with digesting such a fatwa and implementing its message within the financial institution.

Should we expect every compliance officer in Islamic finance to be Muslim? This might be impractical for boutique firms and could create yet another bottleneck of human capital. Instead, we should ensure that compliance officers are well-trained in Shariah, shower them with plenty of helpful tools, and ensure that their roles & responsibilities are better defined. It is curious that when you perform due diligence on a fund manager we will direct our queries to the head of risk management, trading teams, or chief financial officer. However, when it comes to matters of Shariah compliance we are directed to an external individual, sometimes located multiple timezones away, who probably has had a few days of interaction with the financial institution and maintains an arms-length relationship.

It seems that the understanding of fatwa (and that of Shariah itself) has been outsourced to this third party, which sits outside of the financial institution. Thus when you inquire on the Shariah compliance of a product you are invited to refer to the Shariah supervisory board (often comprised of three or more well-known Scholars). Of course one cannot downplay or diminish the importance of scholars in this process, but shouldn't we also be directed to talk to the Chief Risk Officer or Chief Compliance Officer or someone in a similar capacity? It boils down to whether Islamic finance and the understanding of the principles of Islam is to be an internal function, rather than an external one. What is the point of having an investment bank launch an Islamic product (with all the corresponding bells and whistles) if nobody within that organization understands an iota of Islam?

The Modern Day Nuristan

Upon the conquest of Kafiristan, the region came to be known as Nuristan, the land of light. Islamic finance has the opportunity to be regarded as a new land of enlightenment, where we can shine a spotlight on its multi-ethnic and multi-cultural amalgamation. We might as well regard Islamic finance as a large 'special purpose vehicle' as it can be used to exemplify a progressive & modern Islam, a testament to its inclusiveness.

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

IFSB - Published Standards

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

Considering that the flow of information in the industry is in so many ways limited or lethargic, the published standards of the IFSB represent a shining example of efficient dissemination. We include below the list of current IFSB standards, all of which are available free and online, an indispensable starting point for any Islamic finance institution:

IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

IFSB-3: Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)

IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)

IFSB-5: Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)

IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes

IFSB-7: Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate investment

IFSB-8: Guiding Principles on Governance For Takaful (Islamic Insurance) Undertakings

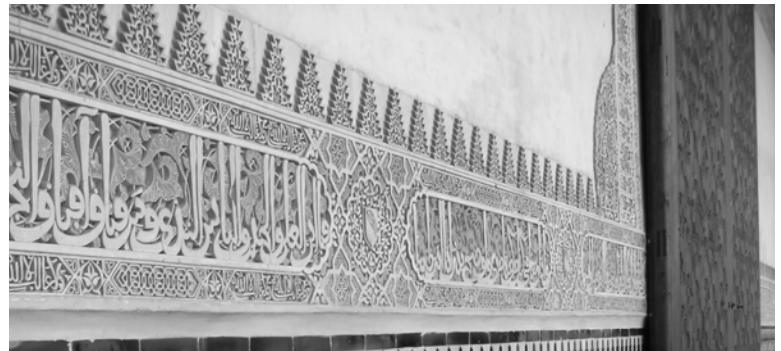
IFSB-9: Guiding Principles on Conduct Of Business For Institutions Offering Islamic Financial Services

IFSB-10: Guiding Principles On Shariah Governance Systems For Institutions Offering Islamic Financial Services

Shariah Compliant Structured Product: Consecutive or Rolled Murabaha

By Nikan Firoozye, PhD

Nikan has over 14 years experience in leading Wall Street and City firms on the buy and sell-side including Lehman Brothers, Goldman-Sachs, Deutsche Bank, Sanford Bernstein Alliance, Citadel and Nomura where he is currently Head of European Rates Strategy. He has worked in a variety of primarily technical or quantitative fixed income roles from Rates & Hybrids Structuring to Rates Strategy and Quantitative Modelling to Asset Allocation and Risk Management to Prepayment Analysis and Securitization and Capital Markets. Education: PhD Mathematics (Courant Institute, NYU), Asst Prof University of Illinois.



Structured Product, by its nature is something that can deliver diverse risky cashflows to investors. Delivering this to a conventional investor involves hedging, sometimes statically, sometimes dynamically with vanilla options, swaps and swaptions, basis and asset swaps, correlation products and a whole host of other 'slightly less exotic' products. That being said, structured product is a huge business, one that generates large returns for banks (less so recently) and to a certain extent encourages Islamic Structuring desks to look for ways to deliver the same cashflows to Islamic investors.

Can it be done? Yes, well, maybe, or depending on your viewpoint, definitely not. There are two standard methods for delivering structured product cashflows to investors that are in common use today. Both are exceptionally simple and banks seem to believe they are applicable in a wide variety of cases. As we have already spoken at some length on the Wa'd Swap (see reference link), we will focus on the Rolled Murabaha approach.

Sample Structured Product

We take as a case in point a principal protected commodity-linked range-accrual. The example structure will be as follows with initial price of \$100.

Final Payoff in year 5: $\$100 + (\text{LIBOR}(t) + \text{Spread}) \times \text{Num} \times \100

where Num = $(1/252)$ number of days over the 5Y of the product that Commodity(t) is between LB (Lower Bound) and UB (Upper Bound).

(1/252 would usually be some other more conventional daycount convention, but we don't want to go into that here.)

Featured Structure

Conventional Structure

To structure this conventionally we need the following:

1. We purchase a zero-coupon bond. With prevailing rates at 5% and the structure maturing in 5Y, the cost is around \$75.
2. With the remaining \$25, we enter into the risky trade, effectively purchasing a warrant/option linked to this range accrual cashflow. If we simplify the structure to say that it pays $(\text{HighFixedInterestRate}) \times \text{Num} \times \100 , we note that this is merely a set of daily digital options on the commodity, struck at LB and UB. The payoff of each daily digital is exactly $\text{HighFixedInterestRate} \times \$100 \times 1/252$. Each payoff is tiny, so the premium for each daily digital is also tiny. Combined it will be \$25 worth.
3. In reality, nobody would hedge using daily digitals. The trader uses a model to determine greeks (deltas, gammas, vegas) with respect to the commodity and commodity volatility, etc. The structure is a bit tricky since the gamma switches signs at the upper and lower boundaries, effectively leading to a more erratic hedging behaviour. Nonetheless, it is a very standard product.

We should fully expect that Spread is relatively large to make this attractive, and that in a backtest the structure will appear to have some amazing return over the last 10 years (as though someone actually offered us the structure for the last 10 years? Not likely.).

Rolling Murabaha: Shariah Compliant Alternatives

This would be a standard commodity-linked range-accrual product. Unfortunately, we cannot deliver it exactly as is, but with some very minor modifications.

1. First we enter into a 5Y murabaha which matures at value \$100 (the principal protection component). The markup will be prevailing 5Y swap rates (since there is no 5Y LIBOR). If rates are close to 5%, then we effectively use \$75 for this.
2. The bank offers the investor a unilateral undertaking to enter into a subsequent murabaha starting in 5Y for the duration of 1M. This second murabaha will have a markup of $(\text{LIBOR} + \text{Spread}) \times \text{Num} \times \100 where this markup is determined from today to year 5 at which point it is fixed.
3. If the markup is less than or equal to 0 (it will not be negative in this specific example but we can devise cases where it easily could be), the client receives \$100 in year 5 and chooses not to roll into the second murabaha.
4. If the markup is in fact positive, the client will choose to exercise the wa'd and roll into the second murabaha, receiving $\$100 + (\text{LIBOR} + \text{Spread}) \times \text{Num} \times \100 in 5Y and 1M.

This is not exactly fair as stated. The \$100 from the first murabaha should at least get 1M libor over the final month. But except for some minor pricing and minor timing related differences, we have managed to replicate the conventional range-accrual structure.

The Deconstruction

Principal protected product can easily be decomposed into a risk-free principal protection piece (well, not exactly risk-free since it is usually financial paper), and a risky option/warrant. Oftentimes this warrant can and will be traded separately, depending on the risk-profiles of the end-user. In European markets, most retail investors want principal protection, while in Asia warrants are quite common.

In this specific case, we can split off the first murabaha as an ordinary murabaha (i.e., a zero-coupon bond). In the above example we invested \$75 in the first murabaha. Where did the remaining \$25 go? It was spent on the warrant. Effectively, we spent \$25 to purchase a wa'd (promise) to enter a murabaha starting in 5Y time, maturing in 5Y1M, with a markup linked to a particularly off-market rate of $(\text{LIBOR} + \text{Spread}) \times \text{Num} \times \100 .

Featured Structure

We have effectively purchased a promise. And this undertaking allows us to enter into a murabaha not at the prevailing rate of 1M LIBOR at that time, but instead some odd range-accrual-linked cashflow. Note that unlike the conventional structure which can be sold to a third party or resold to the bank, this rolled murabaha is not transferrable. Otherwise it would be bay' al dayn (sale of debt). The wa'd swap structure is fully transferrable.

The Criticism: Short but Sweet

We state the criticism of this structure succinctly:

1. The structure involves entering a murabaha with a markup linked to a possibly non-shariah-compliant underlying/cashflow. The muslim investor, by buying this product, enables, enjoins or effectly invests in non-compliant products. (that extra \$25 that was set aside to buy daily digitals in the conventional case? Well, here it 'buys a promise to enter a murabaha'. Effectively, it allows/compels the hedging bank to hedge using options and futures, etc, all haram assets. Consequently, Sh Yusuf Talal DeLorenzo's objection to the Shariah-Conversion Technology applies here (see reference link). NB: If the second murabaha had a markup linked only to halal underlyings then Sh Yusuf's objection does not apply.

2. The structure involves a purchase of a promise (to enter a second murabaha). Can promises be purchased? Wa'd is a unilateral promise with no consideration under virtually all definitions. Can it be purchased? I believe most shaykhs would say no. A promise is an intangible which cannot be owned and cannot be the subject matter of sale in Islam. One cannot even buy usufruct, let alone intangibles such as promises. Instead the nomenclature is that the offering bank asks to charge an 'upfront fee' to offset expenses for offering this wa'd/undertaking. But a 'fee' is consideration. The wa'd has suddenly been turned into a unilateral promise for consideration.

This sort of structure allows a whole range of otherwise haram activities to be made 'legitimized' merely through the linking process. Is this right or appropriate? Note that this method for packaging structured product is in fact very common. Many if not most structured product are delivered this way. The wa'd swap is playing catchup. Note as well that all the interesting and more intricate structures we have talked about before are rarely used for structured product cashflows. Why? Because they are more costly and not nearly as general! The wa'd swap and the rolled murabaha are so simple we can even devise platforms for their issuance and standardized legal matter for each new product. It has revolutionized Islamic Structuring. No need to think of how to adapt this or that Islamic contract and combine them to deliver interesting end-results. Instead we can just jam it all into Murabahas or Wa'd swaps.

Mass production on the way!

