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First of all we would like to extend our sincere gratitude for the warm reception and the extensive feedback received following the first edition of Opalesque Islamic Finance Intelligence. Our maiden issue saw OIFI building a readership of well over 2,000 and this only solidifies our commitment to explore industry-specific content, encourage critical discussions and lively interaction. All of which we resume in this our second installment, where we explore the specifics of Shariah scholars and Shariah boards.

It is the most essential question for practitioners and non-practitioners alike: how do you achieve Shariah compliance? While there is no clear cut answer we run through a Shariah Compliance Toolkit that delves into the mechanics of engaging Shariah advisors, the existing business models, procedures & timelines, agency & monetary costs, as well as some recent developments. Our Featured Resource section sheds further light on various Fatwa databases and search engines that are useful in specific areas of research.

While we scrutinize the Shariah compliance function, it is imperative to debunk the notion that this is to be handled purely by scholars and/or advisors, input/responsibility must be borne by issuers/developers as well. Nikan explores how the manufacturing process has fared in this regard in the Featured Structure section, highlighting some of the recent entries into the landscape of Islamic products (such as CPPI vehicles and other structured notes).

We focus further attention on the perspective of the boutique (or more specifically the perspective of a non-Islamic financial institution) as it pertains to creating and developing solutions. Our Allocator Interview examines the experience of Amiri Capital in putting together a Shariah compliant platform and the challenges faced in bringing products to market.

While we have dissected exotics, even the most vanilla of contracts isn't exempt from scrutiny, as Khalil explores the intricacies of modern murabaha contracts in the Lexicus Islamicus column. Moreover, differing opinions on this and other instruments have reignited the debate of whether Shariah boards (and their approval process) should rest within financial institutions or at the country level, with the Discussion Board opening the floor to industry voices.

Finally, from these various inputs we probe the outputs as well - surveying the 'bad habits' of Islamic fund managers in our Industry Snapshot section. Once again we welcome your comments & suggestions, and please check the archive of Opalesque Islamic Finance Briefing which is now available online - providing a free historical data bank of industry news (over 3,300 articles) as well as back issues of OIFI. It's all there, it's all free.

Thanks & Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

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The Shariah Compliance Toolkit

This must be clear from the outset: Shariah compliance is not a label or a marketing gimmick, it must be regarded as a companywide framework which - as the IFSB puts it - "reinforces good governance and integrity, but also influences the way governance structures and procedures are implemented." In other words, Shariah compliance is not an end by itself; instead it should be understood as a process which provides guidelines for corporations to increase their benefit to society. How can this be done? What are the steps required?

From A to Z

A suggested starting point can be the IFSB itself, as it has set out guiding principles for 'corporate governance' and much more recently for 'Islamic collective investment schemes' (which specifically address capital market instruments). They are readily available and most importantly should be regarded as prudential in nature - thus useful from a top-down perspective to setup the initial groundwork. However, they are also meant to be inclusive of all schools and approaches and hence they have been criticized for not being descriptive enough. On the other end of the spectrum we have AAOIFI standards, which are instrument-specific and deal with the actual financial instruments and contractual specificities (such as setting up a Shariah board of review). While only available in hardcopy format they explore in ample detail the range of Islamic instruments, although it is left to institutions themselves to determine the ultimate purpose and how they should be used (this requires a separate and extensive discussion as well).

These industry bodies can be viewed as promoting two different approaches: principle-based (IFSB) and rules-based (AAOIFI). Although this might be an over-simplification, taking on a dual-approach can go a long way in establishing a solid Shariah compliance framework. Crucially though, both IFSB and

AAOIFI are not enforceable and they are only recognized by specific jurisdictions (for instance Bahrain where the latter is headquartered), ultimately observance rests on the individual financial institutions themselves. Despite the fact that their application is not universal and membership is not a pre-requisite, they do provide a sensible starting point. Currently though, AAOIFI has 180 members and IFSB 185 members (for both a substantial percentage being central banks and/or regulatory agencies), so there are growing calls to increase the number of institutions representing the private sector.

The crux of the matter is connecting the initial prudential framework (i.e. IFSB) with the final mechanics (i.e. AAOIFI) and this is open to various approaches. Nevertheless, in the context of an Islamic investment fund the following key conditions should be highlighted (as outlined by Sheikh Nizam Yacuby):

- (1) *Complete Segregation of Funds* – not comingling investor funds with those of conventional ones.
- (2) *Shariah Supervisory Board (SSB)* – this should be clearly stipulated in the articles of association, prospectus or statutes.
- (3) *Management Fully Convinced of Islamic Concepts* – as opposed to compartmentalizing the carrying out and application of principles.
- (4) *Safeguarding Investors against Negligence, Trespass and Fraud* – while capital is not guaranteed the investor interest should be catered for (and beyond the construct of an Islamic window)
- (5) *Compliance with Standards (of AAOIFI)* - in order to avoid confusion, misunderstanding and ambiguity, and to seek clarity and sound business activities.

Methodologies

While there is no specific approach for doing so, the market does exhibit a variety of models that can be emulated. This very much depends on the type, number and complexity of the product



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to be developed as well as the strategic objectives of the parties involved. Nevertheless there will be two core steps: the initial setup and the periodic review.

The initial setup can be broken down into the following (predominantly a legal exercise where documentation is examined by Scholars, lawyers and manufacturers):

- (1) *Stipulating Shariah compliance in the legal context* (documentation stipulating this internally as in the articles of association and externally as in the prospectus or offering document).
- (2) *Developing Shariah investment guidelines* (which funds, objectives, mechanics, and crucially the internal compliance function, etc).
- (3) *Drafting a Shariah compliant manual* (addressing steps, resolutions, non-compliance events, purification of non-permissible income, etc).
- (4) *Formation of the Shariah board* (which issues a fatwa for the product/service being considered).

The periodic review is equally important as it solidifies compliance of the product/service as a going concern (i.e. compliance function, problem/dispute resolution, and continuous guidance of the SSB). More specifically the following would be required: (1) an internal Shariah audit (which can be carried out by the existing internal compliance officer provided they are knowledgeable of the requisite Islamic banking principles) and (2) an external Shariah audit (which can be supported by an audit firm with Islamic finance expertise such as Deloitte, PWC, E&Y, etc).

SSB - Business Models

Once again there are options, with some providers having retained the services of a single Shariah advisor (for plain vanilla or standalone products) whilst others have multiple-scholars attached to their boards (in case of having an extensive product suite). Another prominent scholar has clearly outlined that it is completely acceptable to have a single scholar in place but at the same time *"the presence of a full board would undoubtedly be more assuring to investors, and quite possibly more effective as well."* IFSB guidelines also stipulate that a Shariah Supervisory Board or Advisory Company should be in place, although there is no mention of multiple scholars (it is left instead to the discretion of the institution and to 'market forces').

What is imperative is the establishment of an SSB and incorporating this function into the organization. Sheikh Nizam is unambiguous in this regard: *"the Articles of Association or the prospectus, or statutes, depending on the type of activities, should provide for the existence of the Sharia Supervisory Board."* This SSB though, can come into existence in various forms:

- (1) *Internal SSB*: most likely to be used in the case of a fully-fledged Islamic Financial Institution that requires a wide range of products/services.
- (2) *External advisor* (standalone - independent): a single advisor where the product in itself might be vanilla, straight-forward and/or to be offered locally.
- (3) *External advisor* (company - consultancy): external advisory firms have proliferated in recent years, arguing they can support more complex or sophisticated solutions and provide a board that has regional/global representation.
- (4) *Hybrid Model* - External SSB (country board): certain jurisdictions will provide blanket approval of pre-approved products or acceptance of generic business practices, albeit this is recognized for their local market.
- (5) *Hybrid model* - External SSB (strategic partners): a more recent development where Islamic banks (with an SSB already in place) partner with conventional institutions and each contributes their respective expertise to bring a product to market.

