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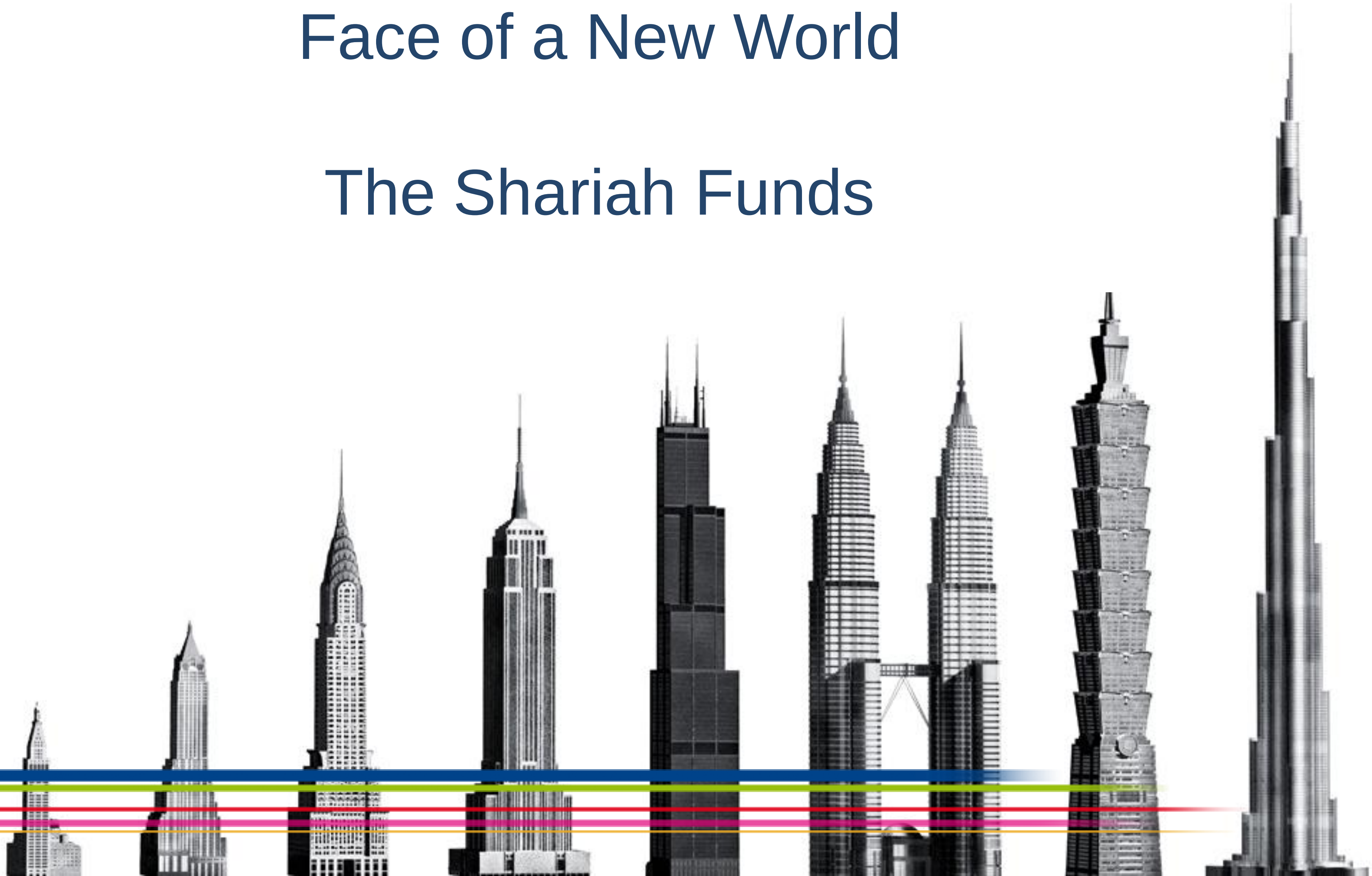
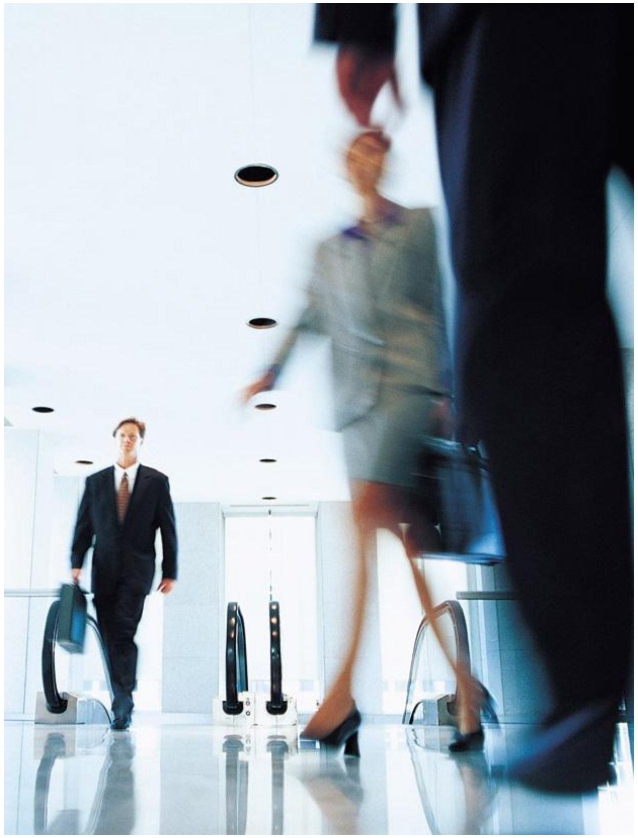
Face of a New World