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

When Sukuk Default - Asset Priority of Certificate-holders vis a vis Creditors

By Mohammed Khnifer

Mohammed Khnifer is regarded as part of a 'second generation' of Islamic banking practitioners who have a solid academic background in Islamic finance. He is a holder of an MSc in Investment Banking & Islamic Finance from Reading University and is a Chartered Islamic Finance Professional (CIFP) from INCEIF. He is one of the most prolific and well-known journalist specializing in Islamic Finance today. For the past six years he has been in charge of the editorial content for the Islamic Banking section of Al Eqtisadiyah (Kingdom of Saudi Arabia).



Asset-backed or Asset-based Issuance?

Sukuk is considered the most sought after financial instruments in the Islamic Finance industry. Western investors view them as debt-like fixed-income instruments, whereas Muslim investors purchase them as it complies with their religious beliefs, but at the same time serve their needs for relatively less-risk investments than equities or real estate.

Sukuk were in the spotlight lately with a high profile defaults that helped to create new perspective on the way these instruments should be legally structured. In this research, three sukuk issuances will be examined: 1) the asset-backed Tamweel RMBS, 2) the asset-based Tamweel Sukuk Limited ("TSL"), 3) the asset-backed issuance of East Cameron Gas (ECG), which has defaulted.

Before we examine the underlying assets of these issuances we need to shed light on a highly controversial subject, i.e., the ownership of the assets underlying sukuk. Just like most bonds, most sukuk issued today are asset-based, which grants the certificate holder rights on a portion of the cash flows. There are often no direct links to actual assets, which is a condition of Shariah. One of the rationale behind asset-based sukuk is the likelihood of obtaining higher ratings, as such sukuk are linked to the credit of the originator that raises the funds, not to physical assets.

From the Shariah perspective it is essential that sukuk are backed by a specific, tangible asset throughout its entire tenure and sukuk holders must have a proprietary interest in the assets which are being financed (Yean, 2008). Indeed, in its recent pronouncement the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) advised originating companies to sell and "legally" transfer ownership of the underlying assets to investors. Michael McMillen (2008) defines asset-backed sukuk as asset securitizations involve asset transfers from an originator into a trust or similar SPV, with sukuk issuance by that trust or SPV and payments on the sukuk derived from the payments received in respect of those transferred assets.

In the past years, Tamweel PJSC ("Tamweel") has issued three types of sukuk, one of which was hailed as the first true sale by the industry. The Shariah-compliant residential mortgage backed securitization (RMBS) transaction was worth US\$210 million and had four ijara sukuk tranches. The underlying assets that back this lease-to-buy ijara are single family homes (villas). Moreover, villas are in short

supply in a rapidly growing real estate market with limited available expansion space and infrastructure. These types of properties are thought to be more resistant to price volatility and depreciation (as compared with apartments, of which there are many more). Further, villa purchasers tend to be families, rather than more transient, single residents (McMillen, 2008).

In the case of these first Tamweel sukuk freehold titles to the underlying properties were transferred to the sukuk holders along with the associated ijarah cash flows (Yean, 2008). Further, and importantly, property titles are registered in the name of the SPV that issued sukuk and sold them to sukuk holders. Any losses on those cash flows (that arise from the sale of distressed property) are passed on to the SPV and subsequently the sukuk holders, who are then directly exposed to asset price risk and as a result its liabilities.

There has been a healthy debate between scholars and lawyers over “legally” registering ownership of assets to sukuk holders as the fees of such registration are costly for the issuer. But, legal ownership acts also as a protective legal buffer if Tamweel, for example, went into insolvency. Unlike asset-based sukuk, this type of securitization should continue to perform regardless of the financial distress of the originator and certainly the process of liquidating the assets will be much easier for the sukuk holders.

The second issuance of Tamweel is an asset-based one where the investor’s legal rights for the ownership of the underlying assets is limited. Tamweel Sukuk Limited (“TSL”) is a special-purpose vehicle incorporated in the Cayman Islands and created to issue Sukuk Trust Certificates to investors and use the proceeds to acquire a pool of Shari’ah-compliant assets from the mortgage finance company Tamweel. TSL, as Trustee, will acquire the assets in the Trust. This special issuance contains two types of sukuk, which merges it into one asset. It has a portfolio of leased assets (i.e. residential ijarah lease-to-own assets) as well as portfolio of Istisna’a property assets that are under construction.

After examining the TSL prospectus, there was no clear mentioning that the \$299.6 million sukuk issue is an asset-based one. Nonetheless, there were some signs that this is the case. When it comes to transferring the portfolio of assets, the originator gave no assurance that any rights, title and interest in and to the portfolio assets has been or will be transferred to the trustee (TSL Prospectus, 2008). Unlike asset-backed sukuk, these certificate holders have no recourse against any other assets of the issuer or the trustee or any right to cause the sale or other dispersion of any of the trust assets, except during the initial purchase undertaking.

On the other hand, East Cameron Gas Co.’s \$165.67 million investment trust certificates are an asset-backed sukuk that were secured by an interest in the oil and gas royalty rights on two gas fields in the Gulf of Mexico. It was structured as a Musharaka (an onshore SPV) between an offshore SPV domiciled in the Cayman Islands and the originator, East Cameron Partners. The offshore SPV issued sukuk and contributed the proceeds to the onshore SPV, while the company made an in-kind contribution of the overriding royalty interest (ORRI) in the lease properties (Goud, 2009).

The unique part of this Musharaka sukuk is the ORRI, which is recognised legally in Louisiana as real property. The ORRI gives the onshore SPV the right to receive a certain volume of production—oil and gas—over the term of the sukuk (Goud, 2009). The oil and gas is then sold and the proceeds are split between the issuer and the offshore SPV, which uses the funds to pay the periodic payments and repayment of principal to sukuk investors. According to Blake Goud, an Islamic finance researcher, the ORRI provides the investors with protection greater than many other debtors in bankruptcy proceedings. This protection is created with a “true sale” of the ORRI to an SPV to ensure it is bankruptcy-remote; that is, through a structure to minimise the chance that the ORRI can be included in the issuer’s bankruptcy estate, which would subject it to claims by other creditors.

Bankruptcy Remoteness and Why it is Crucial

SPVs are often described as “bankruptcy remote.” Moreover, it is used in the context of a transaction where underlying assets are being isolated for the benefit of the sukuk holders (for example, assets are being “sold” to a bankruptcy remote SPV). Hence, the newly created SPV has no exposure to the liabilities of the originator, other than the liabilities of the underlying assets. There are some countries where bankruptcy remoteness is assisted by legislation. For instance, in the Cayman Islands it is possible to receive a certificate from the Government confirming that the newly formed SPV does not ever need to pay tax for 20 years, thus eliminating a potential liability.

In the light of the above instance, the asset-backed sukuk holders can reap the full benefit of bankruptcy remoteness. After identifying which assets are to be securitized, the originator of the securitized assets transfers those assets to the SPV. The SPV will then hold the assets for the benefit of the sukuk holders and issue the sukuk to them. The purpose of this asset transfer is to separate the assets from the risks associated with the originator. This is done especially to reduce the risks associated with a potential bankruptcy or insolvency of the originator, and place them in a vehicle (i.e., an SPV) that has a low likelihood of bankruptcy or insolvency (McMillen, 2008).

To apply the above in our case study, Tamweel PJSC (the originator and one of the two servicers) is under severe liquidity pressure. As Tamweel RMBS constitutes a true sale, the sukuk holders are assured that their underlying assets had been removed from the estate of the originator. Because of this bankruptcy remoteness, the assets will continue to produce rental payments even if the originator files for bankruptcy. This makes the certificate holder only exposed to the originator as a servicer and not the source of cash flows.

Nevertheless, the bankruptcy remoteness function cannot work properly with the asset-based issuance where the beneficial right of the assets is usually sold to the SPV. From a legal perspective, the originator owns the underlying assets and not the certificate holders who have a weaker stake to the underlying assets. This means if the originator files for Chapter 7, the sukuk structure can collapse as it will be wrapped up in a bankruptcy of the originating company. Thus, the sukuk holders will join other creditors to make claims on the assets, which might have a beneficial ownership or fully owned by the SPV.

Contrasting Fixed and Variable Income Streams

The income streams for Tamweel RMBS are both fixed and floating rate. The total instalment due is derived from three components of rent to be paid: (i) fixed rental amount for the recovery of the principle (Hoelter, 2007); (ii) variable rental, which is the profit calculated on the reducing balance of the fixed rentals at a fixed rate, in the case of fixed *ijarah*, or, in the case of flexible *ijarah* or hybrid *ijarah*, at a rate (linked to the Emirates Interbank Offered Rate, EIBOR) which may be reset on a regular basis by the originator (Tamweel RMBS Prospectus, 2007); a supplementary rental calculated by reference to the obligations, expenses and fees the lessor incurs in maintaining and repairing the properties (Hoelter, 2007).

For the periodic distribution of Tamweel Sukuk Limited, the certificate holders are entitled to a floating rate at EIBOR (UAE Interbank offered rate) 3 months plus 2.25% (TSL Prospectus, 2008). On the other hand, the East Cameron sukuk had a fixed payment (11.25% annually). However, there was also a variable component because the sukuk returns depended upon the production quantities (the overriding royalty interest specified a fixed quantity of natural gas be delivered to SPV). It also contained a redemption feature by where a percentage of the sukuk would be redeemed if production exceeded a certain level.

Risk Exposures for Sukuk-holders

The certificate holders of Tamweel RMBS are clearly exposed to the assets that backed such issuance. The credit risk of this true, asset-backed sukuk is driven primarily by the credit risk of the underlying assets, including its liabilities, which have been “sold” to investors, and not the credit risk of Tamweel itself. Despite the stressed economic environment in the UAE this well seasoned *ijarah* portfolio is performing well with 0.00% defaults since issuance and 0.25% of 60+ day delinquencies as of August 2009 (Howladar, 2009). Nevertheless, there are risks of losses associated with declining property values, lack of liquidity in the property market—which would make it more difficult to sell properties—and the high exposure to expatriates who may leave Dubai with short notice if economic conditions deteriorate further.

The asset-backed sukuk has multiple classes (A, B, C and D) of investors, with each class having a more senior legal claim to the secured assets (which are very similar in nature to securitized mortgages elsewhere). Thus, there is a risk relating to the level of the sukuk class one purchases due to what they call the “waterfall” effect if payments slow, delinquencies rise, and defaults increase.

For example, in the waterfall structure, no amounts will be paid to the holders of a class of notes until all amounts owing to the holders of every class of notes having a higher payment priority have been paid in full (Tamweel RMBS Prospectus, 2007).

The complex engineered structure of Tamweel RMBS also makes it exposed to exchange rate movements which may adversely affect the issuer’s ability to meet its obligations under the notes (Tamweel RMBS Prospectus, 2007). Issues may arise due to the fact that the *ijarah* rental payments are designated in Emirati Dirhams (“AED”) and the sukuk payments are in U.S. dollars. While the dirham is currently pegged to the U.S. dollar, there is a possibility, although considered remote, that the fixed rate may be removed in the future. Currency hedges with through banks and exchanges could be effective to address various currency and exchange rate issues of this type (McMillen, 2008).