At the end of the day flexibility (and perhaps confusion) remains - even in their nomenclature: Shariah Committee, Shariah Board, Religious Supervisory Board, Shariah Advisor, Shariah Supervisory Council....

Costs

Price discovery is a fine art in Islamic finance, and as a provider put it "the market is relatively nascent and pricing points are yet to stabilise. Further, client requirements are varied in terms of: the number of funds / assets they need the system for, the level of criteria specification they require, and the sophistication of integration work they need for their systems."

Considering this is a crucial component of the toolkit we tackle costs as openly as possible. Since the methods vary tremendously so does the pricing range: For instance, some criterion used is for a monthly retainer fee but this can be anywhere between US\$300 to US\$10,000 (and is subject to

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the understanding of the parties involved).

Nevertheless, pricing is usually broken down into the two components mentioned earlier (setup and review). More specifically:

- (1) Structuring: for instance in considering an investment fund, this one-off fee can range from US\$20,000 to US\$60,000 (median of US\$40,000) for preparing the structure, legal documentation, issuance of fatwa, etc.
- (2) Review: for the supervisory and monitoring function to ensure that the fund complies with Shariah principles, this retainer fee can range from US\$20,000 to US\$55,000 (median of US\$40,000). Thus, some recent Islamic fund launches have seen approximately US\$80,000 spent on the first year of operation alone.

There are other quotes available and it must be noted that full-fledged Shariah boards will require payment for each board member (sometimes along the lines of 25k to 50k per advisor) and that intricacies such as travel expenses and ancillaries will have to be absorbed as well.

Variations

The range of costs is wide since there are multiple products to be considered. For instance, if a single vehicle is setup then a single (and in some cases external) Shariah advisor would suffice, whereas if a master-feeder type structure were to be considered (with subsequent sub-funds being launched) then a more comprehensive SSB should be considered to look into the underlying structures and issue a Shariah compliance certificate for all the underlying assets/funds. In this case having an SSB for every single fund may be more expensive.

Furthermore, there are additional products/services that might be required and that should be taken into account as well, a case in point being Shariah screening mechanisms. In certain instances stock screening will be an integral part of the investment process, and some advisors might not be able to provide this specific service or there might be more sophisticated/ superior screening from specialized providers.

Pricing varies due to client specifications: some screening systems stipulate a pricing of three basis points of AUM, whereas a global universe screening might command from US\$20,000 to US\$150,000, although a passive product (i.e. ETF) would be significantly cheaper. Once again, permutations

exist where a combination of an upfront fee and basis points thereafter can be established. In other cases some providers aim for a revenue-sharing approach (say 30% to 50% of revenues) in particular where the solution is a passive product or an index/benchmark that would be used for public dissemination.

Issues

Launching a specialized fund, even in a stringent jurisdiction (a Hong Kong based hedge fund for example), can cost anywhere between US\$5,000 to US\$16,000, so in comparison the above figures are receiving downward pressure. Nevertheless, pricing is in practice expected to broaden: on one hand one must consider the growing calls for country Shariah boards (which would help streamline the development of vanilla products) and on the other you have advisory consultancies increasingly engaging in more complex structures (i.e. more expensive).

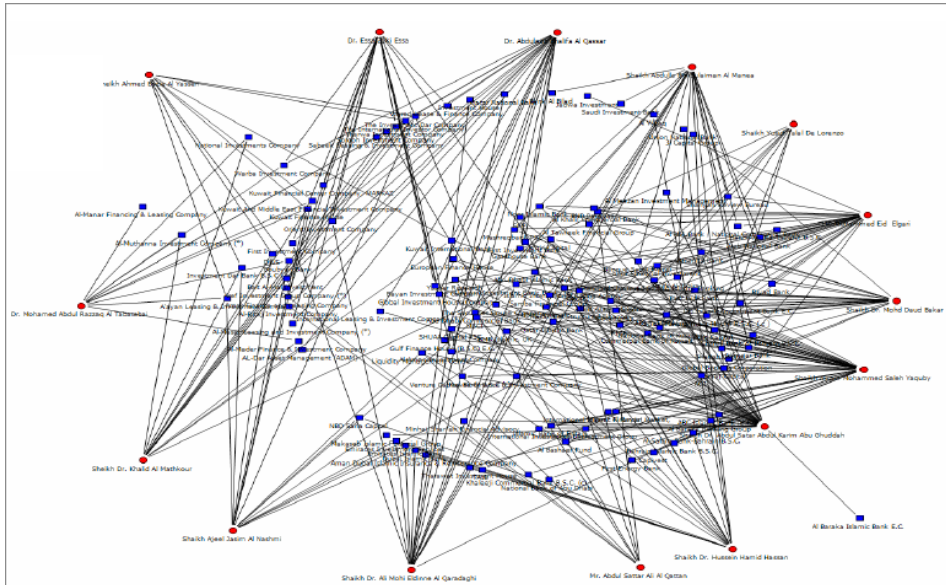
Another development is the increased scrutiny of the compliance process itself, namely the specific role a Shariah advisory firm can undertake (i.e. what they should and shouldn't do) and the independence/impartiality of these boards. With current industry efforts focusing on corporate governance, these issues are bound to take centre stage.

Specifically, some observers and practitioners (INCEIF for instance) recommend that separate entities should be used for the Shariah setup and Shariah review. The fact that it is called a review (rather than an audit) gives rise to questions of how enforceable and critical a Shariah Board might be - in particular when there are breaches (of standards/rules) or deviations (from principles/guidelines). Similarly, there are circumstances where the body that drafts the procedures/manuals then proceeds to audit/review the same, such "self-review" questions the independence and impartiality of the process.

Independence of the board members themselves has been further scrutinized, with research by Funds@Work being particularly noteworthy (see "Shariah Scholars in the GCC – A Network Analytic Perspective"). For instance, they find that three specific Scholars are members of 26% of all Shariah boards in the GCC. There is also differing levels of activity between Scholars (from a total of 121 studied): approximately 56 Scholars holding

less than 3 board positions, whereas the top 10 Scholars hold on average more than 25 board positions.

Well Known Shariah Scholars and their Network of Relationships



Source: Funds@Work

The fact that they are highly interlinked might not come as a surprise (to an extent this is to be expected). As a matter of fact, if they are indeed so inter-linked this substantiates the logic behind having a country or even a regional Shariah board (since so much commonality already exists between the various Islamic banks). Nonetheless, the onus remains with the IFIs themselves to mitigate conflicts of interest, ensure confidentiality and protect intellectual property.

In any case, all the above components must be taken into consideration for comprehensive Shariah compliance to be achieved. The hope is that more and more information is available on this subject and this will in turn encourage more institutions to consider the benefits of Shariah compliant products and of Islamic finance as a whole (as these benefits are increasingly outweighing the costs).

**Featured Resource:
Fatwa Databases & Search Engines**

Fataawa Banks for Fiqh Al Mu'amalat

[Al Baraka Group Fatwa Bank](#)
(Product-specific fatawa)

[Assembly of Muslim Jurists of America](#)
(Financial Transactions fatawa)

[Bank Negara Malaysia](#)
(Shariah Advisory Council resolutions)

[Universiti Sains Islam Malaysia](#)
(World Fatwa Management and Research Institute)

[Harvard Islamic Finance Information Program](#)
(one-time registration required)

[International Shari'ah Research Academy for Islamic Finance](#)
(ISRA) (bilingual fatwa listings)

[Institute of Islamic Banking and Insurance](#)
(IIBF) (Shariah Advisory Unit rulings)

[IslamQA Principles of Fiqh-Transactions](#)
(Jurisprudence and Islamic Rulings)

[IslamWeb Fatwa Center](#)
(Transactions and Inheritance)

[Monzer Kahf's Website](#)
(historical listing of fatawa)

[Malaysia International Islamic Financial Centre](#)
(MIFC) (see The Shariah Resolution Book)

[Securities Commission Shariah Advisory Council Resolutions](#)

Structured Products - the most suitable, efficient and fittest?

