

# A MATTER OF FAITH

Islamic finance has captured the imagination of many countries around the world. Indian institutions, however, remain uncertain about striding into this market

Indira Vergis

Calling it a boom doesn't quite capture it all. An explosion in demand? Slightly better, but it still misses half the story. In fact, the kind of interest Islamic finance – one of the fastest-rising stars in global finance – is generating right now almost defies description.

Never before has doing business the Islamic way found a more willing global audience, with countries from Europe to Asia rushing to roll out the welcome mat. You might think that with the world's second-largest Muslim population – 150 million – India would be a natural market for this kind of finance.

You'd be wrong. Even as many parts of the world have been smitten by Islamic finance, Indian financial institutions have maintained a detached demeanour, refusing to get caught up

in all the excitement. It's not as if businesses here don't care; in fact, most experts acknowledge the potential is undeniable. "There is great potential for Islamic finance in India," says Ashraf Mohammadi, managing director of Idafa Investments, one of few Islamic brokerages around.

So why then do we not have a thriving trade in Islamic finance?

"Given the regulatory regime, products such as equity-based mutual funds and PMS schemes can do well in India"

Dr Shariq Nisar, CEO, Bearys Amanah India



Probe a little deeper and you realise why: "Companies don't want to be seen as attracting investments from a particular community," says Dr Shariq Nisar, CEO, Bearys Amanah, an Islamic finance consultancy in Bangalore.

That means that even if companies want to pursue this rapidly growing segment, they're wary of admitting it. Their principal fear: they'll be branded 'communal'. "It requires a certain amount of courage to say you have an Islamic finance business," adds Idafa's Mohammadi. As experts wrangle over whether embracing Islamic finance could dilute India's secular image, the industry continues to amass more converts around the globe.

### Brimming with potential

So what exactly is Islamic finance? Islamic finance, which can be clubbed

in the category of faith-based investing, is based on Islamic principles and jurisprudence (Shariah). The basic prohibitions are on earning interest, speculation, contractual uncertainty and transactions that are overly advantageous to one party at the expense of another. It also forbids any participation in weapons, pork, gambling, pornography and alcohol businesses (See box: *Shariah Fundamentals*).

Estimates about how much it manages in assets vary from around \$500 billion to a wildly optimistic \$900 billion. That's still an infant business compared to conventional finance which manages trillions of dollars in assets, but it's growing at around 15-20 per cent a year – far higher than conventional finance.

The money fuelling this growth comes primarily from investors in the

oil-rich Middle East. With oil prices roaring past \$100 a barrel, many countries in the region are flooded with cash. Their predominantly Muslim populations are now driving demand for all sorts of Shariah-compliant products, from housing loans to structured products and even Islamic hedge funds. It has also sparked a similar reaction from Muslim communities in Europe and Asia. Add the fact that Muslims account for a fifth of the world's population (most of them living in quickly developing, oil-rich economies) and it's easy to see why most experts believe that Islamic finance is here to stay.

Already, some studies suggest that 20 per cent of Muslim investors would now choose an Islamic financial product over a conventional product. "We believe that Islamic banks will account for 35-40 per cent of total savings of the Muslim population in the next 15 years," says Faisal Hasan, head of research at Kuwait-based Global Finance House (GFH).

How much money are we talking about here? Well, Ernst and Young estimates that Muslims around the world hold about \$1.6 trillion in assets of all kinds, a figure the consultancy forecasts will rise to \$2.7 trillion by 2010.

That kind of money has most financial institutions fighting each other off to grab a toehold in this highly lucrative market. You can see it from the numbers: today, there are more than 470 full-fledged Islamic institutions around the world, up from 250-plus seen in 2005, according to the General Council for Islamic Banks and Financial Institutions. Even several of the world's leading banks – HSBC, Standard Chartered, Citigroup, Deutsche Bank to name a few – have Islamic divisions now.

"In most Muslim countries, Islamic banking is outgrowing conventional banking," says Nabeel Shoaib, Dubai-based global head of HSBC Amanah, the Islamic division of the bank.