On the other hand, the asset-based TSL is not legally “backed” by an asset. Hence, its rating is driven directly by the strength or weakness of Tamweel, not the assets. This sukuk was downgraded August 2009 in line with deterioration of the originator and its market. In light of their exposure to the originator, sukuk holders are exposed to Tamweel’s customer credit risk as well as its operational risk

(TSL Prospectus, 2008). In addition to the risk of over-concentration, i.e. Tamweel's business is regionally concentrated in the UAE. It is noteworthy that upon the insolvency of an asset-based sukuk originator, the assets involved would be taken back by the bankruptcy estate. Sukuk holders have no right to cause any sale or disposition of the trust's assets (TSL Prospectus, 2008). Sukuk investors would have no first-lien or prior ranking or security above any other unsecured creditor (Howladar, 2009).

Further to the above, there is a Shariah risk embedded within the sukuk certificate. There is no assurance that the certificates will be Shariah compliant as differences in opinion among scholars are possible (TSL Prospectus, 2008). In the prospectus, TSL advised investors to obtain their own independent Shariah advice as to the permissibility of the structure, the issuance, and the trading of the certificates. On the other hand, the lack of a liquid sukuk secondary market could adversely affect the liquidity and value of the certificate holders' investments.

As the East Cameron Gas issuance involves in the energy sector, sukuk holders were exposed to certain risks. For example, the volatility of natural gas and condensate prices may adversely affect payments on the sukuk. In order to hedge against severe price fluctuations in oil and gas markets, there was a Shariah-compliant hedge that established a price collar between \$7 and \$8 per million BTU (MMBtu) on half the expected products gas production, and a put option at \$6 per MMBtu for an additional quarter of anticipated production (Goud, 2009).

One should mention the risk of natural catastrophe. The originator's business is located in the Gulf of Mexico and this concentration of activity makes its business vulnerable to the risks associated with that region, including the effects of severe weather. Shortly after the September 2008, hurricane Katrina damaged the underlying assets of the sukuk, S&P downgraded the issuance as a result of the negative impact from the hydrocarbon mix shortfall enforcement event on the overriding royalty interest in oil and gas reserves (ORRI), which is the primary collateral for the sukuk. This enforcement event was triggered by the breach of the 90% minimum stressed reserve level of the hydrocarbon mix threshold stipulated in the transaction documents (Lampasona, 2009).

There are also different types of risks that the issuer may incur. The prospectus has placed great emphasis on the originator's possible failure to successfully develop exploitable reserves or improve production capabilities. This may adversely affect the viability of its operational structure. Moreover, unless the originator replaces its oil and natural gas reserves, its reserves and production will decline, which would adversely affect the payments on the sukuk. There is also uncertainty with respect to U.S. tax treatment of the sukuk, and alternative tax characterizations by the U.S. regulatory authorities may materially affect investments in the product (ECG Prospectus, 2006).

The Role of Rating Agencies

Before we tackle the role of rating agencies in regard to the above issuances, we should first shed light on their methodology for rating such complex instruments. All the rating agencies concur that their ratings are an opinion about the ability and willingness of the originator to meet financial obligations in a timely manner, without commenting on Shariah compliance. Investors rely on such ratings in order to evaluate the risk aspects of the sukuk. From the originator's perspective, a good rating will allow for a well-priced and viable sukuk for the capital markets.

Standard & Poor's details its approach by dividing the sukuk into two categories: 1) Sukuk with full credit-enhancement mechanisms. Under this structure, the sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral (Hassoune, 2007). The guarantor provides Shariah-compliant shortfall amounts in case the SPV cannot make payment. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor; 2) Sukuk with no credit-enhancement mechanisms, i.e., the pure asset-backed sukuk. The ratings on these sukuk are largely based on the ability of the underlying assets to generate sufficient cash to meet, in a timely manner, the SPV's obligations. Standard & Poor's ratings, in this particular case, are based on the performance of the underlying assets under different stress scenarios along with the expected value of these assets at maturity.

All rating agencies exercise due diligence before the rating is given. Moody's ratings address the expected loss on an investment relative to the promise as well as the risk of default. Khalid Howladar (2009) reveals the key substance of a sukuk is the return/profits, payment/cash flows of the instrument as well as risk of loss, or how much income/profit can the investor expect to receive when comparing it to how much was due/expected.

Moody's also relies heavily on legal opinions from law firms expert in local and international law as to how the law would be expected to operate in such circumstances. If Moody's believes that such contracts are not binding or that they are voided in a bankruptcy court

situation, then it gives limited value to the assets in the structure. This is why the risk and rating analysis is usually focussed on the issuing corporate or bank.

Now that we know the background, we should now examine how the two Tamweel sukuk issuances were rated. In August 2009, Moody's lowered Tamweel's long-term issuer rating to Baa1 from A3. The ratings remain on review with direction uncertain. Given the direct link for an asset-based sukuk, the rating on Tamweel's \$299.6 million asset-based Sukuk was also lowered to Baa1 from A3, and also remains on review with direction uncertain. The same issuance was downgraded by Fitch to BBB+ from A. Meanwhile, the asset-backed sukuk (Tamweel RMBS) continues to do well. Hence, no rating downgrade from Aa2, Baa1 and Ba1 for the Class A, B and C notes. For Fitch, there was no downgrading from AA, BBB+ and BB- for the Class A, B and C notes. The D tranche was unrated by both agencies.

On the other hand, the asset-based TSL was engineered to trigger a redemption event, once the obligor is downgraded by at least two notches at any one time between the closing date and the maturity date. Following the occurrence of a rating downgrade event, the certificates may be redeemed in full on the rating downgrade redemption date at the redemption amount, and the trust shall be dissolved following such payment in full (TSL Prospectus, 2008). Indeed this explains the risk associated to asset-based issuance and why this structure was engineered to mitigate such risk for the sukuk holders.

In the case of East Cameron Gas Co.'s \$165.67 million investment trust certificates (sukuk), surveying the securitization was vital for the sukuk holders. S&P downgraded the transaction to 'CC' from 'CCC+' when the structure hit a trigger, breaching a 90% minimum stressed reserve level of the hydrocarbon mix threshold. In March 2009, the agency cut the deal to 'D' on skipped payments and withdrew the rating; the latter event was in response to a failure to receive servicer reports (Lampasona, 2009). The deal initially stood at CCC+ largely because significant amounts of the energy deposits that collateralize the deal were proven undeveloped at that time.

Legal Risk and the Role of the Legal Adviser

After examining the prospectus of Tamweel RMBS and Tamweel Sukuk Limited, it is fair to say that the certificate holders share the risk of not enforcing a foreign judgment in Dubai. Under current law, the courts of Dubai are unlikely to enforce a foreign judgment without re-examining the merits of the claim and may not observe a choice by the parties of foreign law (such as English law, Cayman Islands law or Jersey law) as the governing law for a transaction. This could have an adverse effect on the amounts available to be paid to the certificate holders (Tamweel RMBS Prospectus, 2007). Judicial precedents in Dubai generally have no binding effect on subsequent decisions. These factors create greater judicial uncertainty.

For Tamweel RMBS, the asset composition elements and the legal structure of the sukuk were designed to minimize significant uncertainties. Those uncertainties include: (a) uncertainties as to the interpretation, application and enforcement of relevant laws (most notably, recently-issued bankruptcy and collateral security laws that have not been the subject of judicial proceedings); (b) bankruptcy exposures of the title holders to the properties (McMillen, 2008); (c) incomplete title registrations in respect of the properties as a result of the implementation of a new title registration process at the newly-established registration authority (Dubai Land Development).

On the other hand, Tamweel Sukuk Limited has a different type of legal risk as it is exposed to the originator and not the underlying assets. In the event of Tamweel's insolvency, UAE bankruptcy law may adversely affect Tamweel's ability to perform under the purchase undertaking and the service agency agreement and therefore the trustee's ability to make payments to certificate holders (TSL Prospectus, 2008). Ultimately the payments distributions linked the certificates are dependent upon Tamweel making payments to the trustee. If Tamweel fails to do so, it may be necessary to bring an action against Tamweel to enforce its obligations before the UAE courts which may be costly and time consuming.

As for East Cameron Gas (ECG), it was unique from the start. Apart from the legal complexity of the sukuk structure, there was a lack of information on how the articles of the investment offering prospectus stood in the face of bankruptcy court. In October 2008, East Cameron Partners (the originator) filed for Chapter 11 and created uncertainty about how the sukuk holders would be treated under U.S. bankruptcy law, which was as-yet untested using this kind of Shariah-compliant structure. The Islamic finance industry had to wait a year and a half to hear the bankruptcy judge issuing a court order accepting the transfer of East Cameron's assets to the sukuk holders. Finally the Islamic industry could rest, knowing precedent was established in this critical area of creditor rights with Islamic structures.

In this section, I will attempt to highlight the sequence of events for this case, a case which tested the viability of the sukuk structure within the U.S. legal system. Most importantly, we will come to realize whether the advantages of an asset-based sukuk and a bankruptcy-remote SPV can indeed trigger protection of sukuk holder rights on claims to underlying assets.

Lex Islamicus

As is commonly known a company is in a situation of severe financial distress, it will often do whatever it can to back away from legal obligations to the creditors who once funded its investment activities. Sukuk holders were not an exception. The originator tried to wrap up the sukuk holders' assets and claimed that the transaction was not a "true sale" but a secured loan disguised as a true sale. Under conditions of a true sale the sukuk investors should logically have sole rights to the underlying assets. Under such conditions the originator, behind the sukuk holders in claims to assets, would lose its rights and would have rights to the assets only after resolving creditor claims in Chapter 7 (liquidation).

Indeed the legal risk was real and a worst case scenario was possible, especially for a secular legal system that does not recognize Shariah structured instruments. In July 2009, *Aleqtisadiah* newspaper quoted a source close to the case admitting that there is a need to "establish the sukuk holders ownership of the assets in such a way that courts around the world recognize their ownership rights and rule accordingly" (khnifer, 2009). He continued, "At present, the matter is unclear as to whether sukuk holders enjoy contractual rights to the assets like bondholders, or creditors, so that judges will therefore not rule in favour of their ownership, or whether they enjoy proprietary rights and are therefore considered by the courts to be equity holders," (khnifer, 2009).

The anonymous source then admitted how the originator, investment banks and law firms spent little time discussing how to protect sukuk holders' rights in case a default event took place. "In their desire to deliver products (sukuk) that resemble credit instruments (like bonds), originators have sometimes blurred the distinction between credit and equity; and this has led to difficulties for sukuk holders" (khnifer, 2009). "the originator spent a lot of time on the matter of credit enhancements (protecting banks) and very little time on protecting investors' rights," the source added (khnifer, 2009).

In an order dated 31 March 2010, the judge issued a decision which, surprisingly, vindicated the East Cameron Sukuk structure as there was mounting criticism over the legal firm who structured them. It was a victory for the structure in that the Sukuk certificate holders were able to get full ownership and possession of the assets without sharing it with the other creditors. As a matter of U.S. law, the result is the treatment of the SPV assets as being the product of a true sale. According to Robert E. Michael, bankruptcy lawyer at Robert E. Michael & Associates PLLC, (personal communication, 24 April 2010), the true sale element was upheld by allowing the debtor SPV to be the Seller. This essentially meant that the SPV did in fact own the assets, and was not merely a collateral holder for secured loans.