By Nikan Firoozye, PhD



Are Islamic Investors the new Fertile Ground for conventional structurers looking to exploit a lack of sophistication? This is a question that few are brave enough to ask but should come to the minds of almost everyone who is not overawed by the next best retail product offering multiples of LIBOR returns except for very specific (and historically rare) occurrences. While conventional structuring desks are downsizing (and some investment banks categorically exiting the structured products business) this sector within the Islamic Banking industry is undergoing a relative boom. Despite the fact that the motives, underlying exposures, fees/costs, back-tests, and ultimate delivery of these products is being challenged elsewhere.

Some of the reasons are very subtle but very telling: in most conventional investment banks Islamic finance is merely a branch (or a desk) of other groups, usually Structured Product and Securitizations. Typically, bankers with significant backgrounds in conventional securitization and an interest in Islamic Banking are tasked with structuring and issuing sukuk. This has of course developed into a discipline in and of itself. Thus, those with a background in conventional structured products have merely to figure how to deal with (and

oftentimes circumvent) Shariah constraints on top of the legal, tax, and regulatory issues they already deal with and the pricing, hedging, and willingness of traders and risk managers to take on the residual risk, matters that always come with the territory. Hence, being a branch of Structured Products and one that has managed to survive while other areas are drying up, it makes sense that conventional bankers should be falling all over themselves to come up with the next best Islamic Structured Product. In a sense this also explains why sukuk is engineered to fit into a fixed income device - when it rightfully belongs as an equity-hybrid instrument.

The conventional structured product industry has most certainly had a bumpy ride. Issuance had grown rapidly over the years, with Equity Exotics always leading the way and Fixed Income making major leeway from 2001 onwards with the issuance of a large amount of CMS-linked notes and later range accrual and even autocalls, the majority of which having been placed with retail accounts. However, as early as 2005, there were growing pains. Investors, having bought some highly complex instrument backed by AA financial institution (sometimes on margin) wanted to know why their valuations were down and margin calls were already being made. Structurers in Europe were keen to show that many of the poor valuations of the product that they had sold were not due to the structured cashflows being intrinsically bad, but instead the issuers' credit spreads had widened.

Most structured products in Europe are delivered via private banks to HNW individuals through Euro-MTN (medium term notes) platforms, legally efficient means for large financial and other institutions, sometimes called 'frequent borrowers', so they could issue small notional notes with bespoke structures. In each such structure, the issuing institution, be it a high quality KFW, EIB, or WorldBank or a lower rated entity such as RBS, Barclays

Featured Structure

“As to the claim that these traditional financial institutions want to unfairly compete with Islamic financial institutions, it can be refuted by saying that competition is always in favor of the most suitable, efficient and fittest. Perhaps this kind of competition will prompt Islamic financial institutions to exercise more diligence and care to introduce better quality products and to be more efficient in their activities”.

- Sheikh Nizam Yacuby

Capital, or Lehman Brothers would have their Treasury department - which manages the funding needs - enter into a swap with the underwriting bank's exotic desk in order to hedge it. Treasury merely pays LIBOR plus or minus some attractive spread to compensate Treasury for their minimal efforts. Valuations consequently can change based on the credit quality of the issuer or the change in valuation of the hedging exotic swap.

Nonetheless, issuance continued with 2005-2006 being bumper years for all structuring desks, allowing them to grow and move further down the value-chain. Penetration was high and some regulatory regimes aided the process by being overtly lax. An industry observer in the research department of a large city bank was particularly peeved to learn his mother had walked into her local bank in Germany and bought some CMS-steepeners, mostly because of the higher first coupon and the amazing returns in the backtest. The results were as should have been expected. In Singapore, exotics traders would admit shock that the products similar to those they regularly traded and risk-managed were being offered in brochures to the general public (in vaguely incredible terms) without much in the way of disclaimers. In other countries, the fact that these products are offered only to high-net worth individuals with many disclaimers proved little disincentive and exotics traders (and their delivery channels) worked overtime.

Although credit spreads widened during the same 2005-2006 period, this was only a small hint of what was to come. Many structures did exceptionally poorly during the crisis. Spreads generally widened further (or there were defaults as was the case with Lehman Brothers). With vanilla products being hard to price, structured product became incredibly hard. Obviously there were some winners, but the amounts of money lost were cause for retail clients to pull back entirely from the market.

With their fingers burned, retail accounts lost most demand for any exotic structure. Several structuring desks were shut down (tellingly some were closed well in advance of the actual market downturn, they knew what was coming). Despite the exists this did not cause structuring as an enterprise to cease. Clients still had some appetite for simple structures (i.e., delta-one, simple funds

whether they were algorithmic, indexation, replicants, etc). Structuring desks did not remain stationary although retrenchment continued on the conventional side and few (if any) retail launches to boast in the past year or so. Nevertheless, there is still resilience in Islamic finance and Islamic structured products are still making headlines in the GCC and SouthEastAsia.

Structured Product: Sold on a promise but often misunderstood

Structured products offer considerably higher returns than traditional bonds or equities, and in many cases can do so with a more limited downside. In this they offer a sort of sophisticated approach, preserving capital while still leveraging potential rewards. The utility is obvious. Unfortunately some stick closely to this more sober investment strategy and some are merely highly leveraged bets. Most often it is difficult to tell them apart, especially by the unacquainted investor. In the case of the more sophisticated clients, they must hold a view in the first place and the structure is effectively designed to take advantage of that view, whether it be that volatility is falling, that rates are range bound, that equities will never fall again, or that the Federal Reserve will hike over the next 6 months without fail. The structure will be a risky bet that the view holds true and will pay above-normal returns in such a case. On the other hand, if the view fails to materialize the structure may pay less or may even pay 0% return, all depending on the fine print. Non-principal-protected structures can have of course much more serious downside. Regardless of which one of these, the fact is that probabilities, likelihoods or even a simple payoff distribution are never mentioned or even required.

In reality, most clients are far less sophisticated and they have no view of their own, until the view is marketed to them. The product is sold merely because it looks cheap and it backtests well (i.e., if you could have bought the same product every year over the past 20 years without fail you would have made these stellar returns). Products sold on a backtest are particularly poor since they usually involve buying a risk that is cheap now because of market-wide liquidations, but that risk is likely (if not guaranteed) to revert. Backtests, in all their glory, are a very poor form of statistics.

Featured Structure

Some clients of course do exceptionally well with structured products. Those with a view are paying up for the ability to leverage that view without having to have full-time staff to roll repos, find securities to short, etc. As a structure it can be a very efficient way of encapsulating specific views of the market. Even those who were sold products which they did not clearly understand could have done exceptionally well, depending on the entry point. However the prudential aspect must focus on the many who do not understand what they are buying, allocate disproportionate amounts of their total savings, and exacerbate the problem by trying to liquidate their position in a down market.

Structured products, by design, are more opaque than their vanilla counterparts. Customers and intermediaries oftentimes barely understand the cashflows let alone the way that returns are calculated or delivered. This is especially true about valuations. Margins are sometimes explicit, but oftentimes reserves (for re-hedging costs) and sales credits are completely hidden. Smart buyers, of which there are some, will ask for multiple quotes and many structuring desks are used to reverse engineering a structure just so they can reprice it. Most retail users are sold these products by intermediaries (private banks or other financial entities) who are generally incented by the distribution fees (made explicit, to be fair) and consequently there is little shopping around done by them.

In times of trouble structuring desks have made little actual commitment to make secondary markets. There are exceptions and there are traders who will buy and sell structures (usually those underwritten by their own exotics desks) generally at relatively wide margins. With valuations down, clients will turn to their private banks who in turn will ask for bids to liquidate the structures. With little commitment to make a secondary market, structuring desks may actually make larger fees in the cleanup phase of structures-gone-bad than during the original sale.

