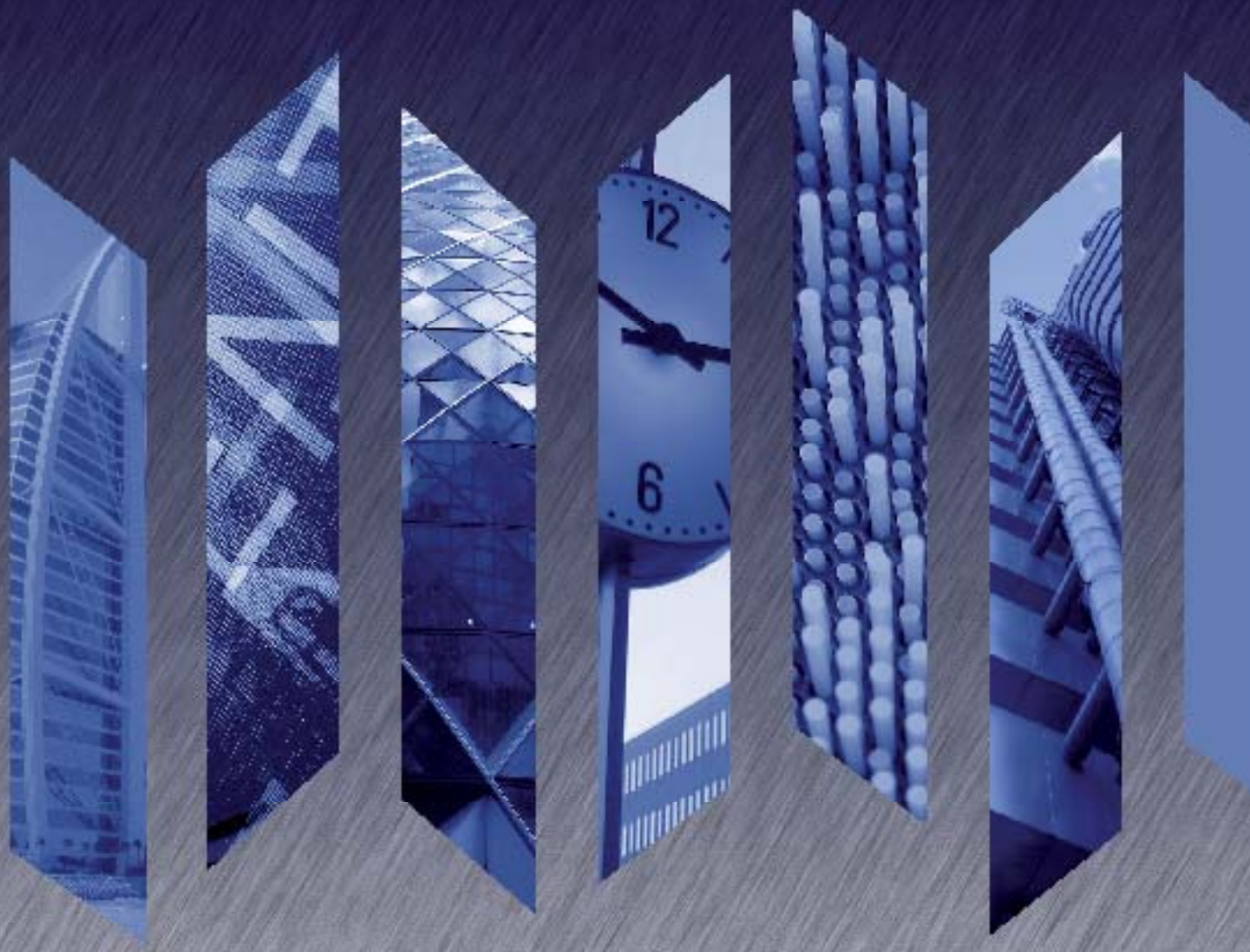
Islamic Finance *news*

Asset & Wealth Management Guide 2008



Product

Islamic Finance news Awards
Poll 2007

Welcome

to the FWU-Group

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"Best Islamic White Label Service Provider"

We wish to thank all our bank distribution and Takaful product partners for this important achievement and success.

FWU-Group is a leader in international Bancatakaful, Shari'ah compliant investments and web based point of sale and administration systems. FWU-Group is also an Observer Member of the Islamic Financial Services Board (IFSB).

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- Open investment architecture embedding active risk-control and dynamic fund allocation
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Bank distribution partners already exist in the Middle East and the Emerging markets.

In the Middle East region, the FWU-Group offers local support through its regional office in Dubai.

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Assurance - Asset Management - Pensions

FWU

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Note from Editor

Even as asset and wealth management gains popularity the world over, its progress in the context of Islamic finance has been phenomenal. It is notable that this is spanning beyond the "captive" market of the sizeable global Muslim population and the concept is being accepted by others who are drawn to the ethics and principles that form the basis of Islamic finance.

Islamic unit trust and investment funds are drawing new emerging players as the market expands in depth and width. While equity funds are the most popular, money market, commodities trading, real estate and debt securities are also becoming prominent sectors. This is ample demonstration of the hold Islamic finance is gaining in asset and wealth management.

This has gone to the extent of many funds going global rather than concentrating on a regional bias. Growing interest in Shariah compliant funds is also driving countries to offer juicier carrots. All this, of course, is creating a virtuous circle.

Another focus is how well indexing is developing as a viable offshoot of the industry. This has become a valuable tool for the Islamic sector, which operates on conservative and consistent principles coupled with transparency. The FTSE Global Islamic Index Series is evidence that such indices are not only workable for Islamic finance, they are also effective. The article also discusses how index leadership is blending smoothly with Shariah expertise.

Takaful has developed remarkably from merely providing coverage in line with Islamic finance to ably adapt the conventional insurance sector's penetration into asset and wealth management. The Muslim community's ready acceptance has persuaded others to appreciate Takaful as well in providing greater assurance on how assets and wealth are taken care of.

This issue also discusses capable asset and wealth management the Shariah way in terms of emerging markets, offshore funds and risk management.

All in all, rewarding reading is in store.

Kind regards,

S Sivaselvam
Editor

AmIslamic

AmIslamic Funds Management

AmIslamic Funds Management offers a comprehensive and innovative range of Shariah-compliant funds management services.

Your Preferred Islamic Investment Solutions Provider

With a solid three decades of proven track record, our funds management team has the expertise to manage Shariah-compliant unit trust funds for retail investors, and provide customised Shariah-compliant investment solutions for institutional investors.

We are amongst the largest fund management houses in Malaysia in terms of assets under management.* We currently manage over RM19 billion in assets as at 30 April 2008 for unit trusts, pension funds, institutions and private discretionary mandates.

** Source: The Malaysian Association of Asset Managers, Lipper Hindsight as at 31 March 2008.*

Our Engine of Growth – Innovation

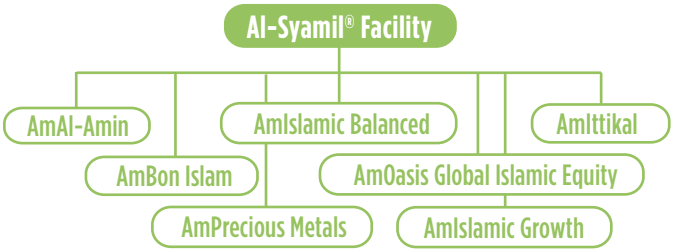
Our success comes by learning to manage change as well as keeping ahead and constantly looking for hidden investment opportunities to create value for our investors. Our pioneering spirit has spanned over the decades which have been seen in a series of notable 'firsts' in the market across a broad spectrum of asset classes.

Year	Fund / Facility	Our Innovation - A series of FIRSTs...
1992	AmIttikal	Malaysia's first Islamic fund based on total Islamic concept of Mudharabah fee
2001	Al-Syamil®	Malaysia's first Islamic switching facility comprising a complete group of asset classes
2001	Islamic Treasury Solution	Malaysia's first Islamic switching facility for corporate treasury requirements
2006	AmOasis Global Islamic Equity	Malaysia's first global Islamic equity fund
2007	AmPrecious Metals	Malaysia's first equity fund that invests in equities related to gold and other precious metals

** Source: Lipper Hindsight as at 31 March 2008.*

Al-Syamil® Facility

One of our firsts in the market is the Al-Syamil® Facility, where our complete menu of Islamic unit trust funds (i.e. fixed income, debt securities, mixed asset and equity) are grouped under one umbrella. The Facility allows switching convenience between the different asset classes. This flexibility allows investors to perform their own asset allocation and reposition their investment from time to time, depending on changing investment needs and market cycles.



A Team of Islamic Specialists

We have a dedicated team of Islamic specialists who bring the best practices of funds management and operate within the strong legal and Shariah framework developed by our Shariah Committee and Advisory Panel. Our team has always been in the forefront in producing innovative Shariah-compliant funds management products and solutions for the retail and institutional markets.

Our Shariah Investment Philosophy and Process

On the broad investment strategy level, our investment professionals perform thorough research based on top down (macroeconomics and quantitative analysis) coupled with bottom up fundamental and stock research. The process is then distilled into careful stock selection based on investment themes, technical and sector weightings.

Our Islamic Solutions

We provide investors both local and global investment solutions. We offer financial solutions across a whole suite of asset classes.

We are sensitive to the requirements and regulations of our customers and will tailor our services to your specific needs.

Contents

News briefs

(From January - June 2008)

Stocks could see a strong 2008

The UAE stock market in 2008 will be supported by a backdrop of robust earnings growth, high oil prices, abundant liquidity and a steady real estate market, investment bank EFG-Hermes said in its latest research report.

The influx of Western institutions is expected to accelerate, with long only funds playing a more decisive role than in 2007, it said. "Over the course of the year, we expect this to help distribute liquidity more evenly across the stocks listed in the UAE and to draw attention to small- and mid-cap names that have so far been below the radar, although we expect this to be a more prominent effect in the second half of 2008," said the report.

Japan banks focus on Islamic funds

Japanese banks have been focusing on Islamic funds, recognizing the country can play the role of a gateway internationally in a regional market from Asia to strengthen inter-regional linkages between Asia and the Gulf, said Tadashi Maeda, director-general of Japan's energy and natural resources finance department.

Gatehouse gets Shariah license

The UK's Financial Services Authority has approved the license for Gatehouse Bank to become the fifth stand-alone Islamic bank in London, the bank said in April.

The bank — a subsidiary of Kuwait-based investment company, Securities House — will focus on Islamic capital markets, institutional wealth management, Islamic treasury business and advisory services.

"London looks well-placed to become the western center of choice for Islamic finance," said Gatehouse Bank CEO David Testa.

ADIA's wealth fund top the chart

Abu Dhabi Investment Authority (ADIA) is the world's largest sovereign wealth fund, reveals Deutsche Bank research. It stated that ADIA has a total of US$900 billion worth of assets under management.

Some of the wealth is expected to trickle into the Islamic finance sector. ADIA had earlier announced it may invest more into Islamic bonds mainly in Kazakhstan and Turkey.

Meanwhile, in the No 2 spot is the Singapore Investment Corporation with assets worth US$330 billion, while Norway's Government Pension Fund-Global (GPFG) came in third with US$322 billion in assets.

Investors parking funds in oil

Flush with funds, investors from the GCC and the Middle East as a whole are increasingly putting their money into currencies and oil. Gold also continues to be an investment of choice, said Wahb Ahmed, manager of sales trading (Middle East) at Saxo Bank.

"The majority of European banks are looking at China, India and the Middle East, where there is more liquidity. We are an investment bank and offer multi-product banking. An investor or trader with liquid assets would want to diversify to reduce risk," he said.

Ahmed said Saxo has a good client base in Qatar as in the rest of the region, although he declined to give numbers or approximate figures invested by nationals.

Eurekahedge launches fund database

Eurekahedge recently announced the launch of the Enhanced Equity (130/30) Fund Database and Directory. It has a global coverage of close to 250 share classes, extending from SEC-registered funds, to offshore products as well as segregated accounts, making it a truly unique platform fully devoted to the short-extension concept. The current estimated assets under management in this sector stand at approximately US$60 billion.

Coverage of the database extends from SEC-registered funds, to offshore products as well as segregated accounts, making it a truly unique platform fully devoted to the short-extension concept. These long/short strategies have a defined net exposure of 100% and gross exposure (i.e. 160% for a 130/30 fund), and characterize the fast-growing hybridization of the alternative asset class.

Information on individual funds in the database includes detailed information on the background of fund manager and their strategy, statistics and performance of the fund, fee and redemption structure, investment profile, service providers and much more.

Mutual funds did well in 2007

The Middle East's mutual funds sector saw strong growth last year (as at the 23rd December 2007) as 87 new funds were released, 52 of which were Shariah compliant, it was reported.