A court document points out that the judge approved the Asset Purchase & Sale Agreement between East Cameron Partners and EC Offshore Properties, Inc., which is owned by the certificate holders. According to Blake Goud, (personal communication, 25 April 2010), the Asset Purchase Agreement transferred the title over both leases (East Cameron block 71/72) to the sukuk certificate holders. "The purchase price, which will not be paid in cash, includes the liabilities assumed by the buyers, as well as the \$4.865 million extended as Debtor In Possession financing (DIP)," he said after examining the court order. The total DIP financing includes all principal, interest, fees, expenses and other charges (Goud, 2010).

To put it bluntly, it appears the sukuk legal structure was in fact imperfect to some extent. For example and without going into details, there were two SPVs, one on- and the other offshore. As the transaction is asset-backed it should have made it easier for the sukuk holders to trigger the bankruptcy and take control of the assets. However, due to legal flaws in the structure they had to wait a year and a half for resolution. In light of recent developments, it becomes clear a third SPV independent of the others needed to be formed under a *Musharaka*, which would have made the separation of the assets from the bankruptcy estate much easier.

While the event proved successful for sukuk investors, it was nonetheless a setback for the Islamic finance industry in that the deal was structured as a purchase, not a distribution to owners. According to Mr. Michael, the result was a decision that accomplished everything the Islamic finance wanted on a practical level. The assets of the sukuk will go to the certificate holders free and clear of claims of creditors of others; but doing so created a precedent where they did not own undivided interests in the assets. Thus, there is legal precedent here, which should concern lawyers, that the sukuk certificate holders were treated as if they were third party buyers, not owners or even secured lenders.

All in all, we are certain from the ECG sukuk that it was the first legal case in Islamic finance history that proved the asset-backed structure (as opposed to the asset-based structure) can indeed protect investors once a default event is triggered. We can as well say in confidence that if these securities were asset-based, then the sukuk holders would have joined the queue with the other creditors. Hopefully lessons learned will contribute to a new generation of sukuk with more thorough due diligence and greater legal protection for investors.

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

Gold Bullion and Islamic Private Equity: Protection and Production

By Shahzad Siddiqui & Toby Birch

Shahzad Siddiqui is a Toronto-based lawyer and Chief Legal Officer at Broadwater Capital Inc, a Toronto-based Islamic finance firm. He was previously an investment banker at Ittihad Securities, an Islamic private equity firm in the same city. He is an author of several Euromoney publications including Sovereign Sukuk, co-written with a manager at the Ontario Financing Authority, and Fruits of the Orchard: Endowments for Mosques and Islamic Charitable Organisations in Western and Muslim Lands.

Toby Birch is Managing Director of Oppenheim and Co Limited (investment management) and Guernsey Gold Limited (bullion dealing). He is a Chartered Fellow of the Chartered Institute for Securities and Investment and also holds the Institute's Islamic Finance Qualification. He is author of The Final Crash, one of the most prescient predictions of the credit crisis published in May 2007. He was previously CEO at Blackfish Capital Holdings where he managed a resources-based hedge fund and senior investment manager at Bank Julius Baer in Guernsey.

I. Redux: how Private Equity is aligned with Islamic Philosophy

Writing in the Financial Times, Nassim Taleb, author of The Black Swan, highlighted the robustness of equity compared with the destabilising effect of debt.^[i] While equity volatility is transparent and immediate, debt-based risks are not, except when in default. Ideally, banks should evolve from accumulating hidden risks to acting as agents of economic activity. This is exactly what Islamic financial theory promotes. Equity is the purest way to share risk and reward either by way of private equity for more mature and specialist projects or venture capital for start-ups. As noted in chapter 2, on the history of private equity, Silicon Valley has been the hotbed for funding some of the most successful companies in American corporate history using venture cap methods.

However, events in America have also proceeded in the opposite direction, with the formation of the Federal Reserve in 1913. The rationale behind the Reserve was to provide 'elasticity' for the money supply. In the nine decades that followed, there was a 96% decline in the purchasing power of the dollar.

This had an effect on the sphere of private equity, where we witnessed a mutation of the original spirit of risk-sharing via share options, massive debt and a tax system biased towards use of leverage. Prior to the crisis, private equity became a by-word for highly aggressive acquisitions. Companies that tried to be conservative in the run-up to the crisis became take-over targets, such that greater leverage was either the default defensive position or was saddled onto them post-buyout. Like a good marriage, risk and reward are the yin and yang of markets where the excess of each component is mutually tempered by the other.

However, this symbiotic process has been increasingly disentangled in recent years, with resulting economic chaos. This has important implications for private equity, bullion and other financial instruments. In the public sector, there is a focus

Allocator Interview

16

on quota-based systems where meeting annual targets very often overrides quality of service to the end-user. This focus on targets rather than quality can also take place within corporations. The corporate role is to offer products or services that are competitive and provide value for money. As the corporation achieves volume and market share, customers benefit and shareholders enjoy dividends and potential stock appreciation. When shareholder, staff and customer interests are aligned, a winning formula is achieved. Indeed, some investment houses specifically target companies where employees hold significant equity, because they offer a competitive advantage for long-term investors. However, good ideas can be mutated by short-term thinking. Through this mutation, the healthy approach of sharing risk and reward through public equity has become deformed through leverage and derivatives.

Stock price targets are used as an incentive to align management with shareholders but can have unintended consequences. In trying to meet quarterly (and therefore, short-term) price targets, corporations may start "cutting corners" on their product and service offering while paring costs and benefits to non-managerial staff. They may also, like Enron and Worldcom, start to manipulate earnings by spinning off loss-making components into special purpose vehicles.

Stock options can also become problematic. For example, at the peak of the Internet bubble some 80% of executive rewards stemmed from stock options. This has an effect on stewardship and long-term planning, as management and staff members with options start focusing more on shoring up the short-term value of the stock price rather than the long-term vision of the corporation. Moreover, as identified in chapter 7, on due diligence, stock dilution is a danger to the equity investor. Shareholders have lost value as earnings became diluted through the exercise of stock options. In the realm of the public markets, we have seen stock market follies of this sort, compounded by the crisis, contributing to a double-digit decline in indices like the S&P 500 from 2000-2009.

Meanwhile, the elasticity of money supply has contributed to erosion of earnings. For example, Société Générale[ii] has analysed the inflation-adjusted earnings of American workers since 1970. They found that the top 20% of workers enjoyed a rise of 60% whereas the remaining population (4/5ths) suffered a decline of 10% since 1970. This is the true measure of purchasing power disparity through the mass-creation of money. Money creation draws wealth from the poorest to the wealthiest and has produced the so-called 'hourglass economy'[iii] that has impoverished the middle class. Private equity can act as a bulwark to the creation of an hourglass economy if it rediscovers its original and valuable purpose on a global scale. Before looking at its beneficial combination with bullion we must first understand the role of precious metals in both Islamic and Western culture.

II. Gold and Silver in Islamic Culture

The best-known coinage in Islamic history is that of the gold dinar and silver dirham. Muslims first used gold and silver by weight, but in the year 75 (695 CE) the first dirham was minted. This was followed by minting of the dinar, which continued to be the official Islamic currency until the end of the Ottoman Empire in 1924. It was later re-launched by the Islamic Mint in Malaysia in November 2001, albeit with limited success. There are many examples in the Qur'an of how gold and silver should be used in aspects of trade. In order to gain an insight into the Islamic approach to these precious commodities, it is necessary to examine some of the relevant verses.

The first mention of both gold and silver is in sura Imran, wherein it states[iv]:

Alluring to man is the enjoyment of worldly desires through women, and children, and heaped-up treasures of gold and silver, and horses of high mark, and cattle, and lands. All this may be enjoyed in the life of this world - but the most beautiful of all goals is with God.

And among the followers of earlier revelation there is many a one who, if thou entrust him with a treasure, will restore it to thee; and there is among them many a one who, if thou entrust him with a tiny gold coin, will not restore it to thee unless thou keep standing over him...

In sura Tauba (the Repentance), in keeping with the message of the entire chapter, it states:

...as for all who lay up treasures of gold and silver and do not spend them for the sake of God - give them the tiding of grievous suffering.[v]

Allocator Interview

In sura Kahf (the Cave), there is the first description of paradise mentioning gold:

...theirs shall be gardens of perpetual bliss - through which running waters flow - wherein they will be adorned with bracelets of gold and will wear green garments of silk and brocade, wherein upon couches they will recline: how excellent a recompense, and how goodly a place to rest![vi]

Similarly, in sura Al-Hajj (The Pilgrimage), it states:

Behold, God will admit those who attain to faith and do righteous deeds into gardens through which running waters flow, wherein they will be adorned with bracelets of gold and pearls, and where silk will be their raiment.[vii]

In a continuation of this theme, in sura Al-Fatir (The Originator of Creation), it states:

Gardens of perpetual bliss will they enter, therein to be adorned with bracelets of gold and pearls, and therein to be clad in raiments of silk.[viii]

There is even a sura of the sacred book entitled Az-Zukhruf: Ornaments of Gold. This sura provides detailed arguments using gold and silver metaphors:

We might indeed have provided for those who deny the Most Gracious roofs of silver for their houses, and stairways whereon to ascend, and doors for their houses, and couches whereon to recline, and gold. Yet all this would have been nothing but...enjoyment of life in this world - whereas the life to come awaits the God-conscious with thy Sustainer.[ix]

Finally, it says of those of who believe in the Divine:

They will be waited upon with trays and goblets of gold; and there will be found all that the souls might desire, and the eyes might delight in. And therein shall you abide.[x]

Three themes emerge from these verses: (1) there will be an abundance of gold in paradise (together with pearls and silk) in the form of goblets, trays and bracelets; (2) one should not hoard gold and silver in this life; (3) gold is explicitly recognised as valuable currency.

III. A Brief History of Gold from an Islamic Perspective

In the time of Prophet Mohammed (ﷺ), gold and silver were simply forms of currency for the purpose of buying and selling goods.[xi] Their universal value ensured that there was no need for a foreign exchange market which, in modern times, has become a boon for speculators and a burden for manufacturers. The Prophet (ﷺ) taught that money should not be used to make money without some form of risk, otherwise the activity is a form of usury or *riba*. The Arabic translation is 'increase' which is sublime in its simplicity. The intention is to avoid the creation of something from nothing and was stipulated in the Qur'anic verse "...they say 'Trade is like *riba*, but Allah hath permitted trade and forbidden *riba*.'"[xii] The prohibition ensures that business activities are anchored in reality, whereby the sharing of risk and reward delivers a genuine economic outcome. Without this restraint, the increase of money without work becomes highly destructive.

As mentioned in chapter 3, on global and Shari'a regulation of private equity, the words of the wise have echoed down the ages to warn against usury, from Aquinas to Aristotle to the Old and New Testament. This warning about *riba* applies to many forms of finance, as interest-based banking is easily susceptible to speculation and the inflationary effect of credit creation. This was also well understood by the Founding Fathers of America, who insisted on gold and silver coinage when they completed the U.S. Constitution in 1789; the same year as the French Revolution. France, at that time, had racked up massive debt in supporting a foreign war. This resulted in domestic poverty, escalating food prices, growing disparity between social classes and ultimately, a violent revolution.