Loaded with cash, a lot of these institutions are scouring the globe for suitable opportunities for investment. For capital-starved India, these investors can be a useful resource to draw on – if we choose to.

Many experts believe enthusiasm for investing in Indian projects and equities already runs high among Islamic financial institutions. So far, attempts have been made only in fits and starts for attracting their money. The Kotak group and UTI Asset Management each have an offshore Islamic equity fund which invests primarily in Indian equities and are targeted at Mid-



## SHARIAH FUNDAMENTALS

- The basic Shariah prohibitions are on the earning (or payment) of interest, speculation, contractual uncertainty and transactions which are overly advantageous to one party at the expense of another.
- Shariah also prohibits any participation in weapons, pork, gambling, pornography and alcohol-related businesses.
- The industry has several Shariah-compliant structures to meet the needs of businesses and investors. These structures deliver results similar to those achieved via conventional financing transactions, say experts.
- Some Islamic financing techniques include Ijara (based on the leasing of an asset); Musharaka (equity investment/profit and loss sharing); Istisna (production/construction financing); and Salam (forward financing).
- The most high-profile Islamic instruments have been the sukuk. Sukuk are asset-based, Shariah-compliant trust certificates. The closest conventional finance instruments to them are bonds. But unlike bonds, holding a sukuk confers a beneficial interest to the holder (the investor holds a proportional ownership of the underlying asset) as well as the income it generates. The sukuk-holder also assumes all rights and obligations for the maintenance of the asset. A conventional bond-holder on the other hand, is only entitled to receive interest.

dle East investors. Recently, Reliance Money launched an Islamic portfolio management service for investors in India and overseas.

It still adds up to very little, given that many other countries are pushing ahead more vigorously in their efforts to become Islamic finance hubs.

WORLD CITIES VYING TO BE THE NEXT BIG ISLAMIC FINANCE HUB



MANAMA

Bahrain's capital is widely acknowledged to be the home of Islamic finance, with its origins going back to the 1970s. Recent plans include the launch of a new \$11 billion Islamic investment bank in 2009. Private equity will finance \$2bn and the rest will be raised through a mammoth IPO.



DUBAI

The UAE's most financially savvy city is currently one of the biggest markets for sukuk sales. It recently announced plans to create a \$10 billion investment firm to invest across the region, Africa and Asia. About 15 per cent of the UAE's banking assets are Islamic, growing at 39 per cent a year.



HONG KONG

Hong Kong comes late to the game but the launch of the Hang Seng Islamic China Index Fund signals an important start. Hong Kong's airport operator also aims to issue the city's first Islamic bond in the third quarter, and is currently in the process of sorting out tax issues with the government.



LONDON

Britain is set to become the first Western nation to issue bonds in line with Shariah law. The government is changing the rules to allow sukuk bonds to be issued, traded in the same way as corporate bonds to encourage more of them to be issued in London.



SINGAPORE

The city-state has more than \$1.32 bn in Shariah-compliant property funds and 500 million dollars of Islamic insurance funds, at the end of last year. Last month saw the launch of the Daiwa FTSE Shariah Japan 100 exchange-traded fund to track Japanese-listed Shariah-compliant companies.



KUALA LUMPUR

The Malaysian Islamic financial sector is already seen as one of the most progressive and attractive in the world. Its Islamic banking assets are estimated to be worth \$30.9 billion; Islamic insurance assets worth \$1.7 bn; and an active money market channelling about RM40 billion every month.



NOTHING SO RELIGIOUS ABOUT IT

The rules, especially the financial ones, guiding Islamic equity investing, are arguably similar rules followed by conventional investors with a conservative attitude to risk. Shariah rules forbid investors from investing in companies that have more than 33 per cent of its market capitalisation in debt, cash or interest-bearing securities while accounts receivable cannot be over 49 per cent.