The Shariah Funds





Even as banking segments like securitizing subprime mortgages and financing leveraged buyouts suffer from the current crisis, Islamic finance is seeing spectacular growth.

Hedge funds have been blamed for the recent rout in financial stocks but some bankers say hedge fund tools such as derivatives can help Islamic banks manage risks as the industry grows beyond its traditional niche markets.

The Shariah Law

The “Shariah Law” has its foundation in Islamic Law and dictates that an Islamic investor should always invest his assets in goods or services that are of benefit to society, as opposed to simply just gathering and keeping them close to himself. Consequently, an Islamic investor can invest in equipment, properties, water, gas and almost any service that is of value to the community, but is prohibited from investing in anything that involves gambling, pornography, alcohol, the manufacture of arms, or the sale of pork and tobacco.

Shariah law also prohibits the making of money from paying or charging interest (‘usury’) but does not prohibit the making of return on capital if a person is willing to share in the profit or loss of his investments. Under this principle of risk-sharing, each investor can share (either positively or negatively) in the investment. For example, an investment house can accept money from an Islamic investor and invest the funds, say, in various real estate contracts and then share the growth (or the loss) with him.

Shariah-compliant transactions demand transparency throughout the investment process. Short selling is banned because it amounts to selling an asset not owned and risk management must accommodate the exclusion of certain types of derivatives because of their speculative nature.

A Shariah-compliant Hedge Fund

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To ensure that the fund's compliance with Shariah law is sustained, a sequence of steps and procedures must be in place, starting from the stock screening at the trading/stock picking level. Then there is the prime brokerage operation which must be certified as Shariah-compliant as well. Additionally, the administrators you are working with must be also certified to be Shariah-compliant.

The portfolio has to remain Shariah-compliant over time, which means the administrator continues to watch and check the portfolio so that the standards are maintained. "In essence each step is covered. The fund is approved by the Shariah Board, as are the administrator and the prime broker. In our set-up, we the Ratings Intelligence Sharia Board", says Duncan Crawford, Head of Capital Introduction at Newedge Group "One of the key points is having a Sharia Board who is as widely recognized as possible."

The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rated profits actually accrued of the fund. These documents may be called "certificates" "units" "shares" or may be given any other name, but their validity in terms of Shariah, will always be subject to two basic conditions:

First , they must carry a pro-rated profit actually earned by the Fund. Neither the principal nor a rate of profit can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund.

Second, the amounts so pooled together must be invested in a business acceptable to Shariah. It means that not only the channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Some shariah scholars view common hedging techniques as speculative bets on currency and stock movements, which the shariah says is *haram*, meaning not allowed.

Debate on the extend to which Islam allows the use of derivatives has left shariah banks with fewer hedging tools than conventional lenders.