When gold and silver were mainstream currencies, money could not be mass-produced. This led to greater price stability over the course of centuries. Indeed, gold's purchasing power for equivalent tangible goods is little changed since the Middle Ages. However, there have been times when its restrictive effect could cause great poverty. Loans that were readily granted in wartime tended to be rapidly recalled in a post-conflict environment as financial discipline returned. This occurred after both

Allocator Interview

the Napoleonic and First World Wars. Likewise, the gold price has experienced its own peaks and troughs thanks to supply shocks that distorted the market. These included several major discoveries, starting with the Spanish in the New World in the sixteenth century, Russia in the eighteenth and in North America in the nineteenth.

Since the end of the Gold Standard in the 1970s, the money supply has been increasing at an annual double digit rate, up until the credit crisis. The consequence has been a silent dilution and steady devaluation of the dollar coupled with a surge in household and government debt. This will leave generations to come with asset price inflation and liabilities that can scarcely be repaid. Most economists, however, continue to view the economy myopically as a one-sided balance sheet – looking only at the assets while ignoring the mounting liabilities.

There are many examples of how debt compounds over time due to interest and financiers are well aware of the power of compounding. Indeed, in an instructive example, we can look at a theoretical case where a person deposits 10 kilos of gold in a bank account and receives 3% compound interest back in gold. If they did not withdraw the gold from the account, the bank would have to pay back the depositor's heirs all the gold that has been mined by approximately year 484.[xiii] According to precious metal consultants GFMS the total above-ground estimate for stocks of gold stand at 163,000 tonnes, as at the end of 2008.

However, many continue to believe that the growth in debt is benign and cling to the Keynesian principle that it can be paid back in better times. History shows us that this is rarely the case and, in spite of the purported growth of the last decade, developed countries carry debts that can never realistically get repaid. By way of example, the total net liabilities of Britain and Germany stand at 400% GDP with the USA and France at 500%.[xiv]

While it is acceptable in Islam to hold gold and silver bullion for wealth preservation, the Shari'a-sensitive investor has to be mindful of the injunctions against hoarding. This approach applies as much to food and knowledge as it does to wealth. Commodities like gold and silver are gifts or trusts (amanah) from God and are meant to be shared and circulated. To prevent the purchase of gold becoming a form of hoarding, it is essential that any bullion stored or possessed by a Muslim be included as part of their annual zakat calculation for charitable donations. This forces the investor to do something useful with their possessions. If not, their wealth will gradually flow toward charitable purposes, giving stagnant money a half-life. Rather than allowing wealth to fester, zakat helps draw it out of dark storage into the light of economic purpose; a case of 'use it or lose it.' The investor can still benefit and be rewarded but the process ensures that liquidity is provided communally, thereby giving others the chance to create their own wealth and prosperity. This is a true trickle-down effect in direct contrast to interest-based banking that concentrates wealth rather than spreading it.

IV. Gold in the Modern Era

Gold has captured the public imagination in times both ancient and modern. One only has to think of movies like King Solomon's Mines or Goldfinger, with its depiction of bullion bars held at Fort Knox. Gold's enduring nature, verifiable purity and portability has made it an ideal store of wealth throughout history. Its malleability, ductility and consistent quality allow for easy division and use as coinage. Gold has stood the test of time as a keeper of value throughout, subject to cyclical peaks and troughs.[xv] The classic correlation of a weakening dollar and stronger gold price reared back to life, especially during the credit crisis, such that gold and related mining shares have proven to be the best performing asset class of the last decade. Gold gained some 280% in the ten years from 2000-09 while mainstream equities delivered negative returns, even with dividends re-invested.

In the four decades since the Gold Standard was abandoned, central banks have been free to control their economies through monetary policy, uninhibited by the constraints of holding real assets to back paper currency. Central banks sometimes dismiss the rise in bullion as it is seen as a 'vote of no confidence' in paper money and, hence, a poor reflection of their stewardship. Yet in 2009, central banks became net buyers of bullion for the first time in 21 years. A more telling pattern is the fact that indebted Western countries were selling while cash-rich countries such as China, India and Russia were buying.[xvi]

At the cusp of year 2010, the world economy was in the middle of a cycle where financial assets were falling and real assets were rising. This can be illustrated in a number of examples from the late 1970s. During that period, inflation soared and interest rates were in their high teens. Gold was hot and stocks were cold. Thereafter, equities and bonds began their greatest ever bull run. By 2000, a 'new paradigm' was in place, where share prices supposedly never fell and gold was rejected

Allocator Interview

as a relic. The millennium proved to be the turning point for both sets of asset classes. These cycles have been observed by the likes of Jim Rogers, author and co-founder of the Quantum fund with George Soros. In his book *Hot Commodities*, he identified five cycles over the course of two centuries where commodities boomed and financial markets slumped with each bullish phase averaging 17 years.

Having previously endured two decades in the shadow of the bull run, and in spite of a rally during the credit crisis, it is no surprise that gold is not widely-owned. While many investors have an indirect exposure to gold through mining shares or funds, they generally do not hold it in physical form. Islamic investors should always seek what is tangible, so holding real bullion is a Shari'a-compliant approach, especially since so much gold trading takes place by way of paper or derivatives.

The twentieth century witnessed a drift from precious metal coins to paper money and securities followed, ultimately, by electronic transactions. Unfortunately, the benefits of convenience and liquidity have been undermined by speculation and depreciation. Capital will continue to seek out the highest yield and internal rate of return with the greatest security. In times of crisis, it will naturally flow to real assets and commodities.

Precious metal commodities can provide an effective hedge against the declining purchasing power of paper currency. By way of example, one can examine the performance of the Dollar Index (a measure of the US dollar against a basket of six major currencies). Over the course of five years leading to its record low in Q2 2008, the Dollar Index declined by an annualised rate of -5%. Over the same period the gold price rose by an annualised rate of 35%. While the appreciation of gold in future may not always be of the same magnitude, the Dollar Index does show how poorly paper currency has performed relative to real assets.

Gold investing generates heated debate, between the "gold bugs" and their naysayers. "Gold bugs" frequently claim that, in times of turmoil, gold is the ultimate form of payment. However, recent history shows that gold, silver or other precious metals are not the currency of choice for basic things like paying for labour and materials, even when inflation is rife. Most people do not own it and would rather barter functional items than receive gold. However, it is a useful store of value when money is being diluted through mass production, either on a printing press or via a computer entry in the case of credit, and during exponential growth curves seen prior to a crash. As such, gold should be viewed as a long-term 'ledge' rather than a short-term 'safety net.' To avoid being drawn into any speculative activity with gold, Shari'a-sensitive investors should consider it to be a form of insurance. This allows one to adopt a prudent approach and to be totally dispassionate. Gold is neither a "barbarous relic" (as described by Keynes) nor a mystical metal beloved by the Celts, but rather an insurance cover.

There is much debate over the correct amount to hold in a portfolio, and like all choices of investment profile or insurance cover, it depends on an investor's personal taste and asset risk profile. The litmus test for the proportion of precious metals in an asset portfolio is whether they provide 'peace of mind or loss of sleep.' Much like insurance, precious metals should be in the asset portfolio to reassure and to spread risk. Making a claim on the policy may be the least-desired outcome, but if called upon, the policy will be invaluable.

It is interesting to note that the insider selling of equities in 2009 has escalated to levels seen just before the peak of the market in 2007.^[xvii] While wealthy investors will lose money on their paper assets, it is the poorest that bear the brunt of higher food and energy prices as the dollar devalues; the very people who cannot afford bullion as protection.

In an environment of currency devaluation and inflation, gold could be one of the few anchors for one's wealth. If financial and property assets are battered by inflation and interest rate rises, precious metals may offset losses once initial sell-offs occur. Much like the smelting of gold, it takes time before one can differentiate between the "pure and the dross" in financial markets. Gold can also be used to top-slice generated profits and re-invest capital into useful projects, part of which can be Shari'a-compliant private equity.

V. Innovation or Infiltration

Gold's appreciation has spurred the selling of scrap while inhibiting the purchase of new jewellery, which is seen as a luxury item. This has been the case for India in 2009, where the weak rupee added significantly to the cost of buying bullion. While its accumulation by institutions has risen significantly there is little data available on retail ownership. The scramble to buy coins and bars during the 2008 credit crisis has been matched by a great demand for paper-based gold investments in the form of Exchange Traded Funds (ETFs). While most structured products mimic actual bullion prices by way of derivatives,

Allocator Interview

there are some funds, certificates and services that provide genuine ownership. Unfortunately, concerns have arisen in several cases as to whether the bullion one owns on paper is backed by real bars in a vault. There is a great deal of difference between having a call on bullion held by a third party and taking actual possession of it, including from the Shari'a perspective, with its emphasis on qabd (possession).

The custodians of some ETFs have the facility to lend out gold to earn a hidden fee, which adds another layer of counterparty risk. This has been highlighted by James Di Georgia in *The Trader's Great Gold Rush*.^[xviii] As such, it may be advisable for investors, Shari'a-sensitive or not, to look for 'allocated' gold: bars that are specifically set aside for either the individual or the fund. Storage costs may be cheap for some providers, as the full complement of bullion is not necessarily in custody at all times. A similar lack of transparency was exploited by medieval goldsmiths who issued notes in greater value than was backed by gold in their possession. This was the origin of the fractional reserve system which lies at the heart of the credit crisis and the devaluation of the US dollar. Nevertheless there are reputable ETFs, such as Gold Bullion Securities which is traded on the London Stock Exchange as an initiative of the World Gold Council. The benefit of these funds is that the dealing costs are low – in the region of half a percent – compared with coins and bullion where there could be a premium varying between 5 to 10 per cent, or even higher depending on the level of financial distress.

Many investors buy the shares of mining companies to gain access to the appreciation of these metals. For diversification purposes, it is simpler to buy a specialist investment fund that holds dozens of such companies in a well-managed portfolio. The shares of mining companies are more volatile than the underlying precious metals they discover and retrieve. Once the production costs are overcome in a mining operation then any rise in price will feed directly through to profits. This gives rise to a gearing effect whereby the price of mining shares in a gold bull market will rise more substantially than the metals they are extracting. Over the last 15 years, for every 1 per cent rise in the metal one should enjoy a 1.7 per cent rise in the shares, although the gearing effect will vary from company to company. As with any leveraged process, it will also operate on the downside. If metal prices fall, then fixed costs will eat up a larger proportion of the profits. The share price will, therefore, fall faster. As well as providing greater potential for upside performance, gold shares also show negative correlation^[xix] with mainstream equities over the long-term. If the overall stock market is performing badly then it is likely that the gold shares will do well and help offset losses elsewhere. However, this inverse relationship has declined in recent years due to leverage and the close association of commodity prices with the economic cycle.