A good performance by the region's equity markets, with some advancing 30% or more, alongside keen interest from institutional investors, should enable the sector to continue to move forward in 2008. In 2007, 24 of the new funds were established to track Kuwaiti firms.

continued

News Briefs (continued)

Goldman Sachs gets brokerage license

Goldman Sachs has received a license to offer brokerage services in Saudi Arabia, the Middle East's largest equity market. The Wall Street brokerage giant is among three new firms licensed to provide brokerage services in the kingdom's bourse, the market regulator said in a statement on the bourse website.

Foreigners are not allowed to trade directly on the Saudi bourse, which permits only residents and nationals from the GCC states to buy shares. Foreign investors can access a few Saudi mutual funds.

Switzerland's Faisal keen to branch out

Geneva-based Faisal Private Bank wants to set up in Malaysia, Dubai and Saudi Arabia, luring wealthy Muslim clients on the home turf of its parent company Ithmaar Bank.

Having obtained a banking license in 2006, Faisal Private Bank has gathered US$759 million in client assets. But this year, new offices in the abovementioned locations should bring more growth with two new real estate funds adding up to US$400 million.

CBB approves Apex Fund license

The Central Bank of Bahrain (CBB) has granted a license to Apex Fund Services to set up operations in Bahrain. Apex Fund Services (Bahrain) WLL will open its doors in Manama this month under the leadership of Nicolas Angio, who joins Apex from Bisys Hedge Fund Services; and Craig Roberts, managing director of Apex Dubai.

The Bahrain office will be regulated by CBB and will provide daily, weekly and monthly valuations to traditional funds, hedge funds and private equity funds. It will also accept Arabic subscription and redemption documents, as well as offer expertise in Shariah compliant products.

Islamic assets reach US$267 billion

A report by Ernst & Young revealed that Islamic assets in the GCC and Far East regions have reached US$267 billion as a result of strong economic conditions, increased government expenditure and high liquidity. This could lead to US$1.34 billion in annual revenue in the Shariah compliant asset management industry, according to the report entitled "Islamic Funds and Investments Report 2008".

The report also mentioned that there are currently more than 500 Shariah compliant funds worldwide, including 153 funds established last year. The number could reach 1,000 within the next two years.

The report, which is a second edition, also compared the Saudi Arabian and Malaysian markets, focusing on the need for different approaches to the two countries.

Islamic mutual funds underway

Four asset management companies in India are planning to launch Islamic mutual funds within the next few months, although approval from regulators may not come easy. Reliance Mutual Fund, UTI Asset Management, Way2Wealth and Edelweiss Mutual Fund made the decision to attract affluent Muslims in India who do not deal with conventional funds to invest in stocks that are Shariah compliant.

The Securities and Exchange Board of India (SEBI) is still skeptical over a few issues, such as the conduct and the screening process of these funds. Authorities also feel that Shariah compliant funds are only attractive to a selected group of people.

UTI is currently managing an offshore Islamic fund, and is planning to launch the mutual fund with Parsoli Corporation, which has a Shariah board to certify the scheme. Reliance Mutual Fund, on the other hand, is already in the final stages of discussion with an Islamic institution to launch the fund and is filing its application to market regulators soon.

Securities industry eyes Islamic investors

Japan's securities industry is scrambling to develop financial products that will attract so- called "oil money", which has grown to US$1 trillion on high crude oil prices. The industry drive moved into higher gear late last November when the Tokyo Stock Exchange and Standard & Poor's, a major US credit rating agency, jointly launched a new stock index to meet demand from Islamic investors for access to large-capital Japanese companies.

In addition, Société Générale Asset Management (Japan) of the major French financial group is developing an investment fund linked to a Japanese stock index for Islamic investors, while Nomura Asset Management is planning products for pension funds, governmental investment funds and other extra-large investors from the Middle East.

New SC rules on unit trusts

In order to comply with international standards and to boost the global competitiveness of Malaysian unit trust products, the Securities Commission (SC) issued its revised guidelines on unit trust funds in early March, said SC chairman Zarinah Anwar.

The main amendments included the removal of investment restrictions, removal of cash-borrowing restrictions and doing away with the need to seek SC approval to invest in foreign markets, subject to certain conditions.

Last year, the number of funds in operation grew 26%, bringing the total number of domestically incorporated unit trust funds to 495, of which 128 were Islamic funds.

continued

News Briefs (continued)

Investors drawn to Islamic equity funds

With an excellent record for Islamic equity funds in 2007, Dubai has been attracting global investors to Islamic investment funds, according to fund monitoring company, Failaka.

Failaka reports that 2007 was a good year for Islamic equity funds, with GCC markets performing well compared to 2006. By end-2007, the industry had approached US$20 billion in assets for the first time. Funds investing in GCC markets represent over half the whole Islamic equity fund industry.

Some of the high-flying Islamic equity funds are from global investment firms operating from Dubai, such as Permal and DWS, a division of Deutsche Bank.

Challenges for Gulf's private banks

Margin pressures, eroding prices and rapid product commoditization are some challenges faced by foreign players looking to enter the Gulf's increasingly competitive private banking industry, according to global management consultant Boston Consulting Group (BCG).

In its report on global wealth management and private banking, BCG said global wealth grew by 7.5% in 2006 to US$97.9 trillion and it expects assets under management to continue their steady rise. Foreign players face additional challenges, such as growing competition from Islamic banks. In terms of assets, Islamic banking represents 15% to 20% of local retail banking markets in the GCC.

HSBC Amanah plans new Islamic funds

HSBC Amanah is developing new funds, including Islamic structured notes in view of the growing demand for Islamic investments. The GCC region is all set to see new instruments like exchange-traded funds and new asset classes, especially the halal industry, said HSBC Amanah regional head of wealth management, Ishrat Kiyani.

He said HSBC Amanah was currently developing new funds such as HSBC Global Emerging Market Fund and HSBC Amanah Hangseng Index Fund to leverage on growth in emerging markets and Asia-Pacific.

Magnificent growth funds

The Islamic fund industry is one of the fastest-growing sectors in Bahrain, with a significant 80% growth within the last five years, said A Rahman Moh'd Al Baker, Central Bank of Bahrain's executive director of financial institutions supervision.

The country had 99 funds until April this year, with a total amount of US$1.5 billion, but more will be coming in as well, A Rahman added. This equals 10% of the country's total mutual funds sector, which at the end of the first quarter of this year stood at US$60 billion.

Biggest SWF in the offing

Saudi Arabia is planning to establish what could be the world's biggest sovereign wealth fund (SWF), worth more than US$900 billion and dwarfing current title-holder Abu Dhabi, according to a report by a UK daily.

The effort, likely to be led by the country's Public Investment Fund, "will be a formidable rival for other government-owned investment funds in the Middle East and Asia, which are playing an increasingly active role in channeling capital to Western companies", the newspaper said.

SC reveals new venture capital guidelines

New guidelines for Malaysia's Islamic venture capital sector were announced by the Securities Commission attract more investments in Shariah compliant firms.

Two main components under the guidelines are that investees must appoint Shariah advisors and the core business must be Islamic according to Nik Ramlah Nik Mahmood, SC's managing director. She made the announcement during the Islamic Venture Capital and Private Equity Conference.

Nik Ramlah added that it is the right time for Islamic venture capital market to be developed as it will bring in more foreign funds looking into investing in Islamic companies. She further noted that the sector is one in which Malaysia can distinguish itself from other markets.

Dow Jones MSM Index launched

Dow Jones Indexes and Muscat Securities Market, the stock exchange in Oman, have launched the Dow Jones MSM Index. The total-market index measures the performance of all companies listed on the Muscat Securities Market and currently includes 66 stocks.

The MSM Index is designed to underscore financial products such as exchange-traded funds and other investable products that enable investors to participate in the performance of the Oman stock market.

EFG-Hermes wants to raise private equity

EFG-Hermes Holding, Egypt's largest publicly traded investment bank, plans to quadruple the value of its private equity funds to US$4 billion in four years as it looks to expand in the region.

Hany Al-Sonbaty, a partner at EFG-Hermes Private Equity, said its last offering, the Horus III fund, raised US$555 million from financial institutions and high net worth investors.

It is now the largest private equity fund in North Africa and is targeting a rate of return of 20%, he said.

Developments in the Global Islamic Funds Industry

By Funds Management Division, AmBank Group

According to data from Eurekahedge, as at April 2008, Islamic unit trust and investment funds in the world reached 504 while total Islamic assets under management (AUM) were estimated at US$33.9 billion.

There has been strong growth in the industry especially in recent years. It has attracted new emerging players to the marketplace. Consequently, the market has deepened and broadened in a positive manner. Various Shariah compliant funds were introduced across asset classes to meet the needs of investors' investment objectives.

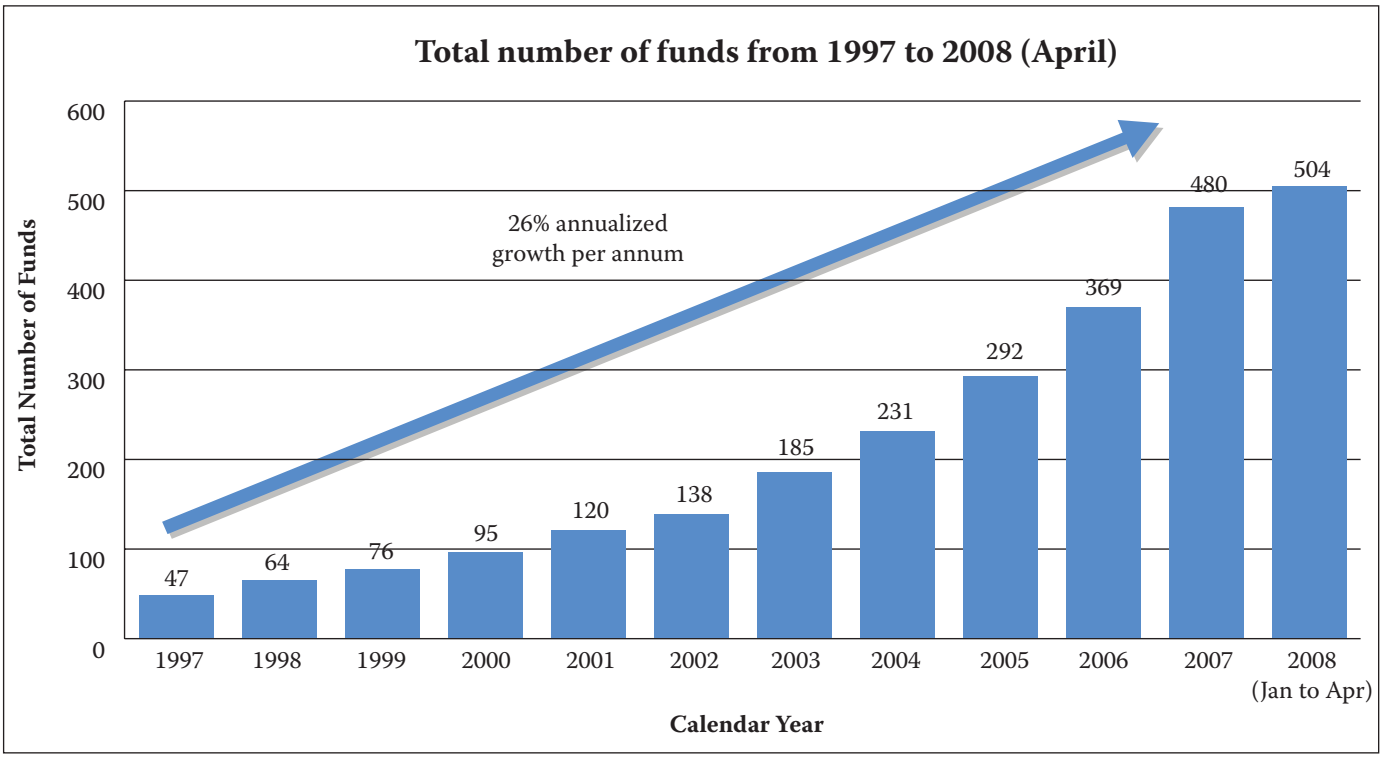
Malaysia and Saudi Arabia were the top two markets for Islamic funds in the world with the most number of funds and biggest fund sizes in terms of AUM.

Industry growth by number of funds

The global Islamic funds industry has produced a commendable annualized growth rate of 26% per annum in terms of the number of funds over 10 years (December 1997 to April 2008). For the first four months of 2008, 24 Islamic funds were launched across the globe. New funds totaled 111 in 2007 compared to 77 in 2006.

continued

Chart 1: Overview of total funds in the market as at the end of each calendar year.



Sources: Eurekahedge, AmInvestment Management

Developments in the Global Islamic Funds Industry (continued)

Analysis of global Islamic funds

We divided our analysis into three parts. Part A details the country of origin of the managers of the funds. Part B discusses the breakdown of Islamic fund types by mandate. Lastly, Part C looks into Islamic funds by investment geography.