Islamic Structured Product

Many investment banks invested time and money in the development of means of structuring a range of structured products. Some of these resulted in platforms for supplying the structures and some of these platforms are much more flexible than others. BNP Paribas launched its BNP Paribas Islamic Issuance BV platform in 2006, and UBS launched a platform for bespoke commodity-linked structures around the same time, while Deutsche took many years to flesh out its platform resulting in al-Mi'yar, launched in January 2009. ABN Amro (now RBS) launched some of its Al Mumtaz capital protected certificates in

2008 (and issuance has been sustained ever since).

Meanwhile, structured products are still front page still while the rest of the world is unwinding. Perhaps Islamic investors, not having invested in structured products in the past, were not scathed by the recent falls in valuations. Perhaps the marketing is key, with structured products finding a home in eager-to-innovate Islamic banks. Certainly the announcement in July 2009 of DIB's 1year Crescent Commodity Twister Strategy, a CPPI on a Long/Short index shows that structured products are alive and well in Islamic Finance.

One can't help notice that Islamic investors flock to structures that have long been disfavoured in the conventional world. This has happened before, when a product loses favor in conventional finance it is wrapped for delivery to Islamic finance. This is not confined to structured products though, there are cases of suboptimal real estate, quasi-distressed projects, highly-adventurous venture capital, downward-sloping equities. They all fund a new life as Shariah compliant vehicles (often garnering attention as trail-blazers, first-of-its-kind, unique).

An example here is CPPI or Dynamic Strategy, something that has become prevalent in Islamic Finance. CPPI (Constant proportional portfolio insurance) is not a bad structure, being a dynamic way of delivering principal protected investments with a good deal of upside potential. However, dynamic structures are hard to explain to clients and - if they are sold - they are even harder to explain to clients ex-post when they want to know why they will only expect to get 0% for the entire lifetime of their investment and the structurer must explain that it is not because equities have fallen but it is because bonds have rallied.

Consequently, even in good times, CPPI has not sold that well in the conventional world. A further problem is something known as gap risk, a kind of insurance wrapper for CPPI structures (insuring the breakdown of hedges) is now almost impossible to source. The recent crisis has shown that assets can gap significantly and the sellers of gap-risk insurance have been called in many cases to help cover losses. Nowadays, almost nobody wants to underwrite this risk and CPPI issuance has come to a halt. In the Islamic banking world though, gap risk is somewhat more of an anomaly and in fact insuring it may not result in a shariah-compliant dynamic strategy.

So while the rest of the world sits back, the Islamic world is moving headlong into structured product. The marriage is not necessarily optimal.

Amiri Capital

Interview with Bindesh Shah, partner and founder, Amiri Capital LLP

Amiri Capital LLP was founded in early 2006 by Bindesh Shah and Richard Ellis. The firm develops, markets and distributes Shariah-compliant investment products for Islamic investors worldwide and has developed its own proprietary Shariah Screening System, called Amiri S3, which scrutinises about 38,000 stocks globally for Shariah compliance.

What are some of the key drivers of growth for the Islamic finance industry? Considering these factors, what the opportunities being presented to new entrants into the space, and more specifically as it relates to alternative products?

The Islamic finance market is young but expanding even in, or maybe even because of, these challenging times in the world's financial markets. One of the drivers of that expansion, of course, is the huge amount of liquidity in the Gulf. Another is the strong economic growth in countries like Malaysia and Indonesia. This is creating a large pool of investable assets, some of which are already Islamic. Within both regions, though, there is a move toward doing more and more investing in Islamic structures.

In spite of this, there is a limited range of good quality Shariah-compliant investment products. Indeed, in the alternative space there are hardly any products. It is highly likely the investment industry in the Islamic sector will move in the same direction as the conventional sector, where there has been a shift toward alternative assets because of the desire to create more predictable and higher returns. This will happen in the Islamic sector as well.

In the context of alternatives, where do you see the industry in terms of investor acceptance and sophistication? What are the major impediments to bringing more of these products into the marketplace?

Potentially, over the next few years, there will be up to USD90bn available to the Islamic alternative investment market. That's still small relative to the conventional alternative investment sector, even with the recent contractions, but it's still big enough that even a small share is a prize worth having.

Part of the reason there is a dearth of alternative Islamic funds is that they are very time-consuming and difficult to launch. A conventional hedge fund takes, on average, a year and a half to

go from idea to market. By contrast, it can take at least three years to launch a Shariah-compliant fund. An Islamic fund faces hurdles unknown to conventional hedge funds – specifically constructing a Shariah vehicle and getting it approved by Shariah scholars. This takes time and patience, particularly in launching something new and untested.

What have been some of the main challenges from the product manufacturing point of view? How can these be mitigated or managed?

Making an alternative investment of any sort Shariah-compliant is just the first hurdle. The second is attracting high quality managers, given that many are put off by the constraints they feel they would be faced with. The key here is to show the potential portfolio managers they will not be able landed with an administrative, legal and operational headache. This is done by setting up the legal structure for them and creating a managed accounts platform where we take care of the administration and operations. As a result of this all they have to really worry about is picking the stocks they want to buy or sell and checking them for Shariah compliance and using your nominated prime broker for the trades. What could be simpler than that? Once you show them this most of the time they are more than happy to run a Shariah compliant portfolio as this then opens up a new source of capital for them.

The third hurdle is managing everything in a cost effective way, so as to avoid creating any additional ongoing cost for the fund – to ensure it is no more expensive to run than a conventional fund. Of course, there will be differences in the cost structure, but the net effect should be broadly equal. This is necessary to reassure investors that their returns will not be hurt.

Can you describe the process you have undertaken to attain Shariah compliance? Are there any specific pitfalls or misconceptions that need to be addressed from the start?

The first step in creating a Shariah fund is to set up a Shariah supervisory committee, which passes judgement on the legality of the proposed fund's structure. It's important to understand that there's not one body of thought in Islam; there are several schools. It's essential to have a Shariah supervisory committee

Portfolio Interview

that covers most of these different schools and get the committee members to come to some sort of agreement. If you don't, you could find yourself with a challenge in the Gulf, say, or Malaysia. It's equally important to get a consensus decision, instead of relying on a majority vote. At the end of the day, the entire committee needs to be comfortable with the decisions it makes.

Why are Shariah compliant alternative solutions so complex and lengthy to develop? While the non-permissibility of interest and/or leverage is at the forefront, what are other issues that must be taken into consideration?

There are specific problems with particular hedge fund strategies. Take, for instance, equity long/short, one of the principal hedge fund strategies, covering about 40%-60% of the market. The key problem with equity long/short from an Islamic perspective is that shorting in the conventional sense is not acceptable. First, shorting involves selling something you don't own, and under Islamic law that is illegal. Secondly, when a manager receives the short proceeds, they are put in a bank account and earn interest – which, as is well known, is also not allowed.

The optimal solution is to devise a new structure that retains the economics of shorting but takes away these issues, while maintaining the commercial viability of the fund. It can't just be fine from the Shariah perspective: it's about everything coming together. In setting up an Islamic fund of funds, the real test for an underlying manager is not whether he or she is willing to give it a try, but whether he or she can make money. One other point: not only must the managers be able to work within the structure, but the prime brokers must be able to implement it. Most of the legal documentation in the conventional hedge fund sector has been developed over the past 20 years, and much of it is unacceptable under Islamic law (actually, now following the Lehman bankruptcy where many hedge funds found that their not as well protected by this legal documentation as they thought much of it is now under question in conventional markets as well). This means a great deal of work with the prime brokers, reengineering their systems and rewriting legal documentation.

While you have developed your capabilities internally, would single managers need to build their own product and compliance function as well? Are there any specific types of managers/strategies that are better suited to do this?