VI. Gold Storage

The major problem when buying quantities of physical gold comes with where to keep it. Without a safe or strong-room, storage at home would be unwise, especially in Britain and America. Some banks will provide what is called 'safe custody' but they will of course charge an annual fee for the privilege. Some banks provide safe deposit boxes in which to safely place valuables, but these are generally too small to store anything bigger than jewellery sets or Krugerrand coins. One can also have access to communal storage of gold coins and bars of differing sizes in secure vaults. However, these are known as 'unallocated' holdings and bear the same risk as a deposit at the bank. While depositor protection is also extended to precious metals in Switzerland, this is not true of every jurisdiction and, of course, the total value covered is limited. Asset security is a political as well as a physical issue. The British government used anti-terrorist legislation to freeze Icelandic assets in 2008. In 1933, the US government criminalised the ownership of bullion so that they could devalue the dollar and inflate the economy to overcome the Depression. As the nature of tax collection becomes more aggressive, every outcome should be considered.

VII. Bulls, Bears and Golden Rallies

For the more active trader, the action is often in commodities. If gold can better its 2009 highs of \$1,226 then this may well be seized on by market participants that an even bigger move is in store. It is important to understand the grounds for positive sentiments. Bull markets tend to come in four distinct phases.^[xx] After a long-term slump, the first stirrings of a rally go unnoticed as the asset is viewed with cynicism: only the most contrarian of thinkers is involved. The second and third phases are the main accumulation periods for wealthy individuals and professional investors. Finally, the public are drawn into the fourth climactic period where exuberance abounds. By this time, the 'smart money' has made an exit, most likely being ridiculed for making such an absurd move when the bull market is so obvious.

Allocator Interview

Should the gold price begin to mimic the performance of Internet stocks in the late 1990s, then there could be a case for top-slicing (halving positions that have doubled). This allows one to take some money out of the gold market but still be involved. It also avoids the decision of liquidating an entire gold portfolio or leaving it all at risk. Gold investors can enjoy the same luxury once prices become exponential. By this stage, the fourth climactic period, the size and time of expansion is usually greater than expected. The insurance aspect will already have fulfilled its role, so selling a good percentage of the portfolio will be prudent at the maturing point of the cycle. In the meantime, the 'steady switch' to other asset classes or so-called 'pound cost averaging' will mean the investor will be diversifying away from gold into other areas. This is the beauty of long-term private equity, which will be coming to fruition and maturity for public listing as precious metal prices peak.

According to South Africa's Investec Asset Management, the proportion of gold-related shares in the world's stock markets was just half a percent of the overall value in 2005. This equated to a \$200 billion market capitalisation compared with a total of \$37 trillion of total financial assets.[xxi] In times of financial stress, this level can rise to 20 per cent plus, as seen in 1934. [xxii] As common stocks collapsed, those that derived their earnings from gold expanded, while companies concerned with consumer discretionary spending withered. A repetition of this divide would imply an incredible upside to mining stocks. Another bullish point to consider is that the ratio of the gold price to the S&P 500 peaked at 6.0 in 1980, then fell to just 0.2 in 2000 and in early 2010 now stands at 1.0.[xxiii]

It is a common theme of the commodity super cycle that financial assets perform poorly as real assets are rallying. This counters the argument of many gold bears who think that gold performs badly during deflation. This was clearly not the case in the Great Depression when mining stocks flourished. The prospect of a repeated rebalancing process has deep implications for gold shares. Another attractive aspect highlighted by Investec Asset Management, is that the gold industry is consolidating. While the top 10 gold producers control some 37 per cent of the market, this is relatively low compared with other metal producers – copper 54 per cent and platinum 98 per cent. This implies that there will be a considerable number of mine mergers, which is generally positive for share prices. Islamic investors can view rising share prices as a bonus, rather than specifically seeking take-over targets, since such speculation would involve a high degree of gharar (uncertainty). As the dollar devalues further and the political picture remains uncertain, there may be plenty of fundamental reasons to own gold. It is a key part of the preparation phase: as important as securing water supplies before a siege situation.

VIII. Reverse Alchemy: Converting Precious Metals into Economic Outcomes

Few non-Muslims realise that there was an Islamic renaissance between the 9th and 13th centuries. Contrary to claims by Joseph Schumpeter, amongst others, Islam's 'House of Wisdom' acted as a repository of philosophical, mathematical and scientific knowledge. Muslim scholars preserved the accumulated wisdom and studies of the ancient world, creating libraries and research institutes at a time when books were a rarity in the rest of the world. It was not just a case of mere preservation; as Muslims were involved in translating, improving and ultimately distributing the knowledge to the wider world. However, throughout ancient Islamic history, Muslim scientists were obsessed with alchemy: the fruitless endeavour of converting base metals to gold. This theme of a short-cut to wealth still resonates through to the modern age.

With the contraction in credit in the global financial crisis, we may witness a form of reverse alchemy: turning to gold to provide liquidity. By converting precious metal into capital it can be combined with labour and materials for genuine innovation, employment and further wealth creation. Just as paper wealth can be traded-in for precious metals, so it can later be re-invested in a virtuous circle. For example, by holding gold and selling it in phases to fund private equity cash-calls, it provides the ideal form of recycling of capital, generating positive returns and helping the economy in the process. The approach purges debt and promotes stability through the reduction of leverage and expansion of equity. As such, it represents a true and sustainable version of organic growth.

If the approach above is followed, over time the proportion of gold in the portfolio will dwindle and the private equity element will increase. In the initial phase, gold acts as both a currency hedge and as a method of portfolio diversification. In times of crisis it will help to counteract the withdrawal of liquidity and declining price of paper assets. As the life-cycle continues, the value of the maturing private equity proposition will be enhanced, requiring a final injection of cash to bring the project to market.

The nurturing effect of continuous capital flow and human endeavour can pay rich rewards in the hands of good managers. As noted early in chapter 1, private equity is by its nature more risky than mainstream equity. Nevertheless, it represents a case of wealthy investors venturing where others cannot go, because of fear of financial capability. Gold offers a cocooning effect to

Allocator Interview

offset private equity risks, provide liquidity and hedge against market volatility and currency devaluation.

Skilfully chosen private equity investments should be market-neutral because the technology and innovation should be attractive on its own merit, regardless of market conditions. A good example of this is UK-based Aquarius Equity's successful listing of Nanoco Technologies in March 2009, at the height of the market slump. A spin-out from Manchester University, Nanoco is now the world's leading developer and manufacturer of Quantum Dots, used in the next generation of flat-screen televisions and LED lighting. Aquarius invested £350,000 in pure private equity in 2005, when Nanoco was a start-up, and by 2010 the investee company had a market capitalisation of £158m; the perfect marriage of risk and intellectual capital. By ploughing returns into gold instead of cash, Aquarius would achieve a double benefit: enjoyment of upside private equity return and protection of the capital until it is re-invested in another promising company.

Conversely, when huge leverage is added to complex private equity transactions, it skews the original beneficial purpose of the private equity play. As noted by risk manager Richard Bookstaber, it is leverage and complexity that has created tight coupling and correlation.^[xxiv] This combination has led to increasingly volatile markets in the last 20 years, countering the misplaced belief that derivatives hedge risk and cushion instability.

In many instances, Islamic private equity reserve funds could consider gold as a form of hedging. Instead of attempting to enter a questionable short position using Shari'a-compliant stocks or trading in short-term commodity murabaha vehicles or simply holding cash, gold can help diversify risk while enhancing returns. It acts as an 'event hedge' providing positive returns in periods of significant stock market declines. Most institutions do not want to hold liquidity while waiting to fund private equity cash calls, which may be many years down the pipeline. Likewise, wealthy investors often wish to 'sweat' their assets or do something constructive with stagnant cash. They may understand or instinctively feel that cash is a wasting asset because fractional banking continues to mass-produce money.

Yet, at the same time, private equity investors, be they institutions or individuals, need to have assets that are easily liquidated for cash calls. The problem with holding conventional securities is that in times of financial distress, most investments immediately lose liquidity. This is where gold comes into its own because financial turmoil generates demand for bullion, particularly when banks are unstable. This does not necessarily mean the gold price will rise or even stay stable, but it does mean that there will be willing counterparties ready to swap 'bullion for bucks.'

While the credit crisis has had devastating effects worldwide, there are some positive consequences. The contraction of credit and holding of cash could have the same effect as the Gold Standard which limited easy lending and engendered greater stewardship. Likewise, the lack of significant interest on deposits motivates depositors to consider interest-free alternatives.

Once governments stop creating money, markets can find a true equilibrium point. For a short duration, we may even see a return to Victorian-style markets, where capital growth was the exception rather than the rule; in effect, the market was a highly efficient mechanism for recycling capital back into the economy. Listed stocks acted as dividend machines such that the small, higher-risk entities generated greater yields whereas larger companies paid out smaller, but more stable, dividends. The low tax rates of the era also aided the recycling effect. In the Victorian environment, the best place for capital growth was for new issues coming to the market which underpins the role of venture capital and private equity.

In conclusion, by combining protective assets such as gold with private equity, one maintains a store of value while providing cash flow for projects, benefiting the individual investor and promoting prosperity for the population as a whole. The result may well be a transition from usury and speculation to real assets and production.

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

From a Mosque to a Museum

By Rushdi Siddiqui

Rushdi Siddiqui is the Global Head of Islamic Finance and OIC Countries at Thomson Reuters (TR). He works closely with Islamic finance stakeholders, Halal industry, and the OIC countries. Rushdi recently received an award at the 2nd Sri Lanka Islamic Banking & Finance Conference for Contribution to Islamic Banking in Sri Lanka (2010). Mr. Siddiqui joined Thomson Reuters from Dow Jones, where he was global director for their Islamic Market Indices. Over his 10 years there, Mr. Siddiqui led the entry and expansion of the Dow Jones Indexes into Islamic finance, resulting in numerous awards from leading finance organizations and media outlets. Mr. Siddiqui has considerable experience in the financial markets, having worked at a Wall Street investment bank and commercial bank in the 1990s. Mr. Siddiqui has authored a number of white papers and articles on Islamic indexes for publications including WIEF, ABANA Review, CPI Financial, the Chicago Journal of International Law, Euromoney, writes fortnightly for Gulf News, and is a frequent speaker at industry events hosted by Harvard, Columbia Business School, London Business School, Oxford, the Economist, Islamic Development Bank, Bahrain's BIBF, Malaysia's MIFC, IIRME (Dubai), and more. Mr. Siddiqui holds a JD from Albany Law School of Union University, an MBA in international business from Baruch College, and a Bachelor of Science in Management and Marketing from New York University.



The continued pursuit of the proposed 'Ground Zero Mosque' by Imam Feisal Abdul Rauf (also known as Project51) has incited a major protest near ground zero, led to the announcement of 'Koran burning day' out of Florida, a NYC Muslim cab driver being stabbed, finger-pointing of bigotry, raised as an issue for some candidates in the November elections, and so on, hence, unnecessarily stress-testing the US Muslim community without achieving any high moral ground. We have an estimated 2000-3000 mosques in the US, from basements to grand architectures, and yet, there already exists several mosques within waking distance from Ground Zero. The New York Times columnist, Thomas Friedman, in a recent column, 'Surprise, Surprise, Surprise,' raises an interesting point about the need of the hour in the Islamic world for intra-communal bridge-building, akin to Nelson Mandela. Now, what advice would Mr. Mandela give the Imam regarding the community center?