PART A — Analysis by fund manager countries

Table 1

Funds by fund manager countries (as at April 2008)

Fund manager country	Number of funds	%	Fund size (US$ mil)	%
Saudi Arabia	133	26.38	20,360	60.04
Malaysia	126	25.00	4,141	12.21
Kuwait	76	15.08	3,437	10.14
UAE	39	7.74	2,002	5.90
Indonesia	25	4.96	253	0.75
Singapore	21	4.17	559	1.65
Bahrain	14	2.78	368	1.09
Pakistan	13	2.58	240	0.71
Others	57	11.31	2,547	7.51
Total	504	100	33,907	100

Sources: Eurekahedge, AmInvestment Management

Table 1 shows that of the total 504 Islamic funds as at end-April 2008, more than half were dominated by fund managers from Saudi Arabia (26%) and Malaysia (25%).

In terms of fund size, the two countries held three-quarters of market share with US$24.5 billion of funds out of a total of almost US$34 billion. They were the earliest to develop Islamic funds — Malaysia offered the first one in 1968 while Saudi Arabia started offering funds in the 1980s.

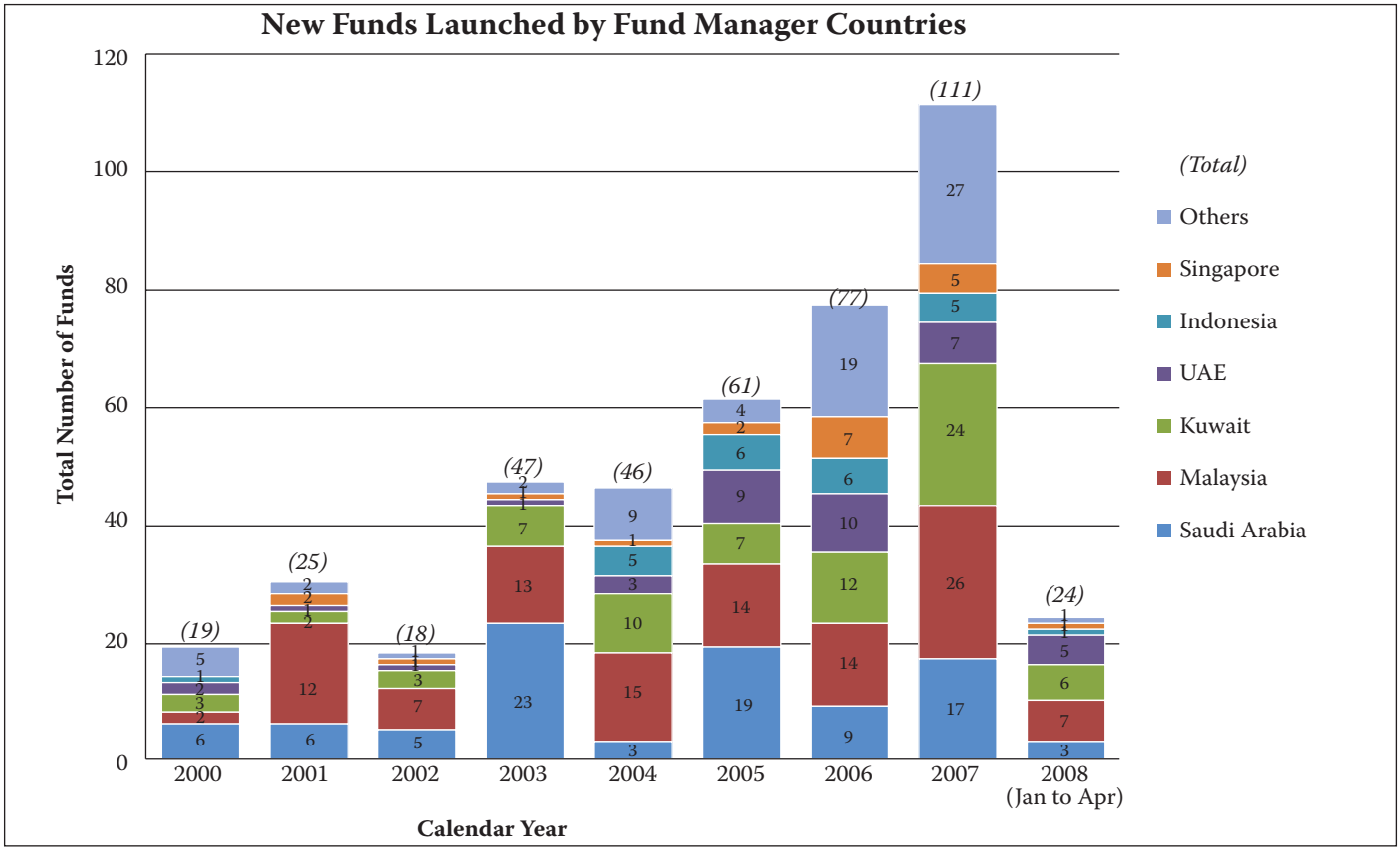
Saudi Arabian fund managers managed 133 funds with a total fund size of US$20.4 billion, making it the largest fund manager in terms of number of funds and total fund size. The kingdom commandeered 60% of total AUM.

Malaysian fund managers, on the other hand, managed 126 totaling US$4.1 billion. They were second in terms of number of funds and corresponding total fund size. Notably, Malaysian fund managers had been actively involved in launching both conventional and Islamic funds; increasingly, attention was focused on the Islamic arena, holding a market share of 12% of AUM.

Kuwaiti managers oversaw 76 funds totaling US$3.4 billion in AUM, or 10% of the total fund size of almost US$33.9 billion in the industry. The country was the third biggest in terms of number of funds and total fund size managed.

continued

Chart 2



Sources: Eurekahedge, AmInvestment Management

Developments in the Global Islamic Funds Industry (continued)

As per Chart 2, there were 24 new funds in the market in the first four months of 2008.

Malaysia had the most number with seven. Kuwait was second with six new funds. The UAE introduced five, hence making the country the third highest in terms of number of new funds launched in the said period.

The total number of new funds for 2007 was 111, with Malaysia again leading with 26. Kuwait added 24 funds to the industry, becoming the second highest in terms of number of new funds launched. Saudi Arabia launched 17 funds for 2007.

Malaysia showed a consistent trend of launching Islamic funds, especially over the last five years. Kuwait followed the same pattern and steadily introduced new funds every year.

On the other hand, Saudi Arabia reported a sporadic trend in the number of new funds launched, with 23 in 2003 before slowing down the following year. It launched 19 funds in 2005 and slowed down the following year.

The UAE also saw growth in a number of new funds launched annually since 2000. Note that new emerging countries — Singapore, Indonesia, Bahrain and Pakistan — are joining the fray. Interestingly, Luxembourg and Ireland had since offered funds in 2007 and 2008.

PART B — Analysis by mandate

Table 2

Funds by mandate (as at April 2008)

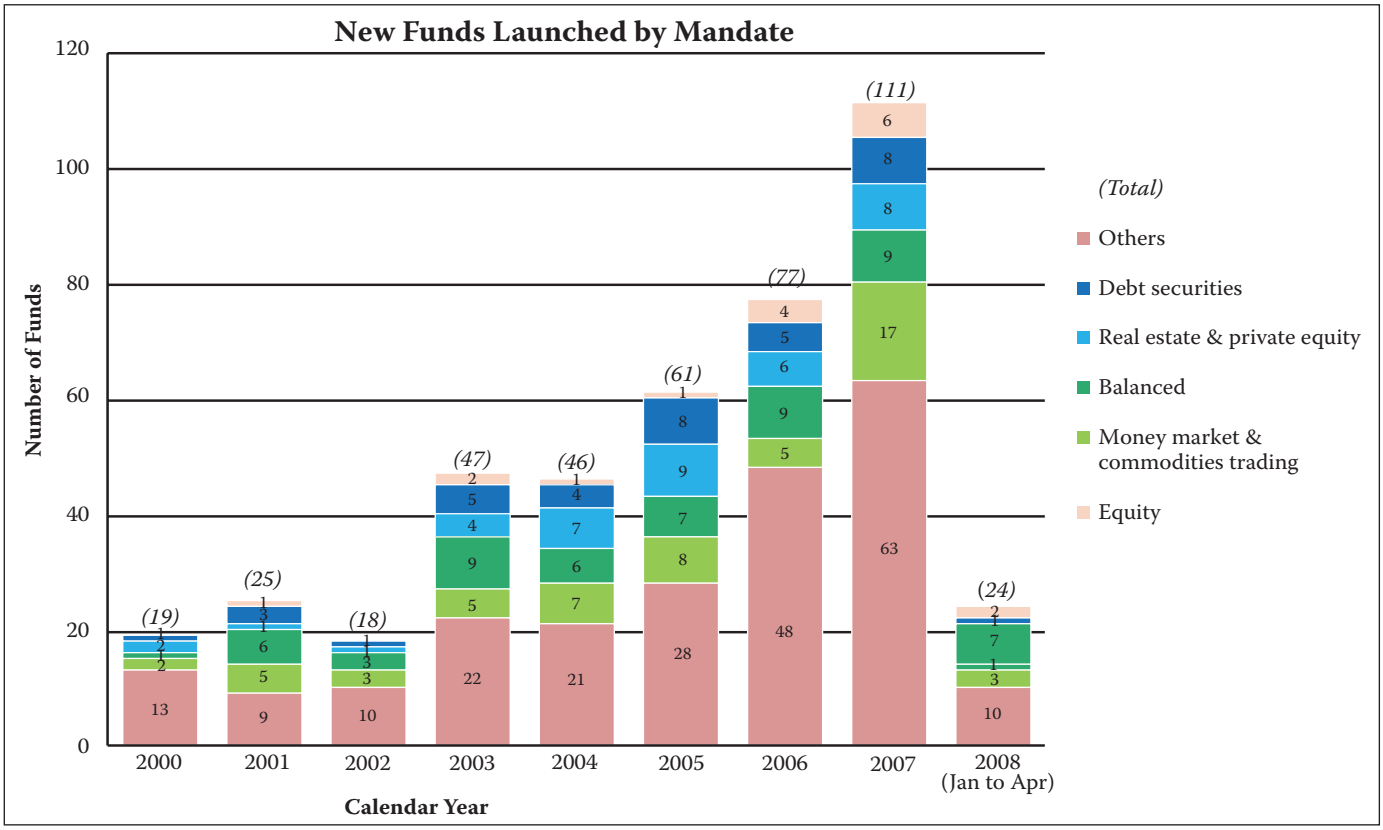
Mandate	Number of funds	%	Fund size (US$ mil)	%
Equity	278	55.16	18,333	54.06
Money market and commodities trading	70	13.89	10,931	32.24
Balanced	55	10.91	1,068	3.15
Real estate and private equity	45	8.93	2,274	6.71
Debt securities	36	7.14	1,054	3.11
Others	20	3.97	247	0.73
Total	504	100	33,907	100

Sources: Eurekahedge, AmInvestment Management

Of 504 funds as at April 2008, 278 were equity funds with a total fund size (AUM) of US$18.3 billion. Equity funds were the most popular, accounting for more than half by number and fund size (see Table 2).

continued

Chart 3



Sources: Eurekahedge, AmInvestment Management

Developments in the Global Islamic Funds Industry (continued)

Money market and commodities trading fund mandates were second at 70, with fund size nearly touching US$11 billion. There were 55 balanced funds with fund size of approximately US$1.1 billion as at April 2008.

The number of real estate and private equity funds as at April 2008 was 45 with a total fund size of close to US$2.3 billion. Debt securities accounted for 36 funds, totaling nearly US$1.1 billion as at April 2008.

The 24 new funds launched in the first four months of 2008 as per Chart 3 (see previous page) included 10 equity funds — the highest in terms of new funds launched by mandate. For the same period, real estate and private equity saw the second highest number of new funds launched by mandate, with seven. This was followed by money market and commodities trading,with three.

In 2007, equity funds made up 63 funds of the total 111 launched, thus making this category the most popular for number of funds launched.

Next was money market and commodities trading, which accounted for 17 funds last year. Balanced funds were the third biggest category as nine funds were launched.

Over the years, equity funds remained the most popular in terms of number of funds launched. This was followed far behind by money market and commodity trading funds and balanced funds. Money market and commodities trading funds saw an increase in the number of funds launched in 2007 and have grown in popularity.