This means banks are excluded but energy firms, with low debt, typically have a big weightage. It does limit the universe of investment-worthy stocks but as experts point out, it also means lower risk. (For a list of Shariah-compliant stocks in India, turn to page 79). Most value investors, by the way, are conservative in their attitude to risk. Legendary investors such as Warren Buffett are also known to look at metrics like debt ratios.

The UK is a very good example of that. Untroubled by doubt about whether it's doing the right thing, London, one of the world's top financial centres, was among the first off the bloc outside the Middle East to introduce regulations allowing for easier Shariah transactions. It already boasts five Islamic banks: four investment banks and a retail bank. It is now being held up as a role model for the rest of Europe to follow. (The UK's Muslim population, by the way, is only about 2 million – less than 3 per cent of its total population.)

It's the same story across Asia as well: from Japan to Malaysia, cities are burnishing their Islamic finance credentials. The gung-ho mood suggests there will be room for everyone to grow. "We feel the industry has such huge potential that we will need 3-4 Islamic hubs in the future," says GFH's Hasan.

Indeed, from banks and financial markets to corporate boardrooms, everyone's experiencing the march of Islamic finance.

Early this year, one of the Europe's biggest headline-making stories involved the majority stake sale of British luxury car marque Aston Martin to a consortium led by Kuwaiti Islamic firm Investment Dar. Another interesting fact: Caribou Coffee, America's largest speciality coffee chain after Starbucks, also has a Bahrain-

based Islamic private equity owner.

Sukuk surge

One of the most high-profile business financing/investment instruments in the Shariah business has been the sukuk or Islamic bonds. In the Middle East for instance, a lot of project financing is taking place through sukuk sales. Experts say the market for sukuk has been sizzling in recent years, leaping by nearly 70 per cent every year.

According to the Islamic Finance Information Service, global volumes of sukuk rose by 73 per cent in 2007 to \$47.1 billion. Malaysia and the Gulf Co-operation Council – Oman, Kuwait, Bahrain, Saudi Arabia, Qatar and the UAE – account for more than three-fourths of all bonds outstanding.

They're highly sought after by Muslims seeking investments that comply with their beliefs and by non-Muslims as well seeking exposure to booming Gulf economies. So high is the popularity of these bonds that even the UK, Thailand and Japan have announced that they will issue sovereign sukuks soon, as part of attempts to cosy up to their Islamic clients.

Even businesses are latching on. Japanese car giant Toyota, for instance, says it is mulling an Islamic bond to expand business in Malaysia; it's already received permission from regulatory authorities to raise up to one million Malaysian ringgit (\$312 million).

"Nobody wants to pay a premium to be a part of an Islamic fund"

Mark Smyth, managing director, Failaka Advisors



"The innovation has primarily originated from western institutions, which now offer a wide range of structured products"

Dr Humayon Dar, CEO, BMB Islamic Group



He believes that for Islamic finance to thrive, it must come up with good alternatives to conventional products. His reasoning is simple: "All Islamic financial institutions operate in conventional environments. If an Islamic bank comes up with a product that has a completely different risk-return profile, there is a possibility of a risk-return arbitrage in the short run. "In a competitive environment, however, other players will soon adjust. In the end, there will always be a comparison between the two. If a currency swap is available with Citibank, for instance, then a similar structure should be available with an Islamic bank."

under Islamic law? Dr Dar disagrees, saying that's a common misconception. Products like these can be designed in such a way that they adhere to Shariah rules, he says.

No wonder then, that the global sukuk market is tipped to hit \$200 billion by 2010. But even sukuks don't seem to be enough to soak up all the money sloshing around the Middle East. So now investors are shopping abroad, especially in Asia.

That's encouraged several cities across the region to dress up and present themselves as the hottest shopping destination (See box: World Cities Vying to be the Next Big Islamic Hub). Kuala Lumpur is already a star attraction, while Singapore and Hong Kong have also surged into contention as possible Islamic fund magnets. Indonesia – home to ten per cent of the world's Muslims – surprisingly, has been rather slow to don its Islamic badge, only recently passing a long-awaited Shariah finance law.