Dubai Shari'ah Hedge Fund Index Launched

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The Dubai Shariah Hedge Fund Index, the first internationally recognized index comprised exclusively of Shari'ah-compliant hedge funds, has been launched by the Dubai Multi Commodities Centre Authority (DMCCA) and Shari'ah Capital in January 2009.

The index is calculated and reported by Thomson Reuters and reflects the performance of the DSAM Kauthar Commodity Fund, an equally weighted fund of funds comprised initially of four single-strategy, commodity focused funds that are Shari'ah compliant. The funds all follow long/short equity strategies and are on the Al Safi Trust platform.

The Al Safi Trust, launched in 2008 by Barclays Capital and Shariah Capital, is a Shari'ah compliant platform designed specifically for hedge funds. The four funds, distributed under the DSAM Kauthar label, form the index.

The makeup of the index is 25% each for the funds: the DSAM* Kauthar Gold Fund, the DSAM Kauthar Energy Fund, the DSAM Kauthar Natural Resources Fund and the DSAM Kauthar Global Resources & Mining Fund.

The index is not investable.

*Dubai Shariah Asset Management is a joint venture between Dubai Commodity Asset Management, a wholly owned subsidiary of DMCCA, and Shariah Capital.

Shariah Funds in Numbers

In 2007, Shariah-compliant assets have grown **almost 30 per cent**, to **more than USD 500.5 billion**.

Islamic ethical investment vehicles have an estimated **EUR 10 billion** to spend on European commercial real estate, with Britain to preferred destination. Britain is seen as the most "Shariah friendly" investment area because it has the most expertise and the necessary institutional and legal framework and political environment. What is surprising in terms of country rakings is that Britain, a non-Muslim country, albeit one with about two million resident Muslims, is the **10th largest** measured, with **10.4 billion in Shariah-compliant assets**.

*In terms of countries, Iran has the most Islamic finance assets, with **USD155 billion**, as all institutions must be Shariah-compliant, and it has a large population of 71 million. In Saudi Arabia and Malaysia, the banks and insurance companies can offer conventional products as well.*

Shariah-compliant property investment funds form part of the fast-growing Islamic banking and finance market, which is estimated to be worth up to $500 billion worldwide.

The Islamic banking and finance market is expected to grow by between 12 per cent and 15 per cent a year over the next ten years. Commercial property accounts for a large slice of the market.

Shariah property investment funds typically favor industrial property because it generates high investment returns and is better suited for stock approval by Shariah boards because it is not usually let to companies that engage in prohibited activities under Islamic law.

Three quarters of Shariah funds invest in offices and industrial property, two thirds invest in logistics and distribution and about half the funds invest in shops and housing.

How we see the future

As more and more Islamic institutions and individuals move into various regions of the world, it is only natural that they will want to invest, build homes and provide security for their descendants. This will cause an automatic need for banks and other institutions to cater to their requirements, leading to the development of new and enhanced Shariah-compliant investments. Over the past few years, UK lending institutions, for example, have developed Shariah-compliant mortgages as a mean of capitalizing on the influx from the Islamic community looking to purchase homes.

Lexical terms

Ijara:
This is basically a leasing arrangement in which an investment house uses the investor's money to acquire an asset, such a property. Rental income is collected and passed on to the investor. At the end of the contract, the properties are disposed of by the investor himself.

Ijara wa iqtina:
This is very similar to the above arrangement; however, at the end of the contract period, the investor has the option to purchase the asset.

Mudaraba:
This is somewhat similar to an English/Cayman Islands trust structure (although the investment is carried out mainly through companies and not by setting up a trust). Essentially, a manager (trustee) accepts money and then invests according to investment guidelines agreed between the manager and the investor. The principal sum is later returned to the investor together with a share of the profits.

Sukuk:
Several different types of Sukuk products have been created to meet different investor needs. This kind of investment, however, is the closest to conventional investment opportunities, whilst still remaining compliant with Shariah Law. Sukuk products belong to the family of asset-backed securities structures. The essence of a Sukuk is a securisation whereby future cash flows from a pool of assets are capitalized by the issue of financial certificates to investors. It may be thought of as an Islamic equivalent of a bond, albeit the bond must not be interest-bearing.

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