In Mr. Friedman's words, 'When the post-apartheid, black-led South African sports committee moved to change the team's name and colors, President Mandela stopped them. He explained that part of making whites feel at home in a black-led South Africa was not uprooting all their cherished symbols. "That is selfish thinking," Mandela, played by Morgan Freeman, says in the movie Invictus. "It does not serve the nation." Then speaking of South Africa's whites, Mandela adds, "We have to surprise them with restraint and generosity." It may not be too late for the Imam to 'surprise' the protestors with 'restraint' and relocation. The issue on relocation should be reasonable, otherwise it becomes a religious issue and not a sensitivity concern.

Mosques

Mosques are an important symbol of the Muslim community 'having arrived' in a new country, no different than building a Synagogue for Jews or a Church for Christians. It is an interesting indicator on the pulse of the local Muslim community for affluence, ethnicities, politics, and, at times, even interpretation of Islam. According to the protestors this is not a freedom of religion issue (to build the mosque), but insensitivity on the location of the mosque.

To some, the reality of the situation is most mosques are 'full' during Friday Jumma prayers and during the month of fasting (Ramadan). Nevertheless, during the remainder of the times, especially weekdays, a Mosque's Imam has had to encourage the worshippers to come to the mosque. At one level, its not about building a mosque, but constructing another mosque in 'visual' vicinity of other mosques.

During the ensuing media circus, two interesting points have been flushed by some in the US Muslim community as well as the vocal non-Muslim minority . Did the Imam reach out to US Muslims about the location of the mosque? One wonders if the Imam is able to get a permit for a 'Mosque March,' in, say, Washington, DC, which may be less heated than one in NYC, what kind of support he would gather, in terms of numbers, from both Muslims and non-Muslims?

The second point, it is easier to build a mosque in the US than a Church/Synagogue in a Muslim country. Maybe the Imam's Cordoba Initiative needs to expand the inter-faith dialogue to selected Muslim countries. It would indeed test the Imam's ability to be the voice of non-Muslims in a Muslim country for building a house of worship. Being on a recent State Department sponsored trip to the Gulf countries, he may want to test the waters of bridge building, instead of sticking to the script.

These houses of worship and their activities, be it a mosque, church or synagogue, facilitate intra-community and inter-community dialogue, and community leaders are mindful of location resulting in provocation. To a number of people, Ground Zero is seen as a sacred cemetery of nearly 3000 graves, hence, an obvious expected push back on building a mosque on a cemetery. To them, no different than building a Japanese shrine at Pearl Harbor, legally doable but morally questionable.

Inter-Faith Dialogue

Interfaith dialogue has been around before the tragedy of 9/11, but this mosque scenario has flushed out the need for more meaningful ways to lift ignorance about Islam and Muslims. One of the most often heard phrases is, 'not all Muslims are terrorists, but all terrorists are Muslims,' hence, something more pronounced needs to be introduced in the dialogue. The Bush Administration, now the Obama Administration, and the media seem to go to Imam Feisal Abdul Rauf for issues related to Islam/Muslims, giving the impression there are no comparable qualified Imams in the US. Lets hear what the Imams in Chicago, Los Angeles, Houston, and other places have to say about the location of the proposed mosque and on inter-faith dialogue.

The US had no Grand Mufti, and we do not need one today as it will inevitably result in talks of conspiracy theories, much like state controlled Friday (Jumma) sermons (Khutbahs) in selected Muslim countries. The last thing the Imam wants is to be seen as a 'contractor' (some would say 'puppet') of the State Department, as his credibility will take a beating in the Muslim world.

Today's ignorance-removal, for Muslims and non-Muslims, requires something deeper than inter-faith dialogue, as it sometimes becomes a photo opportunity with the usual sound bites. The history and contribution of Islam/Muslims is a visual story, rich with inventions and innovations, pioneering men and women, and compassion and convergence towards non-Muslims. This cannot be captured in a controlled two-hour town hall meeting with glowing speeches and repetitive type of questions, as the message does not reach the masses.

Islamic Museum

Lets take a cue from the enlightened country of Qatar, which has been involved in hosting a dialogue for several years in Doha about Islam and the West. Qatar, like Abu Dhabi, wants to be the cultural hub for the Muslim world, and recently opened an Islamic Arts museum, i.e., utilizing culture to build bridges between civilizations.

It make sense to focus on the Museum part of Project51, as that would show the history of Islam and Muslim contributions to mankind, from mathematics to music to mechanical engineering. This is the opposite message of the extremists. Such a project would have an

easier time in raising the funds domestically in a transparent manner, as many Muslims may not be informed or aware of our rich history. For example take the recent exhibition '1000 Inventions' at London's Science Museum, which profiled Muslim contributions to society.

Another example is the King Abdullah University of Science & Technology (KAUST) near Jeddah, which has a Museum of Science & Technology in Islam (MOSTI). According to their website, '[T]he Museum celebrates the contributions of Muslim scholars to science and technology during the first Golden Age of Islam from the 7th to 17th century. These Muslim scholars include amongst them the great scientists, inventors, engineers, mathematicians and teachers of that time, such as Jabir ibn Hayyan, Abbas bin Firnas, al-Kindi, al-Razi, al-Jazari and Taqi al-Din.'

Museums and Exhibitions about Muslim contributions to mankind is the need of the hour, over another mosque, to build bridges between civilizations, whilst breaking walls of ignorance.

Cordoba

Cordoba, in the history of Islam, was an era of education, enlightenment and inclusiveness to the major faiths, meaning reasonable sensitivities were acknowledged and actions done accordingly.

To say the Imam and the developer behind this project did not expect this kind of divisive uproar on the mosque location implies their ignorance of their namesake organization: Cordoba Initiative. Put the ego to the side by offering a 'Cordobian' gesture, build Project51 with emphasis on the ultimate bridge builder of civilizations, understanding, and appreciation: an Islamic Museum, which could include Islamic finance, and let Islamic finance, via Sukuk, fund its building.

Several hypothetical queries can be raised here: What would be the reaction by the media and/or pposition if, instead of mosque, it was an Islamic bank near Ground Zero (which is in the proximity to Wall Street's financial district)? One wonders if it would make a difference if the backers of the proposed banks were from secular democracies, like Malaysia and Turkey, instead of Arabs?

The passage of time commences the healing process of the trauma and tragedy of 9/11 on the psyche of Muslims and non-Muslims leaving a soft scab, but such undertakings, location of Mosques near Ground Zero's 'sacred cemetery', just pulls it raw. Moving the mosque is not a defeat for Muslims/Islam or caving to extremist, but rather being good neighbors. The same neighbors that may understand and possibly join in the celebration of Eid-il-Fitr if it falls on September 11th!

The article is written in the author's personal capacity and does not represent the views of his employer.

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

A Study of Islamic Mutual Funds

By Mobasher Zein Kazmi

The writer completed his MBA (Investment Management) from Concordia University and is a CFA Level 3 candidate. He was recently awarded the Islamic Finance Qualification (IFQ) designation. Mobasher has had four articles published in the Journal of Strategic Studies, Bahrain Center for Studies and Research. The first three dealt exclusively with Islamic finance topics namely: Sukuk ([see reference link](#)), Islamic Hedge Funds ([see reference link](#)) and the impact of the current financial crisis on Islamic banks ([see reference link](#)). The last paper dealt with the rise of sovereign wealth funds.

The introduction of Islamic mutual funds in recent years has been an important component in the growth and development of Sharia compliant financial products. The industry itself is undergoing consolidation following a tumultuous period of global economic uncertainty and market reversal. Under such circumstances a critical examination is needed to evaluate whether such Sharia compliant funds have been offering superior risk-adjusted returns. Furthermore fund managers need to consider formulating investment strategies that will lead to sustainable competitive advantage over conventional fund structures and help attract capital on a long-term basis.

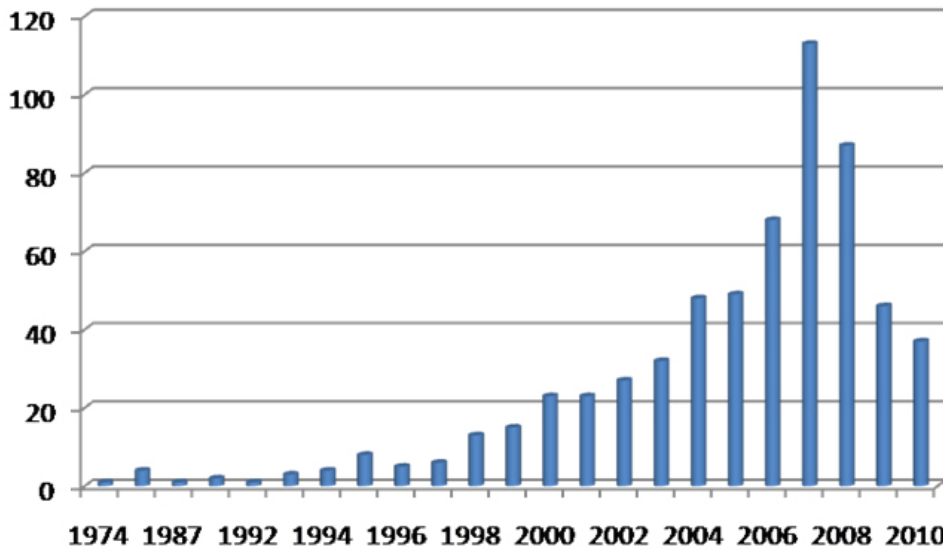
Mutual funds are open ended investment schemes tradable on an ongoing basis and redeemable at the respective Net Asset Value (NAV). Sharia compliant funds are identically structured although managers use specific screens in security selection restricting the investment universe to assets that are interest free and of halal origin. A rethink of the investment processes coupled with a serious re-branding of Islamic mutual funds within the context of socially responsible investing should be adopted so that Sharia funds can be positioned within the mainstream of international capital markets. Islamic financial institutions should redirect their energies to strengthening their fund offerings underlining its ethical and social underpinnings to investors. Indeed Islamic private equity and other exotic alternative investments operating within the realm of Islamic finance have proven to be relatively ineffective in generating the desired return among serious investors.

The Market

The Islamic Funds & Investor Report of 2010, published by Ernst & Young's Islamic Financial Services Group, has projected funds under management to be an estimated \$52.3 billion in 2009 (predominantly based on the data from the Eureka hedge Islamic funds database); a fraction of the \$22 trillion global asset management industry [i] and a minor component of the estimated \$ 1 trillion Islamic finance industry. The number of new fund offerings per annum also shrank from the high of 173 in 2007 to 29 in 2009. [ii] The only encouraging sign is the overall growth in the pool of investable assets that has risen to \$480 billion [iii] underscoring the depth of investment opportunities available to the average retail investor.