PART C — Analysis by investment geography

Table 3

Funds by investment geography (as at April 2008)

Investment geography	Number of funds	%	Fund size (US$ mil)	%
Asia-Pacific	184	36.52	5,012	14.78
Middle East/Africa	155	30.75	21,966	64.79
Global	117	23.21	4,979	14.68
North America	32	6.35	1,547	4.56
Europe	11	2.18	143	0.42
Emerging markets	5	0.99	260	0.77
Total	504	100	33,907	100

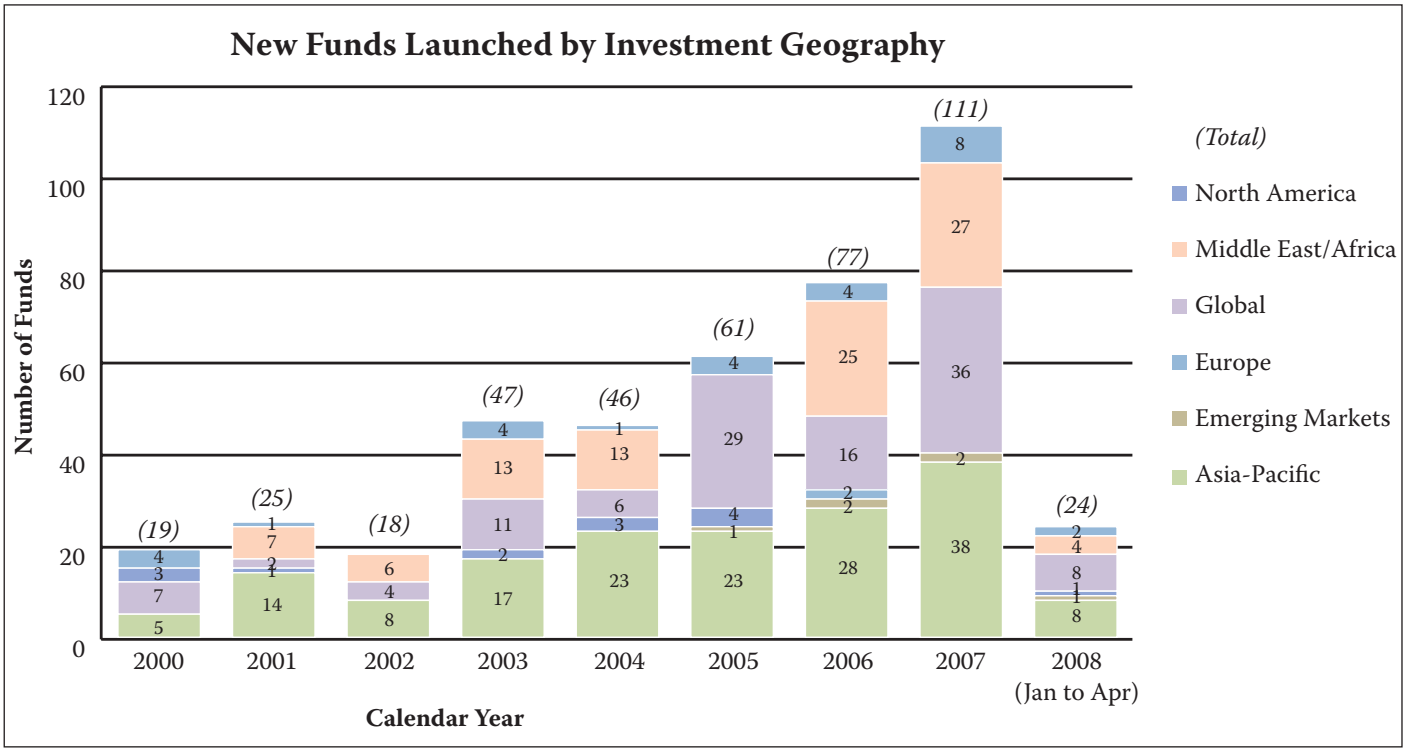
Sources: Eurekahedge, AmInvestment Management

Table 3 shows where the funds were invested in geographically as at April 2008. There were 184 Asia-Pacific funds with a fund size amounting to US$5 billion of the total US$34 billion in global Islamic fund assets.

On the other hand, Middle East/Africa mandates accounted for 155 funds, dominating with US$22 billion in AUM which was 64.8% of the total market share.

continued

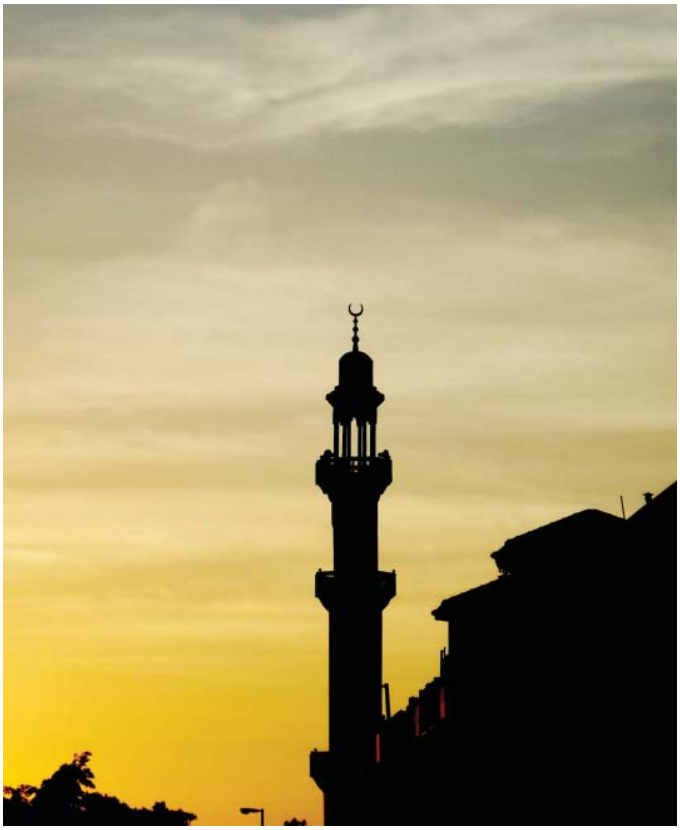
Chart 4



Sources: Eurekahedge, AmInvestment Management

Developments in the Global Islamic Funds Industry (continued)

There were 117 global funds as at April 2008, with the total fund size amounting to US$5 billion. Funds with North American investment exposure accounted for US$1.5 billion spread across 32 funds.



European market funds were not popular and took less than 0.5% of market share at US$143 million with 11 funds. Emerging markets, while only accounting for five funds, had a fund size of US$260 million.

Chart 4 (see previous page) shows that of the 24 funds launched in the first four months of 2008, funds with an Asia-Pacific mandate were represented by eight funds, which was the highest in terms of number of new funds launched by investment geography.

There were also eight funds with a global mandate, followed by four with Middle East/African mandates.

In 2007, funds with an Asia-Pacific mandate were the most popular in terms of funds launched, accounting for 38 of the 111. Funds with a global mandate were the second most popular as 36 came from that category. Funds with Middle East/African mandates were the third most popular, with 27 from the category.

We observe a key trend in the Islamic funds industry in terms of new funds launched by investment geography, which is the re-emergence of funds with a global mandate in the last two years.

Emerging-markets strategy first appeared in 2006 and two funds were each launched in 2006 and 2007.

Generally, the popularity of the different regions has to do with where the funds were launched. For instance, Malaysia launched numerous Asia-Pacific investment funds because it is part of Asia-Pacific and the fund managers and investors there were more familiar with the investments.

Likewise, Saudi Arabia and Kuwait were more likely to have launched Middle East/African mandates as they are more comfortable with investing close to where they came from.

Conclusion

Interest in Islamic and Shariah compliant funds remains keen with more jurisdictions across the world creating incentives and promoting their respective countries as the center for Islamic funds and capital markets.

We foresee interest in and demand for such funds will increase significantly as Islamic and non-Islamic investors become more aware of the potential rewards from investing in such funds. Thus, education on and awareness of the benefits and features of Islamic funds must continue and grow.

Stakeholders and market players need to continue playing their part to fulfil the objective of getting Islamic funds to reach parity with conventional funds in terms of popularity and standard.

Note: Fund data was obtained from Eurekahedge. The article mentioned there were 126 Islamic funds in Malaysia as at April 2008. According to the Securities Commission of Malaysia's website on "Summary of Statistics – Unit Trust Funds in Malaysia", there were 134 launched unit trust funds for the same period.

AmIslamic Funds Management

This article was researched and written by the marketing and product development unit under the Funds Management Division of AmBank Group.

Islamic Finance news

A RedMoney Product

Vol. 5, Issue 23 13th June 2008

The World's Global Islamic Finance News Provider

SAUDI ARABIA

Muslim world to see US$1.2 trillion inflow for projects

The Islamic Development Bank (IDB) expects its 56 member countries to invest US$1.2 trillion in infrastructure development over the next 10 years mainly in the telecommunications, transport and water and power sectors. It estimates about US$675 billion to be taken up by telecommunications and power projects, almost half of that in the Gulf Cooperation Council states.

The IDB sees about US$290 billion going into expanding and upgrading air, sea and land transport infrastructure with about half of it for Muslim countries in Asia.

Another US$115 billion is to be invested to expand and upgrade water and sanitation services, with about 60% of it for Arab and African states.

The private sector is expected to provide much of this financing, the bank said.

(Also see IFN Reports on page 11)

MALAYSIA

Faisal Bank to use Malaysia as launch pad

Faisal Private Bank has favored Malaysia to establish itself in the Southeast Asian region in the Islamic private banking market.

Its investment banking head, Giovanni Perin, said a representative office will be opened soon that will be used as a platform to enter markets such as Singapore and Indonesia.

Faisal has obtain an approval from the Swiss Federal banking Commission to open its representative office in Malaysia and was currently in the process of getting a nod from Malaysia's central bank.

Faisal, which is 79.8% owned by Bahrain-based Ithmaar Bank, will target private and corporate clientele in the US$1 million to US$15 million investment bracket.

Faisal currently have two local institutional clients, whose funds are mainly invest in real estate and equity in Asia.

Faisal's representatives were in Kuala Lumpur this week to showcase their Central Eastern Europe Real Estate Fund.

(Also see IFN Reports on page 12)

AFRICA/SAUDI ARABIA

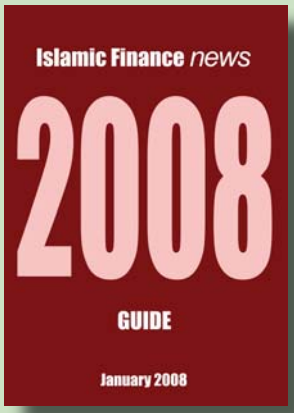
Islamic fund targets Africa

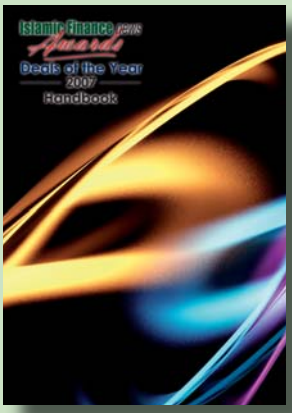
Investec Asset Management and Jadwa Investment are co-launching a new Shariah compliant fund to invest in African equity markets, making it the first fund in the Middle East to specialize in Africa. The fund aims to raise more than US$100 million in its first year.

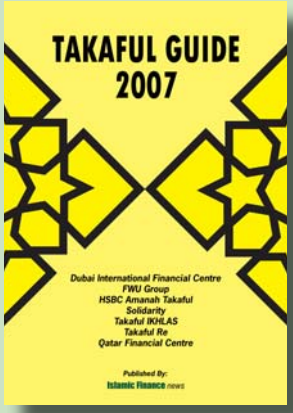
Investec is a Johannesburg-based investment company that specializes in African and frontier investments. It will manage the fund and oversee the stock selection. Riyadh-based Jadwa is responsible to raise the funds and advise whether stocks are Shariah compliant.

In this Issue

x 50 online issues







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Shariah Compliant Indexation: Fueling the Development of a Growing Industry

By Donald Keith

Indexing is a key tool in the development of financial markets — indices offer retail and institutional investors a means of tracking and analyzing financial performance, and a basis from which to support the development of new investable products. In this way, indices act as a platform for market growth as witnessed in the adoption of indices as the underlying basis for financial products.

The evolution of the financial industry has reached a point where it must cater to the needs of various market segments. The proliferation of niche investor segments stimulates the demand for appropriate tools to measure these niche areas, such as benchmark indices. On the other hand, it also creates the need to provide tailored investment vehicles to facilitate access to markets based on the investment beliefs of the investor. For example, ethical investing has seen accelerated growth, particularly in the last five years, showing there is real money being put behind companies governed by sound environmental or social standards.

More recently, faith-based investing, such as that of Islamic investors, has perhaps seen much substantial growth. This may seem like an obvious comment when studying the numbers. There is an estimated US$800 billion in Islamic invested assets today, up from US$150 million in 2000, with an expected annual growth rate of 10% to 15%.