Innovation in motion

It's not just soaring demand that is responsible for the high-spirited state of Islamic finance today: credit must also be given to financial product suppliers and their creative burst of energy which has engendered several innovations.

"Financial institutions have come up with a wide range of products, making the switch easier from conventional to Islamic finance," says Dr Humayon Dar, CEO at London-based consultancy BMB Islamic and an internationally renowned Islamic finance expert.

"The innovation has primarily originated from western institutions, which now offer a wide range of structured products, from those that can replicate a swap deal to call and put options."

But aren't such products forbidden



DRIVING CHANGE: James Bond's favourite car marque, Aston Martin, is owned by a Kuwaiti investment firm

CASINO ROYALE

**RULES FOR EQUITY INVESTING THE SHARIAH WAY**

- ☛ The main business of the company is not in violation of Shariah. Therefore, it is not permissible to acquire the shares of companies providing financial services on interest like conventional banks, insurance companies. Also, companies manufacturing, selling or offering liquors, pork, haram meat, or involved in gambling, night club activities, pornography etc. are not allowed.
- ☛ If the main business of the companies is halal but they deposit surplus amounts in an interest-bearing account or borrow money on interest, the share-holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.
- ☛ If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing

deposits, 5% of the dividend must be given in charity.

- ☛ The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, the share represents money only and the money cannot be traded in except at par.
- ☛ What should be the exact proportion of non-liquid assets of a company for the negotiability of its shares? Some scholars are of the view that the ratio of non-liquid assets must be 51% at the least. Some other scholars have opined that even if the non-liquid asset of a company are 33%, its shares can be treated as negotiable. The third view is based on the Hanafi jurisprudence. The principle of the Hanafi school is that whenever an asset is a mixture of a liquid and non-liquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions: First, the non-liquid part of the mixture must not be in a negligible quantity. It means that

it should be in a considerable proportion. Second, the price of the mixture should be more than the price of the liquid amount contained therein. For example, if a share of \$100 represents \$75, plus some fixed assets the price of the share must be more than \$75. In this case, if the price of the share is fixed as \$105, it will mean that \$75 is in exchange of \$75 owned by the share and the rest of \$30 is in exchange of the fixed asset. Conversely, if the price of that share is fixed as \$70, it will not be allowed, because the \$75 owned by the share are in this case against an amount which is less than \$75. This kind of exchange falls within the definition of "riba" or interest and is not allowed. Subject to these conditions, the purchase and sale of shares is permissible in Shariah.

*Abridged from An Introduction to Islamic Finance by Mufti Muhammad Taqi Usmani, chairman of the Shariah Standard Council, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).*