Let's look at what managers have got to do that's different in an Islamic fund of funds. First, it would not be possible for a Shariah-compliant fund to invest in the managers' conventional funds because they will have any number of investments in them that would not be Shariah-compliant. Essentially, underlying managers can only run a dedicated managed account. They

are offering investment expertise. In the end, this simplifies things because they are not required to run a fund. Of course a conventional single manager can set up their own single manager Shariah compliant fund but they would need to separate out the legal structure from their existing funds, establish their own Shariah Supervisory Committee and build their own Shariah compliance operational function. Therefore, it is possible but it all takes money and this could act a significant drag on performance for a single manager.

The next thing they need to take into account is that every investment must be checked against a Shariah screening system and every investment must be scrutinised to see if it meets an Islamic fund's criteria. This can be unnerving for some managers. From the point of view of an Islamic fund of funds, the best managers are likely to be value managers, operating concentrated portfolios. They're the most suitable to work in the Shariah space where the investment universe is limited by Shariah criteria and managers need to look at the stock more fundamentally than otherwise.

What are some of the issues relating to the product itself (i.e. portfolio construction, manager identification/selection, diversification of idiosyncratic risk, etc)?

One of the criticisms of Shariah-compliant funds is that if the investment universe is reduced, then returns must also be reduced. Fortunately, that's not true. Many academic studies have shown that if managers select from a smaller pool of stocks the returns are not reduced, but the volatility is slightly increased. Even that, however, can be quite marginal if the universe of potential stocks numbers in the thousands, rather than in the hundreds.

There is also the issue of the number of underlying managers. Shariah-compliant funds of funds will tend to have fewer managers than conventional funds of funds – principally because there are fewer managers who can meet the criteria of an Islamic fund. Some people say a true fund of funds needs a multiplicity of underlying managers to gain the benefits of diversification. But again, academic study after academic study has shown that you get 80% of the benefit of diversification by using just five managers.

We often hear about tapping Middle East liquidity and several industry guesstimates, on the ground though how crucial is product distribution and how does it differ from conventional products?

Marketing a Shariah-compliant product is different. Doing business in the Islamic world is about building relationships. You need to spend the time and effort to get to know the clients and understand their businesses. This can mean spending a lot of time in the region – not necessarily a hardship, but not something you need to do with a conventional fund.

Modern Murabaha - a fiduciary sale or a misnomer?

By Khalil Jarrar, J.D.

The use of the term infancy in reference to Islamic finance law - *murabaha* included - is somewhat revolting when the infant is over fourteen hundred years old. It gives rise to questioning the term used introducing old instruments in a new garb, embroidered with Islamic calligraphy that might or might not be *shari'a* compliant.

Notwithstanding the known prohibitions in Islamic law, business transactions are permissible by default. Absent necessities, when prohibitions are clearly expressed, the perfect tender rule applies where substantial compliance does not render an instrument permissible. Thus it seems the infancy label is used in the context of modern finance and adapting some Islamic principles to accommodate conventional financial instruments or banking practices. However, Islamic market ethics have existed throughout history protecting pecuniary, property and liberty interests of members of society. More specifically, money in Islamic law is to be circulated creating equitable economic opportunities with negative covenants safeguarding the exploitation of the weaker party. The modern use the *murabaha* contract is at the center of this debate.

Loitering on the use and definition of *murabaha* is necessary as there are significant implications: Today *murabaha* is far and wide the most popular and most common mode of Islamic financing. It is also known as mark up or cost plus financing (in fact the word *murabaha* is derived from the Arabic word Ribh that means profit). It is by far the instrument of choice in most Islamic finance houses minimizing risk for such institutions, with higher return in a short investment cycle. This is further evidenced by some of the largest Islamic funds trading vast amounts of *murabaha* contracts – often in the overnight or money markets (indeed some *murabaha* mutual funds in Saudi Arabia hold well over US\$1 billion in assets under management).

Modern *murabaha* is as controversial an instrument as it is maligned by practitioners, mainly due to the fact that the bank plays a marginal role in the goods or commodities sold (where the bank is neither a merchant nor in the business of selling the goods - rather a basket of kaleidoscope goods being financed). Aside from being a financier, such practice will be held as a violation of the ultra vires doctrine in most common law jurisdictions. Recently though, there have been modest moves in Kuwait, Qatar and the UAE where banks have become merchants acquiring car dealerships and real estate properties, selling the products with a deferred mark-up margin, a move that is closely aligned with *shari'a* principles (for instance in Kuwait some car dealerships operate under the concept of *musawama* albeit the markup is not disclosed to the buyer but asset ownership is far more exact). Although AAOIFI has attempted to standardize *murabaha* contracts, the use of *murabaha* by IFIs is consistently inconsistent - at least a dozen definitions or methods for structuring such contracts exist.



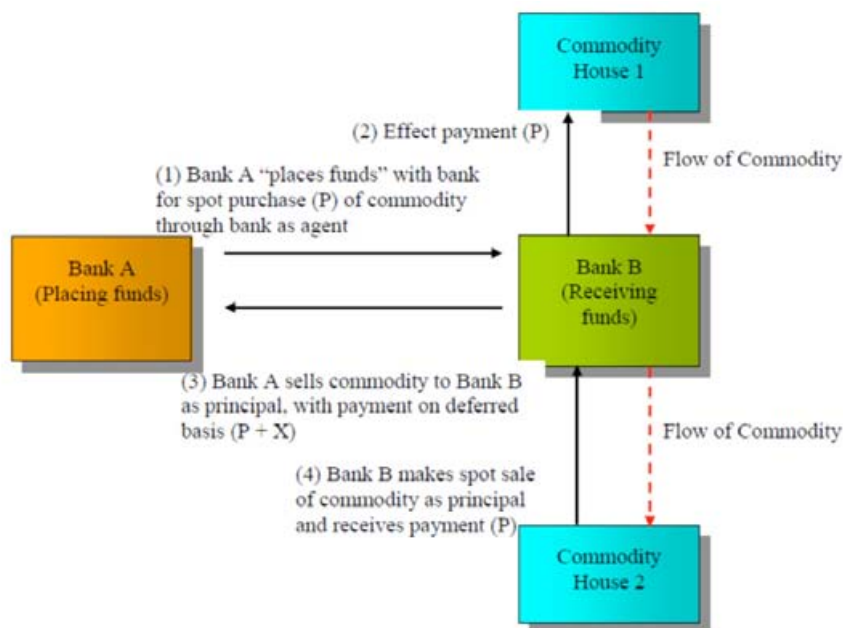
In an article by Haider Ala Hamoudi on modern law *murabaha* titled “Chasing Chickens and the *Murabaha*” the author describes a debate on the issue of compliance of *Murabaha* contracts between him and Sheikh Yusuf Talal DeLorenzo, this specific anecdote comes to mind:

“I referred to a moment in my childhood when I complained to my grandfather respecting the Shi’a prohibitions on eating rabbit. Why was it, I wanted to know, that all the Sunni school kids could eat rabbit, but I could not? My grandfather, Allah bless him, was unfazed, and told me I wasn’t missing out on anything, because scientists had shown that if you chase a chicken around for 30 minutes and then slaughter it, it ends up tasting precisely like rabbit. (If he’s right, then I can confirm, rabbit tastes just like chicken.)”

Traditional *murabaha* is neither a chicken nor a rabbit, rather a fiduciary sale where the seller expressly mentions the cost he has incurred on the commodities to be sold with a mark-up known to the buyer conditioned by an honest declaration of cost. Plain and simple. *Murabaha* is rarely used by Islamic banks with the price paid immediately by the customer. In such cases, there would be no financing included and the Islamic bank would simply be a middle-man or broker-agent (*simsar*).