Some commentators forecast this to overshoot the US$1 trillion threshold by the end of 2008. This industry growth is predominantly from the rapid rise in wealth of the oil-backed Gulf states and is in turn pushing up demand for investments that are in line with the religious beliefs of Islamic investors who reside there. Concurrently, the rising wealth of emerging Islamic nations such as Malaysia and Indonesia, as well as markets with large Islamic communities such as India, are also driving demand for onshore investment products in their own domestic markets.

New opportunities for Islamic and conventional institutions
To meet the demand of an unprecedented growth in this investment segment, established Islamic institutions and financial services need to innovate within the boundaries of Shariah law to maintain market share. In addition, if the Islamic finance industry is to develop to its full potential, the conventional finance industry needs to adapt itself to build the infrastructure and products if it wishes to offer an alternative to this growing investor base.

For traditional financial providers, an understanding of the investment beliefs of Islamic investors, and the principles of Shariah law that govern them, is paramount. In the case of index providers, Shariah compliant indices should be based on conservative and consistent principles. Screening methodology and processes should be transparent and auditable if they are to be accepted by the Islamic community. Traditional financial screens applied to conventional indices need to be retained. These include screens for size, governance, liquidity or free float, which ensure the base universe is investable before the overlay of Shariah screens is applied.

"There is an estimated US$800 billion in Islamic invested assets today, up from US$150 million in 2000, with an expected annual growth rate of 10% to 15%"

Blending index leadership with Shariah expertise

FTSE Group is probably best known for the blue-chip FTSE 100 index. Among finance professionals, FTSE is also known to lead the way in introducing innovative methodology techniques, or financial screens, to conventional indices. Among other innovations, FTSE was the first global index provider to introduce free-float adjustment into its Global Equity Index Series (GEIS). More recently, refinements were made to the liquidity screens to ensure the underlying stocks are highly investable over a continuous period. These hallmarks of innovation, alongside the philosophy to provide objective, transparently managed and rules-driven index products, are in keeping with the philosophy of Islamic investors.

Global index providers such as FTSE, Dow Jones Indexes and Standard & Poor's (S&P) have their roots in conventional investment. This presents a quandary — either to establish in-house expertise to develop and consistently govern the indices, or to seek specialized knowledge through outsourcing or partnering with external professionals who have dedicated their careers to understanding and applying Shariah law. Dow Jones Indexes have taken the in-house approach whereas FTSE and S&P have looked externally for Shariah expertise.

FTSE is well known for its ability to partner with exchanges, organizations or businesses that provide specialist

continued

Shariah Compliant Indexation: Fueling the Development of a Growing Industry (continued)

knowledge in a field which is not a core function of an index provider. Shariah compliance being a faith-based necessity for Islamic investors is a particularly sensitive and complex area. Recognizing this and to uphold the vision to provide best-of-breed indices, FTSE has partnered with Yasaar, the independent Shariah research house whose principals are experts in Fiqh al Maumalat (Shariah law relating to financial transactions). Yasaar's Shariah Board comprises a panel of highly experienced and respected scholars who ensure that the Shariah screening overlay applied to FTSE's stock universe adheres to the requirements of the most conservative investor.

For example, all stocks are deemed non-compliant until proven otherwise. The strict, rules-based approach ensures the screening process is objective and consistent across regions, a particularly important quality today as the globalization of the investment industry continues. Yasaar's Shariah Board monitors, reviews and audits the screening process regularly and scrutinizes borderline or questionable stocks before passing judgment using a consensus approach.

Shariah compliance overseen by a recognized panel of Shariah scholars, combined with the abovementioned financial screens, are considerations that investors should take the time to examine when looking at the methodologies behind the index series offered.

Need for diversified investment vehicles

Steadfast adherence to underlying principles will help Shariah compliant indices achieve mainstream acceptance among the Islamic community thereby positioning indices as a tool that fuels faster growth of Islamic markets. In turn, it is expected that this will accelerate asset flows into equities through index-linked products as investors seek the risk-mitigating advantages of a diversified portfolio. This is particularly true in the current day's context, where the credit crunch in the US is causing instability in the world's largest market and knock-on effects are resulting in volatile markets the world over. If we examine the top 20 constituents of the FTSE All-World Index and compare these to the top-ranking constituents in the FTSE Shariah Global Equity Index Series, there is a higher concentration of US-listed stocks in the conventional index. If the highlighted companies, such as General Electric, AT&T and HSBC Holdings, are removed because they don't meet the Shariah screening criteria, the sector weightings are re-distributed to exclude the heavily weighted banking sector.

continued

Table 1: Top 20 constituents of the FTSE All-World Index (global large and mid-cap stocks)

Rank	Constituent name	Country	Sector	Investable market cap (US$ mil)	Weight (%)
1	ExxonMobil Corporation	US	Oil and gas	468,981	1.44
2	General Electric	US	Construction and metals	306,760	0.94
3	Microsoft Corp	US	Technology	265,514	0.81
4	AT&T	US	Telecommunications	237,046	0.73
5	BP	UK	Oil and gas	226,401	0.69
6	Total	France	Oil and gas	208,493	0.64
7	Chevron	US	Oil and gas	205,081	0.63
8	Procter & Gamble	US	Personal and household goods	203,269	0.62
9	HSBC Holdings	UK	Banks	202,245	0.62
10	Néstle	Switzerland	Food and beverage	192,821	0.59
11	Johnson & Johnson	US	Healthcare	188,086	0.58
12	International Bus Machines	US	Technology	178,349	0.55
13	Wal-Mart Stores	US	Retail	171,248	0.52
14	Vodafone Group	UK	Telecommunications	168,750	0.52
15	Apple Inc	US	Technology	166,406	0.51
16	Cisco Systems	US	Technology	159,278	0.49
17	Royal Dutch Shell A	UK	Oil and gas	152,616	0.47
18	Bank of America	US	Banks	151,622	0.46
19	ConocoPhillips	US	Oil and gas	145,376	0.44
20	JPMorgan Chase	US	Banks	144,439	0.44

Shariah Compliant Indexation: Fueling the Development of a Growing Industry (continued)

There seems to also be more geographic diversity in the Shariah index according to this sample.

The establishment of the Sukuk market was well ahead of index products being made available and has already seen phenomenal growth, with some commentators estimating it will double to US$100 billion by the end of 2008. However, Islamic investors are becoming more sophisticated and are seeking out ways to take best practice conventional investment techniques or vehicles and adapt them to meet their own investment beliefs.

Past trends among regular investors, be they institutional or savvy retail investors, indicate a tendency to move assets into index-linked vehicles in volatile times as they offer a greater spread of risk across a basket of stocks. This suggests that Islamic investors will generate new demand for Shariah compliant index-linked products as they study and adopt similar conventional practices.

Fast-paced growth presents own challenges

There are several challenges to the Islamic finance industry as it accelerates at a phenomenal pace. At present, demand far outweighs the availability of appropriate investment products, with reports of products being oversubscribed in some instances. Consequentially, index providers face their own set of challenges, the first being the availability or a range of Shariah-compliant indices that offer choice to the Islamic community. This has now been resolved with every major index provider launching index series in the last one to two years.

"At present, demand far outweighs the availability of appropriate investment products"

Other common issues, such as harmonization and reliance on a finite group of experienced Shariah scholars, also affect the wider industry, including index providers. In addition, the provision of robust, conservative and consistent screening processes is an ongoing challenge as there is a need to

continued

Table 2: Top 20 constituents of the FTSE Shariah Global Equity Index Series

Rank	Constituent name	Country	Sector	Investable market cap (US$ mil)	Weight (%)
1	ExxonMobil Corporation	US	Oil and gas	468,981	2.77
2	Microsoft	US	Technology	265,514	1.57
3	BP	UK	Oil and gas	226,401	1.34
4	Total	France	Oil and gas	208,493	1.23
5	Chevron	US	Oil and gas	205,081	1.21
6	Procter & Gamble	US	Personal and household goods	203,269	1.20
7	Johnson & Johnson	US	Healthcare	188,086	1.11
8	Vodafone Group	UK	Telecommunications	168,750	1.00
9	Royal Dutch Shell A	UK	Oil and gas	152,616	0.90
10	ConocoPhillips	US	Oil and gas	145,376	0.86
11	OAO Gazprom	Russia	Oil and gas	144,219	0.85
12	E.ON	Germany	Utilities	140,091	0.83
13	BHP Billiton	Australia	Basic resources	139,194	0.82
14	Toyota Motor	Japan	Automobile and parts	137,728	0.81
15	Intel Corp	US	Technology	132,775	0.79
16	Coca-Cola	US	Food and beverage	132,573	0.78
17	Pfizer	US	Healthcare	132,225	0.78
18	Novartis (REGD)	Switzerland	Healthcare	122,355	0.72
19	Roche Holdings (GENUS)	Switzerland	Healthcare	120,849	0.71
20	Schlumberger	US	Oil and gas	120,553	0.71

Shariah Compliant Indexation: Fueling the Development of a Growing Industry (continued)

remain relevant as fresh issues emerge to address modern-day trends or phenomena. All the while, index providers need to differentiate themselves while conforming to common Shariah principles. These issues are explored in greater depth below.

It is well known that harmonization is an ongoing discussion in boardrooms and among academics. The simple fact that the Quran was established around 650 AD and written in ancient Arabic text presents obvious challenges in interpreting Islamic Canon Law, or Shariah law, in the context of today's financial markets. As a result of centuries of developing interpretations, there is some variance in views of the scholars.

While Shariah scholars have an open dialogue to discuss such issues in great depth before passing judgment, several international industry bodies have also been established to facilitate an open dialogue between scholars, investors and practitioners.

As a result, organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) have issued standards as guiding principles for the financial sector. As a supporting member of AAOIFI, FTSE is able to keep abreast of current issues that may affect the administration of the FTSE Shariah Global Equity Index Series.

Harmonization will continue to be an ongoing challenge especially as the range of investment beliefs among Muslims seems to be polarized. Geographically, there is also variance in the strictness of the application of interpretations, with some countries upholding extremely staunch beliefs and others being more liberal.

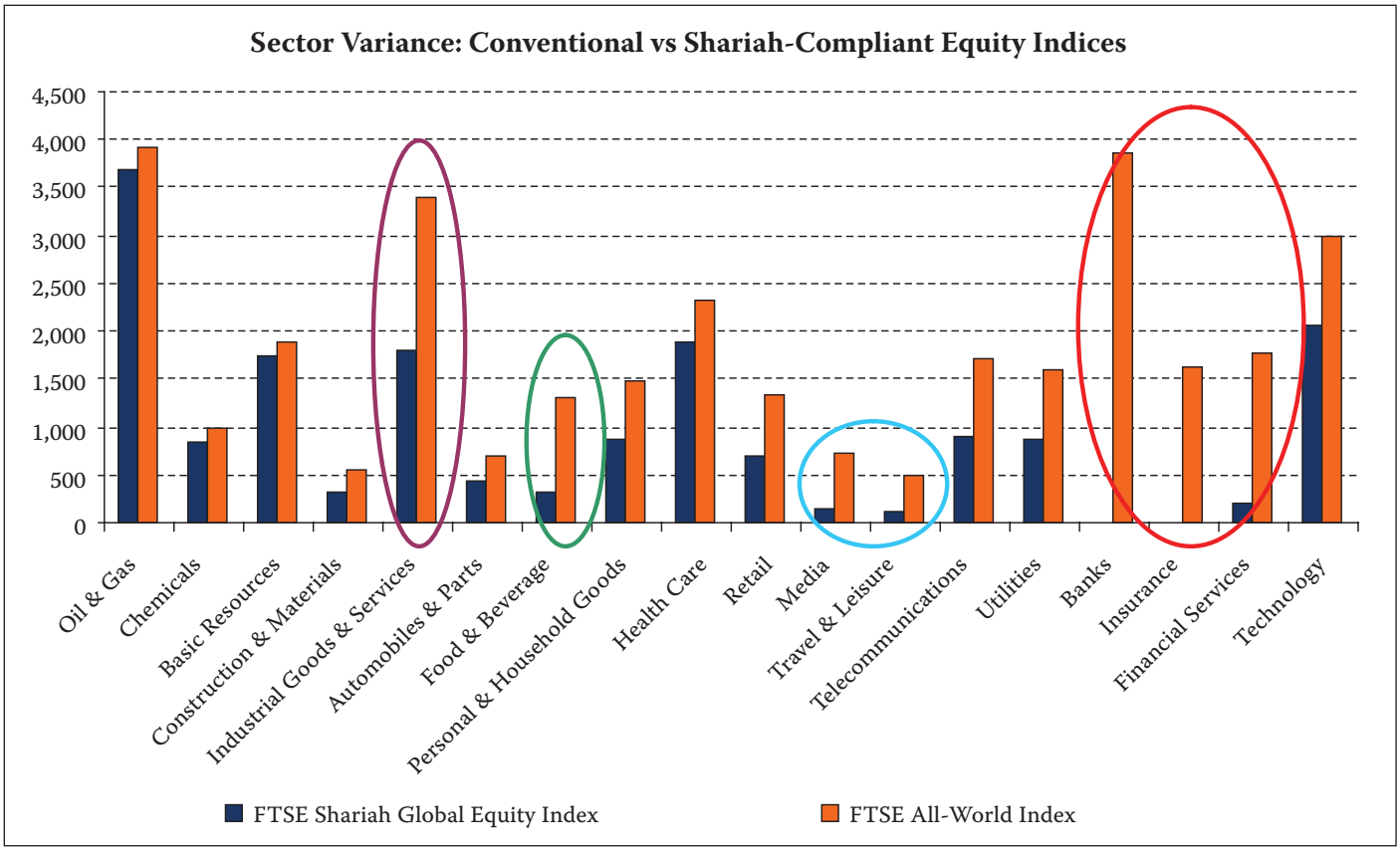
For example, Malaysia is known to have a more liberal view when it comes to investment. The Shariah Advisory Council (SAC) established by the country's Securities Commission has developed a screening methodology to suit the needs of Malay investors. Their screening criteria are applied to the broad-based FTSE Bursa Malaysia EMAS Shariah Index, which replaced the decommissioned KLSI to serve as the benchmark for Shariah compliant stocks listed on the exchange.