**KEEPING THE FAITH**

Islamic equity funds have shown mixed returns

Name	Institution	Cur	Assets (mn)	5-yr (%) returns
AIA Dana Dinamik Fund	American Int'l Assurance	MYR	N/A	13.48
Al Dar-World Equities	Pictet Asset Mgmt	USD	27.70	89.58
Al Huda Islamic Fund	Al Ahlia Investment	KWD	6.66	6.44
Al Khair Global Equity Fund	Bank Aljazira	USD	19.21	8.43
Al Taiyebat Saudi Equities Fund	Bank Aljazira	SAR	130.16	121.25
Al-Nukhba Asia Equity Fund	Al Tawfeek	USD	6.06	106.73
AlAhli Asia Pacific Trading Equity	NCB Capital	USD	24.7	109.43
AlAhli Europe Trading Equity Fund	NCB Capital	USD	32.7	127.25
AlAhli Global Trading Equity Fund	NCB Capital	USD	285.8	86.40
AlAhli Saudi Trading Equity Fund	NCB Capital	SAR	3312	369.79
AlAhli Small Cap Trading	NCB Capital	USD	104.2	94.53
AlAhli US Trading Equity Fund	NCB Capital	USD	32.35	63.65
Alfanar Europe Ltd.	Permal Investment	USD	177.00	22.80
Alfanar US Capital Value	Permal Investment	USD	21.00	10.40
Alfanar US Large Cap	Permal Investment	USD	28.00	38.53
Amana Growth Fund	Saturna Capital Corp	USD	676.8	20.74
Amana Income Fund	Saturna Capital Corp	USD	350.3	19.22
Amlttikal	AmlInvestment Mgmt	MYR	162.00	52.71
Azzad Ethical Income Fund	Azzad Asset Mgmt Inc	USD	6.00	7.50
Azzad Ethical Mid Cap	Azzad Asset Mgmt Inc	USD	3.00	9.78
Citi Islamic Global Equity Portfolio A	Citi Islamic Portfolios SA	USD	8.47	12.71
Citi Islamic Global Equity Portfolio B	Citi Islamic Portfolios SA	USD	N/A	13.56
CMS Islamic Fund	CMS Trust Mgmt	MYR	40.03	149.07
Hegira Global Equity Fund	Wellington Management	USD	34.19	11.11
Mendaki Global Fund	DBS Asset Mgmt	SGD	3.05	5.42
Oasis Crescent Equity Fund	Oasis Group Holdings	ZAR	3737	29.50
Oasis Crescent Global Equity Fund	Crescent Global	USD	256.52	152.93
Prudential Dana Al-Ilham	Prudential Fund	MYR	56.70	143.41
Prudential Dana Al-Islah	Prudential Fund	MYR	19.68	46.82
Public Itttikal Fund	Public Mutual	MYR	1518	167.15
Riyad Equity Fund 2	Riyad Bank	SAR	4035	357.56
Riyad Global Equity Fund	Riyad Bank	USD	48.23	114.56
Sut Ethical Growth Fund	Singapore Unit Trusts	SGD	7.18	2.48
Sut Ethical Value Fund	Singapore Unit Trusts	SGD	8.93	2.86
UBS (Lux) Islamic Global Equities	UBS Islamic Fund Mgmt	USD	34.70	85.54

Source: Failaka Advisors Returns for selected funds in existence for more 5 years as on June 6, 2008

five years show that returns vary widely: from a piddly 2.5 per cent to a stellar 369 per cent. Last year, the best performing fund was the Amanah GCC fund by the Saudi British Bank which handed in an 83 per cent gain to investors, according to Failaka Advisors.

Do good returns really matter for faith-based investors? "Of course they do," retorts Smyth. "Nobody wants to pay a premium to be part of an Islamic fund."

Several Islamic fund houses – including Oasis – have recently expressed interest in investing in Indian equities. While offshore funds do invest in India, allowing such funds within may up the country's chances to catch up with some of the action in this segment. "Given the regulatory regime, products such as equity-based mutual funds and PMS schemes can do well in India," says Beary's Nisar.

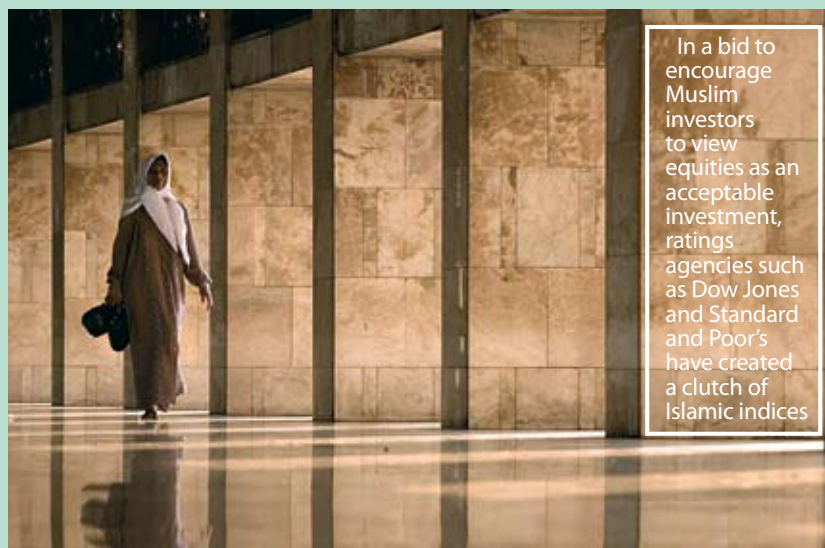
That potential prompted S&P to launch an Islamic index for India in February. "We believe that demand does exist though it may have remained latent due to lack of adequate products and screening tools," says Alka Banerjee, vice president for global equities in S&P's index services division. The best part is, our stock markets don't even have to try too hard to be Shariah-compliant. "By absolute numbers, we are far ahead of any country in the world," says Beary's Nisar. From the 6,000-odd BSE stocks, about 4,200 are considered sound by Islamic standards. By the size of Shariah-complaint stocks, we're the largest market after Malaysia as well.