Modern day *murabaha* contracts arguably meet the requirements of the traditional definition under Islamic Law. Or do they? If we take a look at a generic modern *murabaha* definition (take for reference the recently issued Islamic banking guidelines of the Monetary Authority of Singapore, as shown in figure 1); it is a contract between the Bank (here Bank A) and a customer (here Bank B) under which the customer initiates the purchase of certain goods/commodities/assets as an Agent of the Bank, and after taking possession of the goods/commodities/assets (normally constructive) Bank A sells these to the same customer (Bank B) by adding a certain profit margin to its cost over a deferred period of time (here $P + X$). Finally Bank B, after purchasing the assets back, sells the assets to an external party (a commodity house or other third party).

Figure 1: Structure of a *murabaha* interbank placement



Source: Monetary Authority of Singapore

In most cases, the bank never takes actual or constructive possession of the goods sold (the ‘flow’ of the commodity is very much transient), the buyer does the shopping and price

negotiation. Once a deal is reached between the buyer and the seller, the buyer approaches several Islamic banks and gets approval on financing the product. The buyer signs an agreement with the bank for the scheduled payments and the bank in return communicates with the seller and obtains the relevant information to finalize the purchase and issues a check in the full amount for the goods purchased.

To begin with, we have two transactions: the first is a principal agent relationship which is in most laws acceptable absent an agreement if the principal ratifies this fiduciary relationship after the fact. However in most instances the buyer does the shopping prior to contacting a bank. It is acceptable to have an agency relationship without the knowledge of the principal once the relationship or acts by the agent are ratified by the principal. It is unusual to have an agent status without the knowledge by the agent himself, as intent cannot be retroactive. The accidental agency here is a stretch or a legal fiction of sorts but let's assume that the buyer being an agent is implied in fact.

The second transaction is *Bai' Bithaman Ajil* (BBA) or modern *murabaha*, a contract of deferred payment sale (i.e. the sale of goods on deferred payment basis at an agreed selling price), which includes a profit margin agreed by both parties. The profit margin in this context is justified since it is derived from the buying and selling transaction as opposed to interests accruing from the principal lent out.

As for the profit margin being a fixed rate, the opinion of the permissibility of such contract is best articulated by Dr. Mahmoud Amin El-Gamal, a well-known Islamic economist, in an article titled "Permissible Financing Methods" where he cites Islamic jurists such as 'Ibn Rushd (Malik) and the likes:

"The contemporary confusion is hardly new. In 'Ibn Al-'Araby's 'Ahkam Al-Qur'an, he reports a specific argument given by the Arabs during the time of Prophet Muhammad (pbuh) to support their statement that "trade is like Riba" [2:275]. They argued as follows: Consider a credit sale, with a price of 10 payable in a month. After a month, the buyer and seller agree to postpone for one more month, and increase the price to 11. The latter is forbidden Riba. They then argued: is this not the same as an initial sale with the price of 11 deferred for two months? The answer in [2:275] was a decisive "but Allah has permitted trade and forbidden Riba". The legal difference between the two is very clear: one is a sale in which price is increased for deferment, and the other is an increase in the amount of a debt for deferment. The first is permitted, and meets almost all the financing needs, which can be met through forbidden Riba-based lending. The second, however, is strictly forbidden. The permissibility of the first and the prohibition of the second are both quite clear and unequivocal. Therefore, we may use credit sales as a form of finance, and we must categorically avoid interest-bearing loans."

In the context above it is presumed that the transaction takes place directly between the seller and the buyer. In most cases the bank is not a merchant nor does it deal with the products sold. The role of the bank is less than marginal and only as a financier.

In addition, the problem does not arise from the profit margin being fixed rather the way it is calculated. Most Islamic banks today simply use LIBOR (a *Riba*-based lending index for conventional banks) as a reference or a measuring stick for the profit margin. Permissible? Yes. Ideal? No.

It is preposterous to assume that the need to finance a product is a *Novus* concept in Islamic society, the need has existed throughout history. The two major distinctions between traditional BBA and modern BBA is that currently most Islamic banks take no risk in the transaction and the role is simply limited financing. The commodity is often secured by filing a financing statement securing the bank's interest. And for an added measure

some banks ask for two co-signers who hold deposit accounts in the lending bank for the transaction to be approved.

The disclaimer of all warranties by the bank poses another problem, where the risk of loss is on the buyer dealing with latent defects or the destruction of the subject matter without fault leaving the customer to incur the hardship and the expenses of litigation. The bank must take actual risk for the sale to be a real bona fide shari'a compliant transaction.

Another contentious issue with the current modus operandi is having two sales in one, a sale and a condition in one contract are not permissible in Islam, although some Islamic jurists endorsed such practices if the sale is divided into phases or separate transactions; However, the problem remains where the ultimate buyer is normally unaware of such distinctions when the two transactions take place contemporaneously.

Finally, the use of liquidated damages on non defaulting customers, where the bank imposes a liquidated sum even in cases of an early repayment of the financed amount is simply unconscionable. The liquidated damages provision thus operates as a penalty and should not be enforced because it does not fix damages in light of anticipated or actual harm that never happens. Damages should thus be limited to any harm the bank suffers, if any not as punitive measures.

A fiduciary sale that lacks trust, covenants of good faith and fair dealing or equal bargaining positions is nothing but a misnomer. It is time for banks and fatwa incorporated to reconsider such practices and stop the chase, let that proverbial chicken rest, it will never become a rabbit.

ASIDE: Market signals & side-effects.

The debate over Murabaha is significant because it presents the industry with a slippery slope. In their "Guidelines on the Application of Banking Regulations to Islamic Banking", the Monetary Authority of Singapore clearly states that it "does not expect the risk profile of an Islamic bank to be fundamentally different from its conventional banking counterparts." The MAS is not at fault of equating participatory banking with fractional banking (which could not be more different), it is simply stating the facts of current market practice.

The MAS goes on to state quite succinctly that "the payoffs and risks in making a murabaha deposit are similar to that of a deposit placed in the conventional banking system", it is no surprise that commodity murabaha is often branded as 'comedy murabaha' by practitioners. In that sense, murabaha is just one more example of the divergence we observe: what practitioners are clamoring for and what the industry is delivering to them in practice.

When a regulatory body states that "throughout the transaction, the bank is expected to minimise the holding period of the assets so as to avoid being exposed to the price movements of the assets" one must wonder where are the risk-sharing and asset-ownership principles that form the basis of Islamic banking.

The MAS directive to the industry is clear: "The bank can also choose to take security over the underlying asset in a murabaha to enforce the repayment of the amount owed." Never mind that foreclosure and forced-sale are not exactly ideals of Islamic banking.

These are signals that are allowing the industry to move closer and closer to conventional banking, when that model is suffering the worst crisis it has seen in the last sixty years.

Country versus Bank Shariah Boards



“There are growing calls from within the industry to establish country –specific Shariah boards that complement bank-specific Shariah boards. Is this just another layer of costs (for investors to bear)? How is the role of Shariah advisors and advisory companies evolving in this context? How can the industry simultaneously encourage plain vanilla solutions (i.e. standardized and/or cost effective) as well as innovative structures (i.e. intellectual capital and/or black-box)? Is there a middle-ground?”

It depends on the size and nature of the business. In countries like Mauritius (which has a very small Muslim market) the Bank of Mauritius guidelines allow for a Central Shariah Board under the auspices of the Bankers Association. The banks that need the SSB will pay for the service and employ them on an ad hoc basis or on a retainer basis. This helps mitigate costs. This is a model that can be emulated by other countries, provided there is confidentiality and that Shariah governance from the SSB prevails.

In the case of large IFI's, it is preferable to have their own SSB, because quite often a prompt strategic decision and approval is needed. This is more appropriate for private banks where they often develop products for individual clients, so a bank-specific SSB may help in this instance. The main point to consider is that there are two markets: the local and the international markets. If we talk of the local market then there is no problem having local scholars on the SSB, but when dealing on the international level the whole scenario changes. The Shariah Board will need to have greater product knowledge and recognition at the international level (not just country-wise).