However, recognizing the need to attract investments from the more conservative Middle Eastern investor, the FTSE Bursa Malaysia Hijrah Shariah index was established and overlays both the criteria of the SAC as well as the more stringent criteria established by Yasaar's Shariah Board.

While harmonization is one way to align the governance of Islamic investment products, the current sentiments of investors need to be met if there is demand.

continued

Chart 1: Sector comparison of conventional and Shariah compliant indices



Shariah Compliant Indexation: Fueling the Development of a Growing Industry (continued)

How do investors differentiate between index products?

It seems that while the industry is ultimately working towards harmonization of the interpretation of Shariah law, there is still a need to differentiate the product offering. For example, many index providers now offer Shariah compliant indices but how does an investor or product issuer choose?

The business screening applied to the different indices available is more or less the same because there are certain prohibited activities. These are somewhat standardized such as the provision of alcohol, gambling, armaments, tobacco, pornography, interest-based finance or pork. Most Shariah scholars have put a tolerance level of 5% for such activities. Most Shariah compliant indices would have a shift in sector weighting as a result with significant underweights in sectors such as travel & leisure, media and food and beverage, as well as almost total exclusion of banks, insurance companies and some financial services companies (see chart 1).

Financial screenings such as the gearing levels, receivables and interest income are material with some Shariah boards having a marginal difference in the tolerance level. The Yasaar Shariah Board has adopted a conservative approach. Companies are required to meet the following financial criteria:

- Debt is less than 33% of total assets.
- Cash and interest-bearing items are less than 33% of total assets.
- Accounts receivable and cash are less than 50% of total assets.
- Total interest and non-compliant activities income should not exceed 5% of total revenue.

Unlike competitor methodologies, a more conservative approach to Shariah compliance is ensured by rating debt ratio limits that are measured as a percentage of total assets, rather than more volatile measures that use 12-month trailing market capitalization.

This is very important for index providers as frequent changes in constituents without any underlying change in the nature of the business are likely to distort the index and its utility for benchmarking purposes. This approach gives investors the comfort that stocks do not pass the screening criteria as a result of market price fluctuation, allowing the methodology to be less speculative and more in keeping with Shariah principles.

New opportunities emerge

As with the development of any new market, new issues will continue to arise. However, new opportunities are also created. Shariah compliant investing has tweaked the interest of some conventional investors as there is an affinity with ethical screening, such as the exclusion of tobacco, pornography and armaments. Some industry experts have drawn parallels and allude to Shariah indices being a pseudo for ethically-based indices.

Other investors in traditional markets have been attracted to Shariah compliant products in recent times as they have out-performed in the last year with the downturn in performance of the banking sector. Some are seeing short-term speculative gains by taking advantage of the current sectoral weakness.

Whether new opportunities are created or new thinking emerges in the application of Shariah law to financial products, FTSE and Yasaar believe it is imperative to be alert to new investment trends within Islamic finance to stay in the forefront of the field. A commitment to respond with new indices or refinement of the already stringent screening process will support ongoing innovation and, therefore, development of the industry.

FTSE THE INDEX COMPANY

Donald Keith is deputy CEO of FTSE Group. It calculates the FTSE Shariah Global Equity Index Series, which comprises 96 indices covering large and mid-cap stocks of developed and emerging markets across all regions including the Americas, Europe, the Middle East, Africa and Asia-Pacific.

For more information, visit www.ftse.com, email info@ftse.com or contact your local FTSE office.

OVERVIEW

FTSE SHARIAH GLOBAL EQUITY INDEX SERIES

FTSE THE INDEX COMPANY

OVERVIEW

In response to the rising demand for Shariah-compliant investment opportunities, FTSE has developed an enhanced series of Shariah indices that use improved methodology and provide a broader Shariah index solution for Islamic investors.

Shariah screening is undertaken by Yasaar Research Inc. with FTSE then calculating and disseminating the indices. The new family of Shariah indices have been designed as the basis for trading and benchmarking of financial products, such as institutional and retail funds, exchange traded funds, derivatives contracts, and other financial products.

KEY FEATURES

Comprehensive coverage

The FTSE Shariah Global Equity Index Series covers all regions across both developed and emerging markets, to create a comprehensive Shariah indexing solution. For the latest details of indices in this series, visit: **www.ftse.com/shariah**.

Impartial

By partnering with Yasaar Ltd., an impartial consultancy and leading authority on Shariah, with Shariah screening provided through their subsidiary Yasaar Research Inc., FTSE remain neutral and fully up to date with latest practices.

Fatwa-certified

The FTSE Shariah Global Equity Index Series has been fully certified as Shariah-compliant through the issue of a Fatwa (Islamic legal opinion) by Yasaar's principals. To view this document please visit: **www.ftse.com/shariah**.

Asset-based debt screening

Unlike other competitor methodologies, a more conservative approach to Shariah compliance is ensured by rating debt ratio limits that are measured as a percentage of total assets, rather than more volatile measures that use a 12 month trailing market capitalisation approach. This ensures that companies do not pass the screening criteria due to market price fluctuation, allowing the methodology to be less speculative and more in keeping with Shariah principles.

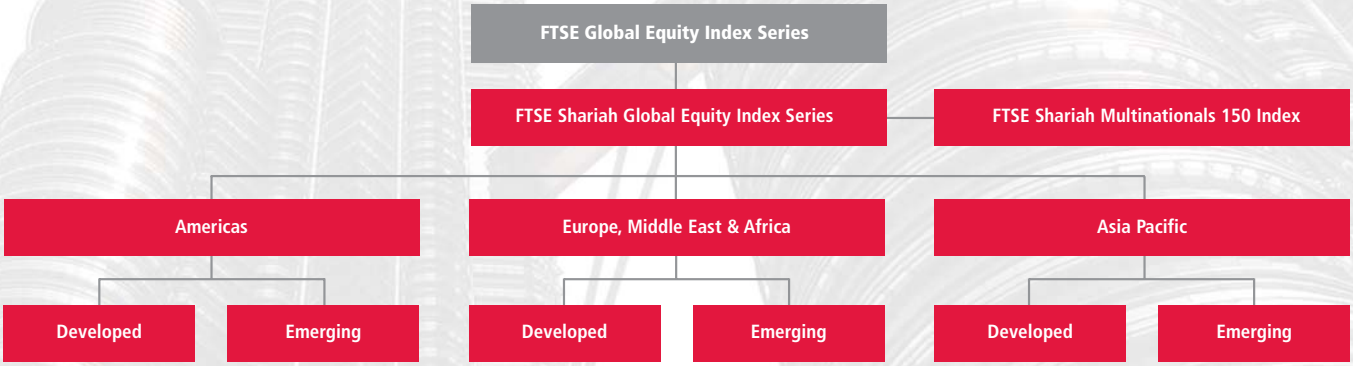
School-neutral

Yasaar Ltd. scholars represent all of the major Shariah schools of thought, creating a best practice approach that has credibility across all regions of the Islamic world.

Continuous evaluation

Constituents are continually evaluated by Yasaar Research Inc. against stringent Shariah principles, enabling FTSE's quarterly reviews to reflect the most current Shariah-compliant status.

FAMILY TREE



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FTSE THE INDEX COMPANY

Takaful: Expanding the Frontiers of Wealth Management

By Sohail Jaffer

Having entered the first half of 2008, indications as to the growth prospects of Takaful (Islamic insurance) have been mixed. A debate at the General Arab Insurance Federation (GAIF) hosted by the Bahrain Insurance Association in February was surprisingly downbeat about Takaful's track record to date.

The CEO for the Middle East and African region of a premier global reinsurance company expressed disappointment with the growth of the Takaful market. The former CEO of a major regional reinsurance company, with hindsight, questioned the timing of their launch of a retakaful company.

That seems to be a curiously short-term perspective, because as Fitch noted in a report published last year, a number of challenges stand in the way of market development in the coming years — including the education of the client base, access to suitable investments, recruitment of staff and the availability of Islamic reinsurance (reTakaful). It is also a perspective that is in marked contrast to the enthusiasm for the sector shown by several other market participants.

At the end of April 2008, for example, Morgan Stanley's equity research department initiated coverage of the Islamic Arab Insurance Company (Salama) with an "overweight" recommendation. Morgan Stanley's bullish earnings estimates for Salama are driven largely by the recognition that the insurance industry in the Muslim world — conventional as well as Shariah compliant — is still at an embryonic stage compared with the G7.

Modest penetration

In a special report on the Takaful industry published to coincide with the initiation of its coverage of Salama, Morgan Stanley observes that "life insurance is practically non-existent in most of the potential Takaful markets such as the GCC, North Africa, Far East and Asia. This is highlighted by the low levels of insurance penetration (life premiums as a percentage of GDP), which is typically below 1%".

Equally positive about the long-term outlook for Takaful is Ernst & Young. It recently released an analysis of the market which advises that an estimated 133 Takaful operators are now active worldwide, almost half of which (59) are located in the GCC, with a further 22 in the Far East and 21 in Africa (mainly in Sudan).

"With estimated total Takaful premiums in 2006 of US$2 billion (against global insurance premiums of US$3.7 trillion), it is clear that there are significant opportunities for Takaful in the years ahead," this report noted. "High levels of liquidity in its natural market should encourage Takaful to raise its global profile."

E&Y calculates that the global Takaful market (excluding Iran) has been expanding since 2004 at a compound annual growth rate (CAGR) of 20.4%, and if that growth rate is sustained in the coming year, global gross contributions will reach US$4.3 billion by 2010.

There are several explanations for the historically modest level of penetration of insurance in the Islamic world. Perhaps the most prominent of these has been the perception that insurance is essentially proscribed in Islam, as providing protection against future events appears to involve *maysir* (speculation) and *gharar* (uncertainty).

In addition, the investment of premiums in the conventional market in instruments that generate income in interest-paying instruments and/or the shares of companies in prohibited industries was also seen as a bar to the evolution of Shariah compliant insurance.

GCC an attractive wealth market

The reasons for the failure of the insurance industry to make significant inroads in Muslim-majority countries are becoming progressively less compelling, for at least three reasons.

First, Islamic scholars are increasingly recognizing that the mechanics of Takaful, which are underpinned by the sharing of profits and losses between insurer and insured, need not violate Quranic teachings. That view has been gathering

continued

Takaful: Expanding the Frontiers of Wealth Management (continued)

growing acceptance since the formal approval of the Takaful system by the Fiqh Council of the Organization for the Islamic Conference (OIC) in 1985.

Second, a growing number of Islamic countries are introducing or planning new legislation designed to support the growth of their local insurance industries and, in some cases, to make insurance compulsory.

Third, buoyant economies throughout the Islamic world, directly or indirectly underpinned in many instances by soaring oil prices, have led to a dramatic increase in disposable personal income levels.

> "Penetration and global acceptance of Takaful are going to be an evolutionary rather than a revolutionary process"

"The Islamic asset management market presents an important opportunity and is centred on the Gulf Cooperation Council," McKinsey & Co advises in its World Islamic Banking Competitiveness Report 2007/08. It is easy enough to see why. Buttressed by high oil prices and a surge in real estate markets throughout the region, disposable income levels in the GCC are at an all-time high. Nor are there any indications that the rise is likely to decelerate in the foreseeable future.

The most recent edition of the Capgemini/Merrill Lynch World Wealth Report, for example, forecasts that the assets of Middle East-based high net worth individuals (HNWIs) will grow faster than those in any other part of the world over the coming few years.

The 2007 report predicts an annual growth rate of HNWIs in the Middle East of 9.5% between 2006 and 2011, which would see the value of their assets expand from US$1.4 trillion to US$2.2 trillion. By contrast, the projected annual global growth rate is a more modest 6.8%, and even in the economically vibrant Asia Pacific, it is 8.5%.