**Spreading global appeal**

The fact that we have so many stocks that comply with Islamic law without even consciously trying shows the promise of growth definitely exists in this sphere. But that should not come as a surprise, since some rules about Islamic equity investing can be described as simply following prudent financial principles (See box: *Nothing so religious about it*). "Islamic investing is as much about following prudent financial principles as it is about religion," says Zafar Sareshwala, CEO, Parsoli Corporation, a Mumbai-based broking house that has its own Islamic equity index.

The fact that even the non-Muslim world is sitting up and taking notice of Islamic finance suggests its rapidly rising appeal. As Beary's Nisar says, "Islamic finance may have its origins in Islamic countries, but the option and its benefits are not restricted to Muslims alone."

Indeed, that says it all. □



In a bid to encourage Muslim investors to view equities as an acceptable investment, ratings agencies such as Dow Jones and Standard and Poor's have created a clutch of Islamic indices

**Building Equity**

It's an accepted fact that the main purveyors of Islamic finance so far have been banks and other financial institu-

tions. Stocks had not exactly captured the hearts of Muslim investors (equity investing was seen as akin to gambling), but that is gradually changing.

Some reports suggest that just about \$20 billion is invested in Islamic equity funds. Islamic funds research organisation Failaka Advisors estimates that there are about 320 equity and balanced funds around the world right now; including other funds that invest in the money markets, real estate and private equity, it could be 600, it adds.

In a bid to encourage Muslim investors to view equities as an acceptable investment, international ratings agencies such as Dow Jones and Standard and Poor's have created a clutch of Islamic indices, covering thousands of Shariah-compliant stocks across individual countries and regions. Assets worth billions of dollars are already benchmarked to these indices, say both agencies.

Each Shariah index typically covers about 60 per cent of the market cap of the parent index – the S&P 500 Shariah index, for instance, contains 276 stocks.

Equity investing Shariah style requires complying with rigorous

screening procedures, according to experts (See box: *Rules for Investing the Shariah way*).

"While the investing universe is smaller, the compensation is much lower risk," says Adam Ibrahim, CEO of South Africa-based Oasis Asset Management, one of the top-ranked fund houses in the Islamic world. One of the house's top funds, the \$256 million Oasis Crescent Global Equity Fund, has jumped by a little more than 150 per cent over the past five years. (this year, it is up 8.5 per cent, even as most global markets have slumped).

One reason for the lower risk, experts say, is that Shariah stock screens often flash danger signals of a flailing company much before conventional screens do. "Companies like Enron,

Worldcom, Tyco etc., were removed from out Islamic indexes before or near bankruptcy levels were reached," says Rushdi Siddiqui, global director, Dow Jones Islamic Markets Indexes.

That kind of stock screening cast Islamic equity funds in a favourable light last year, as they steered clear of the credit crunch hurricane that ripped through the US financial sector.

But this doesn't happen all the time. "The returns show a mixed performance," says Mark Smyth, London-based managing director of Failaka Advisors. "While Islamic funds may have outperformed their conventional peers in 2007, there were other years when they posted similar returns. At other times, they even went the other way."

A cross-section of global Islamic funds that have existed for the past

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