Usually large banks will opt for their own SSB. There are some companies mushrooming to provide such services which are successful, but others are finding it difficult to break through the market. The number of clients who would need such a service is limited and also it is very difficult to have a company having all the expertise needed to cover the full spectrum of clients/products. Another issue is who is approving the products for clients and issuing the fatawas? The number of Shariah scholars having world reputation is limited and it is unlikely that such a small group will sit on the Shariah boards of all these advisory companies.

Yes it is possible to have plain vanilla solutions. In fact the prophetic tradition is clear “religion is easy/simple”. It is the modern financiers who want to complicate Islamic products with SPV's, Swaps etc to avert risks (which they ought to take in a pure Islamic legal context). For example, we have instances in Bahrain where there is undergoing work regarding standardized contracts, with similar work available thru the State Bank of Pakistan. These can be used and adapted to one's needs. Also there are the AAOIFI Standards which can be a good platform to develop plain and straight-forward products as everybody in the industry can acquaint themselves to these standards if they wish. However, this will apply mostly for retail products or takaful where there are one-off products that don't require redesigning every now and then. In the case of private banking or highly engineered products for specific clients this approach would not work. Presently it is difficult to synchronize the industry due to lack of regulation and proper legal framework. It will take some time to reach the level of uniformity to satisfy the industry as a whole.

Sh. Faizal Manjoo

Lecturer in Islamic Law & Finance

Markfield Institute of Higher Education

National Shariah Board: It must be established and maintained under the aegis of the Banking Regulator. Thus, those regulators are excluded which are designed to be insulated against Shariah e.g. UK, Singapore, Hong Kong, some countries in the GCC, or France. Even where a form of National Shariah Council exists e.g. Malaysia, Pakistan, Sudan, some units of GCC; its role could vary on a wide spectrum: It may be restricted to oversight of 'fit & proper' personnel & Processes of Shariah approvals in the individual IFIs, or it could extend its authority - & accountability - to approving products of, or issue binding guidelines to, individual IFIs under the banking regulator.

Costs: An IFI does need a Shariah Committee/Board to approve its specific transactions. A National Body may facilitate domestic & possibly regional harmonization. The problem with National, in addition to IFI-specific, Boards is not so much costs as adding bureaucracy, and considering impact of various views i.e. AAOIFI, Fiqh Academy or ISRA, or IFSB before finalizing the National View.

Shariah Advisory Companies: Those which have reputable professionals in Fiqh & Western Laws do add efficiency and assist in innovation, because they can simultaneously interact with Shariah Scholars and Lawyers. Shariah approval gives comfort on sanctity, and Counsel's opinion gives comfort on enforceability, of the specific transaction. However, if the Company is an entrepreneur competing on Costs and perhaps Shariah arbitrage, then its business aspirations may outweigh other considerations.

'Plain Vanilla' or 'black box' products: Both. The bread & butter plain vanilla products provide volume and territorial coverage. It also subsidizes research & development. What was exotic in 2002 is plain vanilla today, not just in Shariah compliance but e.g. computer software!

The Shari'a Boards at national level will not only complement the bank-specific Shari'a boards, but will also provide a forum for properly regulating the industry at the national level and ensuring compliance by all the players. The National Shari'a Board would have a policy making and general oversight role to ensure Shari'a compliance of the products and practices of Islamic financial institutions; and will not be involved in their day-to-day activities as the bank-specific Shari'a advisors or boards are; so the roles are complementary and not overlapping. Further, it would be a dispute resolution body between the IFIs managements and their Shari'a advisors/boards.

Since the cost of the national Shari'a Boards will be borne by the State/Central Banks, it will not add another layer of cost on the part of the investors.

While the plain vanilla products have been accepted and are being practised by all, there is no bar on innovation and new structures. However, new structures have to pass the scrutiny tests of other stakeholders and be fine-tuned to serve the interests of the industry.

Dr. Muhammad Qaseem

Country Head, Shari'a Department
Dubai Islamic Bank

Prof Mahmood Faruqi

Senior Advisor
Bank Of London and the Middle East Plc

The basis of the success of Islamic finance is the suppleness of the Shariah law, as it accommodates the glitch by providing an alternative solution that provides the desired objective without compromising on Shariah limitations. And I suppose this is the magnificence where no man-made law can have such an immense adaptability.

There has been a constant debate regarding the standardization of agreements, standards and regulations. I personally think that the people who talk about standardization are misguided about the versatility of Shariah law. They want to condense the clouds in a droplet and that is not possible at all. Yes the thing required is to harmonize and regulate the industry by a strong, vigilant and expert group of people supporting and assisting the regulators. Once the supervision is effective, it will consequently bring harmony that will lead to standardization of the system. There will be less of irregularities, and gradually over a period of time it will develop a data that will create precedence for the industry

There has been an overwhelming demand in the industry throughout the globe that such verdicts, deliverables that are said to be Shariah Compliant, must be recognized and regulated unless those turn to be a constraint and a challenge. Introducing a regional or country level Shariah Board is a step ahead towards the debate discussed above. Yes this will at times incur a cost that will be borne by the investors, but think in the broader perspective that an opportunity availed in the short term may not be an opportunity in the long term rather that might be a stigma for the future transactions and investments. So a minute financial burden at this stage will secure a financial arena for the lucrative future to come.

There has been a very strong view that advocated the complete standardization of Islamic transactions. There are many examples of standardization of contracts in various industries, and in financial trading. There has been standardized master agreement, such as agreements developed by the International Swaps Dealer Association (ISDA). In the past there has been efforts by the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) to initiate development of master agreement for documenting privately negotiated Shariah compliant derivatives transactions. The fundamental idea behind this standardization is that the investors are able to incorporate reference definitions contained in the standards, saving costly, time-consuming and peculiar Shariah opinions, resulting in lowered transaction costs and increased transactional efficiency. But I will just add to the last conclusion that when structuring any conventional financial transaction, its documentation does not diminish the legal advisors role despite the fact that the conventional financial system has been prevailing for centuries, then how can we ignore the necessity of the Shariah experts while structuring Shariah Compliant transactions?

This step, I assume, will broaden the framework of vanilla structures, thus more products will fall into a vanilla structure category. However this will not lessen the importance of innovation through hybrid structuring and bundling and unbundling of products and services.

Ehsan Waquar

Member Shariah Committee/Manager Shariah Compliance
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The 7 Bad Habits of Islamic Funds

By Bernardo Vizcaino, CAIA

An occasional mistake in translating Arabic to English occurs with the word 'funds' which sometimes translates into the English language as 'boxes'. Nevertheless, it is a very accurate translation when it comes to Shariah compliant investment products. This is especially true when one considers the inhibited nature of their origination & manufacturing. Indeed they seem stuck in a box, constrained by some imaginary walls, being delivered in sporadic fashion with rather uninspired risk/return profiles. A sector that should be one of the strongest indicators of industry success in reality resembles a desert landscape, dry in ideas. New launches have understandably slowed in the backdrop of the global markets, but product diversity and sophistication still leaves much to talk about.

Some launches do shine, partly because of their pioneer status (often self-proclaimed) but also for their solitary existence, few others have deemed it worthwhile to follow on their ground-breaking footsteps. It seems that such inventive examples are like an oasis - a welcome sight for the thirsty investor but one that is not visited frequently enough. The fact is that their peers (either current or in the pipeline) are simply rare, product manufacturers apparently sucked into a quicksand of conformism. On the other end of the spectrum though, products which are deemed as innovative in nature are more likely to resemble a mirage - failing to deliver on their promise.