An alternative measure of the relative wealth of individuals in the GCC is featured in another analysis of global wealth, published by Boston Consulting Group (BCG). The most recent BCG report finds that the average assets under management of wealthy households in the GCC were close to US$1 million in 2006, compared with the global average of less than US$400,000.

It is no surprise, therefore, that BCG describes the GCC as an "attractive wealth market", or that its report should observe that "nearly all international players are currently working to establish representative offices or a more substantial presence in the GCC region". That has engendered heightened financial literacy among Muslims throughout the world, which in turn has led to burgeoning demand for a broader range of savings products.

As Morgan Stanley observes in its analysis, in Western economies, "increasing wealth and asset accumulation drive the desire to protect possessions" in Islamic societies. As a consequence, for wealth management firms that are concentrating so much of their marketing on the Shariah compliant market, Takaful-based savings products should be an anchor product.

The fast-expanding international FWU group is a pioneer of "white labeled" Takaful based savings, education and retirement plans and has expanded its bancaTakaful investment linked offerings to include Shariah compliant annuity plans and home finance Takaful-based investment linked plans.

For those with confidence in the long-term prospects of the Takaful market and of the role that Takaful should play in a broader wealth management franchise, the precedent that has been set over the last decade in Malaysia is a powerful blueprint for others to follow. In its report, for instance, Morgan Stanley says that Malaysia should be regarded as a "reference point" for the industry.

Malaysian innovativeness and initiatives

In 2008, Malaysia continues to be a trailblazer in the Takaful market. It has also demonstrated leadership qualities by developing products that are helping to globalize the market for Islamic financial services.

In March, for example, the Kuala Lumpur-based Hong Leong Tokio Marine Takaful (HLTM Takaful) became the first operator in the sector to launch a fully Shariah compliant Takaful plan linked to investment opportunities in the Middle East. Structured by Citibank, this capital protection investment-linked product is known as the HLTMT Gulf Opportunities Plan (GOP) and uses the concepts of Wa'ad and commodity Murabahah as a means of delivering Shariah compliant returns to policyholders. In the event of death, the plan pays 125% of the initial investment amount, with initial investments starting as low as RM10,000 (US$3,064), although bonus units are allocated to investors subscribing for at least RM50,000 (US$15,329).

The product is, therefore, a good example of an innovative scheme that combines the protection offered by conventional insurance with the investment returns that leading wealth managers offer their clients. According to a Citibank briefing,

continued

FWU Group - Profile

The FWU Group is a Munich based financial services group founded in 1989 by Dr. Manfred J. Dirrheimer. The FWU Group's core business comprises bancassurance and asset management services. It is a leading international provider of customised white label distribution of Family Takaful and unit-linked investment products via internet-based Point-of-Sale and administration systems. FWU Group's subsidiaries include a life insurance company, an asset management company and a commission factoring company. Its international network includes offices in Luxembourg, Dubai and Kuala Lumpur.

The group is valued for its product development and process innovation, a seamless systems based approach, open investment architecture, the creation and use of a proprietary Fund Selection and Allocation Model (SAM), pioneering of a unique Retakaful solution with a global reinsurance company, high customer service quality and its significant wealth of Sharia and deal structuring expertise. The FWU Group has its own Sharia Board with renowned advisers and it is also an observer member of the Islamic Financial Services Board (IFSB). Today, the group offers an attractive array of bancassurance and investment solutions designed to match the risk/reward profile of both individual and institutional customers. It is a market leader in Family Takaful and Unit linked investment plans and won 5 industry awards including the Euromoney award for being the "Best Takaful provider".

The FWU Group has also attracted minority corporate shareholders such as Swiss Re, an international reinsurer and other European insurance companies. The FWU Group has set up strategic alliances with 5 major takaful operators worldwide. In the Kingdom of Saudi Arabia, the Al Ahli Takaful company was recently established in partnership with the National Commercial Bank (NCB), the IFC, the private investment arm of the World Bank and the FWU group.

The FWU Group also concluded a Cooperation Agreement with Takaful Ikhlas in Malaysia in 2006 and one with Pak Qatar Family Takaful in Pakistan in 2007. Current bancatakaful partners include ADCB, NBD, ABN AMRO, NCB and AM Islamic.

The FWU group is rated as investment grade by Deutsche Bank's independent rating unit in Germany.

If you would like more information on the FWU Group or its Family Takaful products and services please contact

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Takaful: Expanding the Frontiers of Wealth Management *(continued)*

GOP is a three-year Takaful product providing investment returns benchmarked against the performance of Middle Eastern equities, commodities and currencies "where the projected annualized return at maturity could be up to 10%". It adds that "understanding the volatility of today's market, the GOP's investment is based on the 'best-of-profile' structure that allows investors to enjoy the highest return allocation from the underlying investment profiles".

> "Innovative growth of Takaful solutions has not, however, been confined to Muslim-majority countries in recent years"

Another initiative to have emerged recently from the Malaysian Takaful sector, and which again blends elements of conventional insurance with those of wealth management, is an education savings product from CIMB Wealth Advisors.

The 3 in 1 Education Plan, developed in collaboration with CIMB Aviva, CIMB Trustee and CIMB-Principal Asset Management, is marketed as a product that "combines unit trust investment, insurance and Takaful coverage and trust nomination services in a complete solution to enable parents to plan for their children's education".

Innovative growth of Takaful solutions has not, however, been confined to Muslim-majority countries in recent years.

In the UK, for example, an important building block was laid down at the start of May when its first independent Islamic insurance company, Principle Insurance, was granted authorization by the Financial Services Authority.

Principle will be offering Takaful-based motor and home coverage to Britain's estimated two million Muslims who had previously been unable to purchase insurance policies that are compatible with their religious beliefs.

Clearly, penetration and global acceptance of Takaful are going to be an evolutionary rather than a revolutionary process.

But as understanding of its mechanics grows throughout the Muslim world, Shariah compliant insurance should become a pivotal product for companies offering wealth management services to a customer base that is increasingly wealthy and aspirant.


FWU

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Investment Radar Now on Emerging Market

By Ahmed Al Khan

With global economies slowing down and inflation set to spiral in the coming months, the prices of essential commodities are way beyond control. Adding fuel to the fire is the continuous increase in oil prices, which some are predicting could touch the US$250 mark.

Emerging markets face the imminent possibility and increasing specter of economic downturn. Rationalizing the economics of hunger is never easy. Political will buckles down under popular will and the economics of development take a beating. Against such a scenario, the question arises: In our quest to feed the hunger of development, how do we feed the hungry?

Rise of the dragon

Talk about Asia's booming economy and the focus is instantly on two nations, China and India; and, to a certain extent, the Far East region. China and India have been riding the investment wave and emerging as the most "emerged" among the emerging markets. But global economic slowdown has cast its shadow on these two nations and India more than China is feeling the repercussions of the slowdown.

China's spectacular economic growth, increasing trade and emergence on the world economic stage have attracted global attention. It is fast becoming the manufacturing center of the world, gradually moving its export base to more complicated and sophisticated products, most notably in the high-tech and industrial sectors, leading some analysts to report that this is exerting a downward pressure on the prices of competitive products.

Because of these factors and trends, China is emerging as a competitive threat to other Asian economies with its inexpensive range of products matching global quality standards, probably making external trade the country's best-performing sector.

China's economic role in Asia is clearly becoming more prominent. Based on projected trends, China will be Asia's largest exporter by 2010, thereby stiffening export competition with other suppliers for an expanding range of products.

Experts suggest that by 2020, these trade patterns would have shifted dramatically. Trade between China and the rest of Asia will increase significantly. China will increase its structural trade surplus with the western OECD (Organisation for Economic Co-operation and Development) countries, but this trade surplus will be offset by a structural deficit of about equal magnitude with East and Southeast Asia.

Apart from its large supply of unskilled human capital, China is a resource-constrained economy with limited capital, technology, cultivatable land and natural resources. It also faces a growing shortage of highly educated pool of human capital with the necessary skills to sustain a competitive economy in the global marketplace.

In order to sustain its rapid economic growth, China must import resources, technology, capital, products for which it does not have a competitive advantage, and intermediate and capital goods. Also, income growth will alter demand patterns, increasing the demand for imports, particularly for food, agricultural products and energy.

According to Fitch Ratings, despite the knock-on effects of global developments, the economic environment in Asia is unlikely to deteriorate to an extent that would materially affect bank credit quality. In China, while banks enjoyed a stellar 2007, they will face a more difficult environment ahead as borrowers begin to feel the strain from the government's tightened monetary stance, the weakening of the global economy, and rising input and operating costs from 12-year high domestic inflation.

Indian banks, ,for instance, would find themselves in a more challenging operating environment this year, with non-performing loan ratios likely to rise from their historic lows. At the same time, most banks have seen an improvement in their loss absorption capabilities; thus on balance the outlook on their ratings remains mostly stable.

> "China's spectacular economic growth, increasing trade and emergence on the world economic stage have attracted global attention"

India shows plenty of potential

In the case of India, a vibrant nation has rapidly emerged onto the global economic platform. For the first time, a democratic country with a population of over one billion is actively participating in growth, trade and investment. This has significant implications for the world economy and the process of globalization.

continued

Investment Radar Now on Emerging Markets (continued)

In the global context, the emergence of a large consuming and producing nation has the potential to alter the terms of trade and investment. India needs to work multilateral trade talks to its benefit, stressing its natural and comparative advantages.

Economic partnership has the potential to alleviate the scourge of poverty and raise standards of living rapidly. It can enhance productivity, transfer technology, and raise exports and employment.

Yet, the sub-continent continues to present a tentative scenario. Policymakers are glued to the looking glass, analyzing the extent of the slowdown and searching for clues on how to keep the inflation figures down, while ensuring that the forecasted slowdown in economic growth can be arrested.

> "India's monetary muscle is also strengthened by a cheap domestic labor market and its companies' high price-to-earnings ratios"

Indian inflation exceeded 8% in late May and is expected to reach an all-time 13-year high. Energy costs account for more than 14.2% of the inflation index as diesel and petrol are the key inputs through the economy and this will definitely have a cascading impact on overall prices.

In its latest world economic outlook, the International Monetary Fund (IMF) points out that unlike China, whose fiscal position is relatively robust, the scope for a fiscal stimulus in India to counter a possible economic slowdown is slim.

For a start, Indian consumers pay much less than they should for fuel and imported food. India imports three-quarters of the crude oil it consumes, but as at the time of writing, the government had not passed on to consumers the full burden of the global spike in prices (Note: India raised fuel prices by 10% on the 4th June). Moreover, the IMF points out that India's growing demand for food imports is itself putting pressure on global prices.

In March, as countries began setting barricades on their stockpiles of food, India too placed restrictions on the export of rice, edible oil, steel and cement, cut import duties on edible oil and building up domestic stocks of food for distribution. But most importantly, it is election year in India and economic prudence will have to make way for populist measures. But what is unclear is how this will affect investor confidence in the immediate future.

A recent edition of Forbes magazine states that India's economy has already emerged with Indian companies flexing their muscle, and turning to new international markets. Recent high-profile acquisitions by Indian companies include the Tata group's acquisition of Corus Steel and the marquee brands of Jaguar and Land Rover in the UK; and with an annualized five-year total return of 42.2%, India comes second after Brazil in terms of the growth of the world's largest public companies.

India's monetary muscle is also strengthened by a cheap domestic labor market and its companies' high price-to-earnings ratios. In comparison, the growth percentage in Britain and the US are 17.1% and 11.1%,respectively, indicating that the balance of economic power in the world is starting to shift to Asia — China and India in particular have emerged as economic powerhouses.

Sovereign wealth funds

Gulf sovereign wealth funds have dramatically evolved during the last two decades. While in the past, most investments were focused on the US and European markets, today these funds have their investment radar focused on investment opportunities in the emerging markets of Asia as well as Latin America. In fact, along with China and India, countries such as Brazil, Colombia, Mexico, Chile, Turkey, South Africa, Indonesia and South Korea are vying for investments,.

At the end of last year, the Qatar Investment Authority (QIA) announced that it had signed a memorandum of understanding (MoU) to establish a US$1 billion joint fund with the Indonesian government to target infrastructure investment in the Asian nation. In April 2008, QIA announced plans for a similar joint fund, this time with the Vietnamese government investment arm, State Capital Investment Corporation (SCIC).

SCIC and QIA hope to invest in oil, power, infrastructure and property projects in the Southeast Asian country. In May, QIA announced plans to invest in the property sectors of major cities across Asia, adding that such ventures would constitute about of 40% of its investment portfolio — a target that other fund officials have said could apply across all investment sectors.