Industry Snapshot

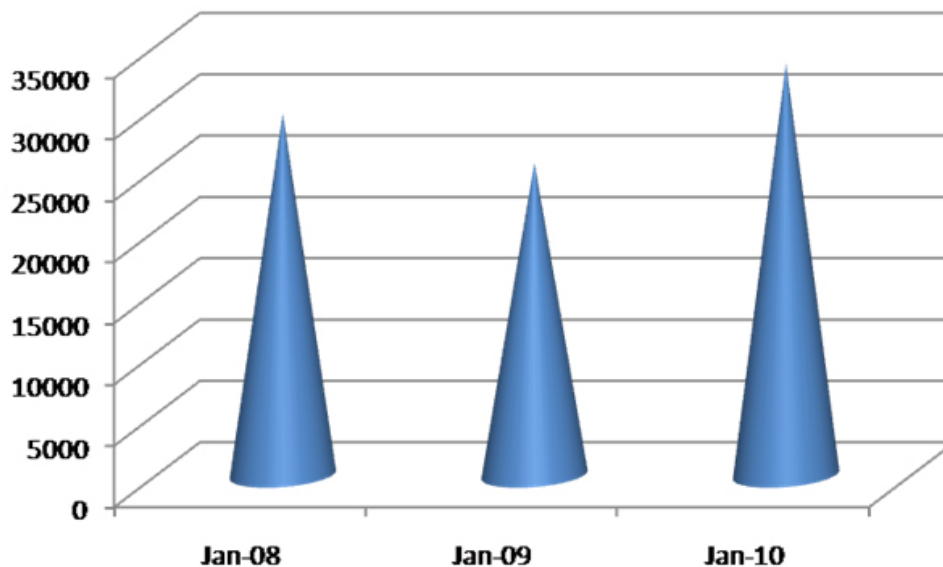
Exhibit 1: New Islamic Fund Launches



Source: Thomson Reuters-Lipper

Fund managers should seek to build on the enlarged market of Sharia compliant assets through superior analysis and asset selection. It will help overcome current fund limitations of scale and profitability while providing investors with a greater range of funds to choose from thereby restoring an element of trust and confidence in the market. The Islamic mutual fund segment has shown remarkable resilience with 37 new fund launches so far in 2010 following the disappointing lows of 2009.

Exhibit 2: Islamic Fund Asset Growth



Note: Net Asset Values based in \$ Millions
Source: Thomson Reuters/Lipper

Industry Snapshot

The last three years have been inordinately challenging for the Islamic industry. The momentum generated in 2007-08 with new fund launches was severely undermined with weak fund performance and a shrinking asset base. While the overall trend has been upward temporary market reversals have tempered asset growth. According to statistics provided by Reuters-Lipper the total NAV of funds stood at an estimated \$ 35 billion in June 2010 with an average fund size of \$ 68 million based on data provided by fund managers. [iv] Interestingly, the five largest Sharia compliant funds are all based in Saudi Arabia with established investment histories and distinct concentration in trade finance assets.

Exhibit 3: The Largest Islamic Funds

Name	Asset Type	Geographic Focus	Domicile	Currency	Date of Launch	Fund Management Company	Total Net Asset Value (\$) in Millions
Al-Ahli Saudi Riyal Trade	Money Market	Saudi Arabia	Saudi Arabia	SAR	03/04/1995	NCB Capital CJSC	5,122.12
Al-Ahli Diversified Saudi Riyal Trade	Trade Finance	Saudi Arabia	Saudi Arabia	SAR	01/10/2003	NCB Capital CJSC	1,580.75
Al-Ahli International Trade	Trade Finance	Global	Saudi Arabia	USD	06/03/1987	NCB Capital CJSC	1,543.30
Al-Rajhi Commodity Mudarabah SAR	Trade Finance	Saudi Arabia	Saudi Arabia	SAR	04/06/2000	Al-Rajhi Capital Co	1,488.53
Al-Sunbula SAR International Trade Finance Fund	Trade Finance	Saudi Arabia	Saudi Arabia	SAR	03/11/1986	Samba Cap & Invest Mgmt	1,407.06

Source: Thomson Reuters-Lipper

A review of the market in 2009 showed inherent weaknesses among Islamic mutual funds particularly in terms of liquidity, transparency and volume.[v] These findings were reinforced in a major academic study of Islamic mutual fund performance where researchers using the three-level Carhart model found that two fifths of Islamic equity fund portfolios significantly underperformed international equity benchmarks.[vi] Researchers were able to reasonably conclude that Islamic investors from Muslim countries do not sacrifice financial returns by investing actively in line with their religious principles. Furthermore, Sharia compliant funds domiciled in Muslim countries outperformed relevant benchmarks, whereas Islamic funds originating in the West lagged behind.[vii]

Performance attribution analysis identified investment style as the principal causal factor where western Islamic funds exhibited a bias towards small cap growth stocks. Investment styles from funds based in the Arab/Islamic world showed no discernable tilt either in terms of market capitalization and/or value growth stock selection. In addition, Islamic funds were shown to be indifferent between momentum and contrarian investment strategies.[viii]

Prospects

Islamic mutual funds by their very nature are low-risk investment vehicles. Funds managers are restricted to invest in assets with minor debt components. Furthermore, funds are disallowed from undertaking leverage and consequently are protected when severe market downturns occur. The gradual introduction of Islamic funds in North America and Europe and commercialization by conventional banks provides opportunities for non-Muslims to invest their assets in a Sharia compliant manner. [ix] This increased commercialization has led to a decrease in transaction costs for Islamic funds and enabled managers to seek discounts on their

Date	Return	Period
Dow Jones Islamic Market Titans 100 Index	(7.01%)	01/01/10 to 26/07/10
MSCI The World Islamic Index	(6.30%)	01/01/10 to 20/08/10
Standard & Poor's 500 Sharia Index	(2.95%)	01/01/10 to 17/08/10
Eureka Hedge Islamic Index	1.47%	01/01/10 to 23/08/10

Industry Snapshot

Return indicators from major international Islamic benchmarks display resilience in the face of troubling economic conditions. With the global financial architecture undergoing an uncertain transformation fund managers must exhibit prudence in asset selection. This is particularly acute given the discernable limitations of dedicated delivery channels in emerging markets where the breadth and depth of various fund offerings has yet to become part of the financial planning tools available to the average investor. In similar vein fund managers operating in developed markets are equally constrained as Islamic funds remain sidelined to the sphere of socially responsible investing. Overcoming fund raising constraints necessitates aggressive rebranding and streamlining of distribution channels to ensure selection of Islamic funds as the investment of choice while helping managers build scale.

Current trends in new Islamic fund launches indicate a concerted push towards the coverage of emerging markets. Saudi Arabia and Pakistan together accounted for one third of total new geographic mandates. Further analysis reveals smaller and less-known fund sponsors such as Kuveyt Turk of Turkey, Amundi Asset Management of Luxembourg and Element Investment Managers of South Africa, to name a few, entering the market competing alongside more established operations such as NCB Capital of Saudi Arabia and CIMB Asset Management of Malaysia. The most aggressive player on the Islamic funds scene has been Emirates Funds Managers that launched 2 sukuk Funds and 3 money market funds all with a global geographic focus targeted for investors in multiple jurisdictions.[xi] Considering its first Islamic fund launch was in 2005 Emirates Funds Managers' trailblazing approach should offer encouragement to newer outfits seeking market entry.

In 2010, portfolio mandates ranged broadly across acceptable asset classes with varied levels of diversification. A clear and discernable tilt towards equities and money market instruments can be identified with new fund offerings. Interestingly, not a single open ended private equity fund was introduced displaying investor nervousness in the market for these alternative investment asset classes.[xii] Sukuk funds have also staged a modest comeback as standalone funds and as components of balanced funds.

It is expected that as the emerging markets in the Arab/Islamic world evolve Islamic mutual fund managers will face similar portfolio value enhancement challenges as their conventional counterparts without the harmful side-effects of assuming additional risk. The potential to develop balanced funds and/or fixed income (Sukuk) funds remains strong as market corrections subside and investors switch from private equity and/or real estate funds to mainstream Islamic funds.

Recommendations

The ongoing global financial crisis has provided an excellent opportunity for fund managers to showcase the superiority and robustness of Islamic mutual funds in terms over their conventional counterparts. Current economic conditions necessitate fund sponsors to stick to traditional asset classes especially equities and bonds. Ideally, balanced funds with an emerging markets focus should provide the perfect blend in generating interest among investors. Sharia compliant commodity funds also remain underutilized and remain an enticing prospect for fund sponsors. Reducing existing market constraints in terms of tradability, size and reliability will be fundamental in branching beyond the core money market instruments and trade finance portfolios. As the industry grows Islamic mutual funds should capitalize on scale and offer today's investor with sustainable long-term risk adjusted growth that is relatively insulated from the reversals in major international capital markets and preserves the real values of portfolios. security trades.[x]

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

accurate

professional reporting service

No wonder that each week, Opalesque publications are **read by more than 600,000 industry professionals in over 160 countries**. Opalesque is the only daily hedge fund publisher which is actually read by the elite managers themselves



Opalesque Islamic Finance Briefing delivers a quick and complete overview on growth, opportunities, products and approaches to Islamic Finance.

Opalesque Futures Intelligence, a new bi-weekly research publication, covers the managed futures community, including commodity trading advisers, fund managers, brokerages and investors in managed futures pools, meeting needs which currently are not served by other publications.

Opalesque Islamic Finance Intelligence offers extensive research, analysis and commentary aimed at providing clarity and transparency on the various aspects of Shariah compliant investments. This new, free monthly publication offers priceless intelligence and arrives at a time when Islamic finance is facing uncharted territory.

Alternative Market Briefing is a daily newsletter on the global hedge fund industry, highly praised for its completeness and timely delivery of the most important daily news for professionals dealing with hedge funds.

A SQUARE is the first web publication, globally, that is dedicated exclusively to alternative investments with "research that reveals" approach, fast facts and investment oriented analysis.

Technical Research Briefing delivers a global perspective / overview on all major markets, including equity indices, fixed Income, currencies, and commodities.

Sovereign Wealth Funds Briefing offers a quick and complete overview on the actions and issues relating to Sovereign Wealth Funds, who rank now amongst the most important and observed participants in the international capital markets.

Commodities Briefing is a free, daily publication covering the global commodity-related news and research in 26 detailed categories.

The daily **Real Estate Briefings** offer a quick and complete oversight on real estate, important news related to that sector as well as commentaries and research in 28 detailed categories.

The **Opalesque Roundtable Series** unites some of the leading hedge fund managers and their investors from specific global hedge fund centers, sharing unique insights on the specific idiosyncrasies and developments as well as issues and advantages of their jurisdiction.

OPALESQUE

www.opalesque.com



OPALESQUE

ISLAMIC FINANCE

INTELLIGENCE

PUBLISHER

Matthias Knab - knab@opalesque.com

EDITOR

Bernardo Vizcaino - bernardo@opalesque.com

ADVERTISING DIRECTOR

Denice Galicia - dgalicia@opalesque.com

FOR REPRINTS OF ARTICLES, PLEASE CONTACT:

Denice Galicia dgalicia@opalesque.com

www.opalesque.com