The culprits are scattered across the product development life-cycle, but these in turn highlight the great opportunities available in the marketplace for those willing to go the extra mile. Here we scrutinize several 'objectionable' habits found across the industry:

1. Comfort Zones
2. Beta in a Box
3. Headless Chickens
4. Re-Repackaging
5. One Size Fits All
6. Off-limits to Off-shore
7. Distribution Dreamland

Comfort Zones

This is embedded in the fund manager psyche, stick to what you know and don't push the boundaries. In effect, the majority of Islamic funds remain focused on asset or country-specific mandates (i.e. Saudi Arabia, Kuwait, Malaysia, Indonesia) and if they choose to take a regional approach it is simply to follow an indigenous requirement of their local market. In the Gulf region the three must-have products remain a Saudi-equity, a GCC-equity and some money market fabrication (murabaha perhaps). The light at the end of the tunnel rests with sukuk funds as they have gradually gained popularity. Nonetheless, product differentiation is hard to come across, and herd mentality seems to remain as the order of the day.

Beta in a Box

Global mandates, despite their extra-large label, are similarly at fault having fallen head over heels for the classic top-down approach that has delivered mostly unexciting large caps: the 'expensive ETF' syndrome (market exposure - or beta - is not bad at all, as long as it is priced correctly). In a fund universe dominated by long-only investments it would seem imperative to move away from vanilla/sanitized solutions, placing greater importance on un-correlation/sophistication. Some argue that as the credit crisis unfolds anything innovative is deemed off-limits. Nevertheless, the industry is chasing after brand names, labels, just plain monikers. Effectively, in the hunt for quantity and quality the product range is missing exactly those two aspects.

Headless Chickens

One might argue that boutiques often launch one specific or standalone product, mainly due to their limited resources and specific area of focus. However, this seems to be the norm even for large-scale operations and quite remarkably for some of the largest conventional players. With the exception of some established industry players, the concept of a product range is non-existent. Fund construction with a portfolio approach (i.e. what does an investor need to buy) is almost unheard of and secondary to

Industry Snapshot

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the commission-fueled machine of product delivery (i.e. what can be sold to investors). The opportunity is there for crafting solutions that straddle multiple asset classes, as opposed to navigating through an array of dispersed offerings.

Re-Repackaging

The hunt for a pure multi-manager solution continues, as current offerings struggle to justify their double fee structures (one at the single manager level and another at the fund of fund level). Then again, products following a global-diversified approach are uncannily similar, and they have all succeeded in diversifying away idiosyncratic risk but excess returns having been diversified away as well. The issue is worsened with in-house wholesale products, which carry an inherent bias towards selecting internal products (why choose those from competitors), the value of independent and objective fund selection is somehow lost in the market-fuelled noise.

One Size Fits All

A common misconception from industry outsiders is the notion that all Islamic investors are the same, a monochromatic approach that regrettably is present within the industry as well. It appears that it is far too complex to launch multiple share classes so as to simultaneously cater to: retail/institutional investors, specific currency-hedging requirements, liquidity preferences and management of dividends. The priority is to sanitize an offering with risk/return characteristics often left totally unaddressed. How telling that the industry is mesmerized by the intricacies of some exotics yet separate share classes are shunned as if the balance of the cosmos might be somehow altered.

Off-limits to Off-shore

It is incomprehensible that one of the most important trade flows of the past few decades has not been openly acknowledged by participants in either side of the Indian Ocean. If one considers the various synergies between the GCC and Southeast Asia regions, it boggles the mind that cross-jurisdictional products haven't become standard operating procedure. Dual listings are very rare and to add insult to injury a ready-made offshore jurisdiction lies underutilized in the extensive corporate infrastructure available in Labuan. Even offshore products (mostly real estate in fact) are far more focused on their tax efficiencies rather than the ability to be offered across various borders. Products seem to be eternally destined to be either onshore or offshore, but seldom both.



Distribution Dreamland

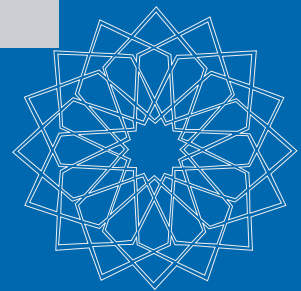
Distribution networks have proven effective in delivering products within their core markets (GCC and Southeast Asia) but are often ignored by institutions that lack an effective presence in these regions. A number of managers thus fail to address product distribution from the outset, instead opting to leave this crucial detail to the very end. Time and again, effectively reaching investors has been successful as long as an established network is already in place. For instance, the largest Syariah mutual funds in Indonesia are the newest launches (run by established non-Islamic fund houses) and DWS funds are distributed across the GCC via a conventional bank network. Joint ventures and distribution agreements should be customary, but for now this remains another unexplored trend in the industry.

Bad habits die hard, but great opportunities are available to those willing to break the mold. Some of these habits will persist far into the future but the industry will find it increasingly necessary to tackle each one of these limiting factors head on. In doing so, greener pastures will emerge in places where there was only but sand.

Islamic Structured Products and Current Issues in Islamic Finance

International Islamic Capital Market Forum

30 July 2009
Conference Hall, Securities Commission,
Kuala Lumpur



The Securities Commission Malaysia will host the third International Islamic Capital Forum in Kuala Lumpur on 30 July 2009 themed "Islamic Structured Products and Current Issues in Islamic Finance".

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* Note: Participants are only eligible for one type of discount.

PROGRAMME

INTERNATIONAL ISLAMIC CAPITAL MARKET FORUM

KEYNOTE ADDRESS

LANDSCAPE FOR ISLAMIC STRUCTURED PRODUCTS AND HEDGING TOOLS

- Islamic finance and structured products, synergies, contradictions, grey areas
- Market trends, growth, supply chains
- Performance, change in conventional investor's perception and demand for highly structured product
- Features
- Shariah compliance: Innovation
 - Basic mechanisms for structured product delivery
 - Room for improvement
 - *Ibaha* (permissible)
 - *Maisir*, *gharar* and *riba*
 - Compliance with *maqasid*
- Opportunities for issuers, distributors and customers

BUILDING BLOCKS FOR ISLAMIC STRUCTURED PRODUCTS

- Standard contracts
- Areas of possible flexibility
- Compliance needs
- Complexity, risks of future non-compatibility
- Justification in light of *maqasid*

REGULATING SHARIAH-COMPLIANT STRUCTURED PRODUCTS

- Updates, issues and challenges in structured products for regulators, from the perspective of Shariah
- Coordination between different organisations, both national and international

CASE STUDY I: SHARIAH-COMPLIANT STRUCTURED INVESTMENT

- Value extraction
- Wrapping
- Delivery

ASSESSMENT OF SHARIAH-COMPLIANT STRUCTURED PRODUCTS

- Performance, history and recent fall from grace of conventional products
- Growth areas of Shariah-compliant structured products
- Risk mitigation versus risk taking
- Sales method
- Strategy
- Uses
- Back-testing and its significance in the valuation of structured products
- Underlyings: Local or global

USE OF SHARIAH-COMPLIANT STRUCTURED PRODUCTS IN ISLAMIC PORTFOLIO

- Shariah perspective of structured products
- Structured product versus leverage
- Structured product as automatic rebalancing scheme
- Structured deposits
- Asset allocation processes

CASE STUDY II: INVESTMENT-LINKED TAKAFUL

- A case for *takaful*
- From plain vanilla to exotic investment-linked *takaful*

SHARIAH ISSUES IN STRUCTURED PRODUCTS AND FUND MANAGEMENT

- End-to-end Shariah compliance
- Capital guarantee versus capital protection
- Leveraging
- Day trade
- Trading in derivatives versus derivatives for hedging
- Benchmarking versus swapping: Returns on swaps from non-halal sources
- Trading on margins versus leveraging

PANEL DISCUSSION: RESILIENCE OF ISLAMIC FINANCE AND ITS DIRECTION

- Resilience of Islamic finance
- Factors impinging on the growth of Islamic finance
- Developing Islamic finance products and achieving Shariah harmonisation

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