The sovereign fund has also signed an MoU with Singapore's Keppel Corporation, which will give it an equity stake in China's Tianjin eco-city development. It is also an investor in the Industrial & Commercial Bank of China, which recently received its first license to operate from the Gulf, and will be based in the Qatar Financial Centre.

Bahrain's sovereign wealth fund was recently voted the most transparent in the Gulf region. Mumtalakat Holding, Company which manages the kingdom's assets, was ranked joint first for transparency alongside the Kuwait Investment Authority, in the US-based Sovereign Wealth Fund Institute's (SWFI) Linaburg Maduell Transparency Index.

continued

Investment Radar Now on Emerging Markets (continued)

The transparency index is based on 10 essential principles that depict sovereign wealth fund transparency to investors. These include the provision of percentage ownership of company holdings, financial returns and geographic locations of holdings as well as the provision of clear strategies and objectives for the future.

Other Gulf sovereign wealth funds transparency index scores were the Investment Corporation of Dubai with five points; the Saudi Arabian Monetary Agency (four points); the Abu Dhabi Investment Council and the UAE's RAK Investment Authority, each with three points; the Oman State General Reserve Fund (two points) and the QIA and the Emirates Investment Authority, each with one point.

SWFI's endorsement of Mumtalakat is a strong reflection of Bahrain's pre-eminent position as the financial hub of the region. Close on the heels of sovereign wealth funds, investment banks in the region, too, have zeroed in on the emerging markets.

Global Banking Corporation, the Bahrain-based global Islamic investment bank, recently launched an energy subsidiary company in strategic partnership with Taylor-DeJongh, focusing exclusively on providing energy advisory services across the hydrocarbon chain, from upstream exploration and production to refining, petrochemicals, power generation and the marketing of refined products, natural gas, and electricity.

Other banks in the region are actively engaged in the Asian markets in industry-specific and infrastructure development projects.

> "The Kuwait Investment Authority recently acquired US$750 million worth of shares in the Industrial & Commercial Bank of China, and plans to double the Asian share of its portfolio to 20%"

The centuries-old trade relations between the Middle East and the Gulf region are flourishing with the major beneficiaries being China and the Far East countries. Indonesia, for example, hopes to see some US$5 billion in investment from the Middle East this year in its financial services, natural resources, infrastructure, property and plantation segments.

The Kuwait Investment Authority recently acquired US$750 million worth of shares in the Industrial & Commercial Bank of China, and plans to double the Asian share of its portfolio to 20%.

According to estimates provided by the Dubai International Financial Centre and the Beijing-based consultancy JL McGregor, the amount of petrodollars flowing into Asia, particularly China, over the next five years could reach US$250 billion.

This is certainly good news for investors of the emerging markets, but the question remains: In our quest to feed the hunger of development, how do we feed the hungry?

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A Study of Offshore Islamic Funds

By Philip Ireland and Aditya Basrur

The 2007-08 financial year has seen continued growth in the formation of collective investment schemes that are compatible with Shariah law (hereafter referred to as "Islamic funds"). Countries in the Gulf Cooperation Council remain flush with liquidity as a result of high oil prices.

Evidently, some of this money is being channeled into the formation of Islamic funds, which remain popular despite — or perhaps because of — the credit crisis in other places. A recent study by Ernst & Young estimated that by the end of March 2008, there were more than 500 Islamic funds globally, 153 of which were launched in 2007. The accounting firm projects that there will be more than 1,000 Islamic funds worldwide by 2010.

"Offshore" Islamic funds (those domiciled outside the country where the Islamic fund invests) continue to form a major subset of Islamic funds in general, with the Cayman Islands remaining a popular jurisdiction.

Apart from providing an overview of some recent trends in Islamic funds, this article seeks to explore the typical structures employed by Islamic funds and the reasons why offshore jurisdictions continue to be popular for Islamic funds. It also outlines a few main issues that investment managers and banks need to consider when structuring offshore Islamic funds.

> "Private equity funds are popular within the Islamic funds sector, and tend to invest in stock markets, infrastructure assets and shares of companies for which there is either no market or a limited one"

Recent trends in Islamic funds

Like conventional funds, Islamic funds consist of investors pooling their money with other investors to purchase a wider range of assets than they would otherwise have been able to acquire as individuals. This reduces their risk and entitles them to the services of investment managers.

For Muslim investors, unlike certain other forms of investment (a traditional bond, for example), investment funds are halal (i.e. permissible). The Shariah ruling that governs Islamic investment funds specifically provides that investment funds are permissible under the Shariah.

Private equity funds are popular within the Islamic funds sector, and tend to invest in stock markets, infrastructure assets and shares of companies for which there is either no market or a limited one (for example, in developing markets and the Middle East and North African sectors).

The principles of the Shariah restrict both the duration and the type of investments. Unlike many conventional funds, which speculate and attempt to "time" the market, Islamic funds and fund managers tend to eschew this approach. Buying and selling investments too quickly come close to gambling for some Shariah advisers.

Gambling is forbidden in Islam. Investments in businesses that run contrary to Islam — such as alcohol, drugs, pornography, pork products and financial services (due to the prohibition on making money from money) — are also forbidden.

As a recent article in *Forbes* suggested, this may be the reason for the success of some Islamic funds; last year, the HSBC Amanah Fund (with US$9.7 billion in assets under management) outperformed a fund managed by the same manager but one that invests in conventional assets. The article stated: "Shariah really pushes a money manager back to the basics of stock investing: Buy established, well-capitalized companies in industries that don't invite a lot of moral or legal backlash and then hold those stocks for a long time, selling only when necessary and never as an attempt to time the market."

This enforced focus on investment fundamentals has ensured the popularity of Islamic investment funds among conventional investors, as they combine the virtues of ethical investing with the advantages of non-correlation with mainstream trends and mainstream equity funds.

With the amount of construction in the region, real estate Islamic funds continue to be popular. The recently launched and Cayman Islands-domiciled Al-Futtaim funds closed with US$500 million of contributions in May 2008.

In what is believed to be a first in the region, an Islamic fund and a conventional fund were launched in parallel, with a co-investment agreement allowing the Islamic fund to remain Shariah compliant. While investors keeping money in the GCC region and wishing to invest in accordance with Shariah principles have tended to stay with real estate funds or funds investing in regional equity markets, there is an increasing sophistication and globalization of available investment

continued

A Study of Offshore Islamic Funds (continued)

funds, with specialist telecoms, energy, healthcare and pharmaceutical funds, among others, in the process of being launched or recently launched. Such sector-focused funds sit very comfortably with the discipline imposed by the Shariah.

Increasingly, the performance of Islamic investment funds has been closely monitored and the Islamic investment funds industry has established its own standards of measurement. Dow Jones, for example, now sponsors its own Islamic index range with its own Shariah committee.

Other compilers of financial data have followed suit. Parsoli Corporation launched India's first Islamic index in 2007, Parsoli Islamic Equity, which now includes 41 companies. This has created an opportunity to develop new Islamic products based on indices. For instance, multi-manager funds are now starting in the region, with funds of funds launching and gaining in popularity over the past year. Further such innovations are anticipated.

Structuring an Islamic fund

In an Islamic fund, it is essential that all investors be treated equally in accordance with the principles of the Shariah, so there will usually only be one class of interest issued to investors. This is readily achievable in the fund's constitutional documents (in the case of a company, the memorandum and articles of association; in a limited partnership, the limited partnership agreement; and in a unit trust, the trust deed).

To ensure compliance with Islamic principles, a fund's investment opportunities need to be pre-screened and approved by a Shariah supervisory board. The manager of the company will select the underlying investments in accordance with the rulings issued from time to time by the Shariah supervisory board.

All such rulings and decisions of the Shariah supervisory board are binding on the fund and the manager, whose actions will be subject to periodic review by the Shariah board. As a matter of Shariah law, subject to any parameters relating to the purification of the asset class which might be relevant, the purchase of securities which are interest-bearing is forbidden, as is the purchase of interests in an entity whose principal business activities involve the manufacture or sale of alcohol, pork products or gambling.

Within the offshore Islamic funds world, exempted limited partnerships domiciled in the Cayman Islands and elsewhere remain popular. Such a partnership structure consists of a general partner and several limited partners (or investors).

Reasons for its popularity probably relate more to the way the funds themselves are structured than any Shariah-related reason. Like a company, exempted limited partnerships bestow the benefit of limited liability upon investors. The general partner (usually a special purpose company incorporated in the jurisdiction of the partnership's domicile) remains liable for the partnership's debts and liabilities.

Unlike a company, the exempted limited partnership structure comes close to resembling true Murabahah. The contributions of limited partners returned over time approximate the hire-purchase type arrangements made in a spirit of partnership, as in classic Murabahah arrangements. This makes the structure popular for those seeking to set up their funds as a long-term relationship.

Whether formed as a company, a unit trust or a partnership, Islamic funds tend to be closed-ended vehicles. Often, open-ended funds where investors can redeem interests at their own option seem too close to gambling for most Shariah scholars, so Shariah compliant investments tend to be locked in.

Popularity of offshore jurisdictions

The Cayman Islands have long been the jurisdiction of choice for fund managers. Many Middle Eastern fund managers who have historically established funds in the Cayman Islands continue to do so when establishing Islamic funds.

Fund managers, when establishing a fund, usually seek a user-friendly jurisdiction with tax neutrality and cost efficiency. The traditional offshore jurisdictions have developed legal structures and personnel which provide this while ensuring legal certainty and stability for investors. Most offshore jurisdictions, due to historic links with the British Commonwealth, have the benefit of common law and binding precedents.

> "The Cayman Islands have long been the jurisdiction of choice for fund managers..."

The Cayman Islands, in particular, offer the advantage of rapid incorporation and registration where required. Most Middle Eastern states are low- or no-tax environments, so the legal and regulatory certainty afforded by the traditional offshore jurisdictions is a major reason for their attractiveness in the Middle East.

Other jurisdictions are also gaining in popularity as a domicile for offshore funds, in particular the Dubai International Financial Centre (DIFC) and Bahrain. The development of the DIFC to service the needs of regional clients is a prime example of how the Islamic financial industry is maturing.

continued

A Study of Offshore Islamic Funds (continued)

The DIFC, which is seeking to position itself as the financial hub of the Gulf region, has succeeded in attracting expertise from the Gulf region and further afield. A number of international fund managers are setting up office there as well as lawyers, administrators and other service providers keen to take advantage of the incentives for moving there (including zero tax on profits, 100% foreign ownership and no restriction on foreign exchange or repatriation of capital). Many of these professionals already have an impressive track record in the Islamic investment fund sector.

Issues to consider

Regulatory hurdles are one of the issues faced most often when structuring offshore Islamic funds, particularly in the Middle East. Managers looking to set up funds not domiciled in the country where investments take place should always seek local advice.

There are many prohibitions on property ownership by outsiders in the Gulf region, for example, and these may cause problems for an Islamic fund domiciled in Jersey or the British Virgin Islands. Only certain funds can be marketed in some jurisdictions, and rules as to disclosure in marketing communications are not uniform across the Middle East. These issues are not insurmountable, but do require fund managers to seek sound advice in the jurisdictions where they wish to obtain and spend money.

As offshore lawyers, the writers find themselves stressing the need for good onshore advice. As the Islamic funds industry grows, there are likely to be further developments in the way that they are regulated and monitored.

At present, Shariah boards provide a level of consumer advocacy and monitoring. The fact that many Islamic funds are formed, sponsored or managed by regulated banks or their subsidiaries also provides a measure of protection. None of these safeguards is foolproof, however.

> "The fact that many Islamic funds are formed, sponsored or managed by regulated banks or their subsidiaries also provides a measure of protection"

The history behind conventional offshore jurisdictions may provide a safeguard if things go wrong for an Islamic fund, with comparatively predictable courts in these jurisdictions and established ways of dealing with insolvencies or forced dissolutions.

The popularity of Shariah compliant investment funds seems set to continue. Investment managers will still launch ambitious Shariah compliant funds to invest in several sectors. As the economies of the region develop, the various industry sectors stabilize and the level of expertise becomes more sophisticated, we would expect to see more new fund structures.

The popularity of offshore jurisdictions such as the Cayman Islands for Islamic funds seems set to increase as well, with vehicles incorporated and registered there continuing to occupy a major place on the Islamic funds landscape.

MAPLES

Philip Ireland is a senior associate and Aditya Basrur an associate at Maples and Calder

Islamic Capital Market Garnering More Support

By Dr Sunil Kumar

The Islamic financial services industry (IFSI) is growing so rapidly that it is sometimes irrelevant to come up with projections since they become outdated before even going to press. Growth can be attributed to several reasons, including a boom in oil prices, higher liquidity in the Middle East, increasing awareness and availability of Islamic financial activities, a shift in focus from Asia to the Middle East for growth participation by global financial markets and the availability of more structured products.

Growth in IFSI in the last few years has been estimated at 15% to 20%. The natural outcome of this is the growing number of Islamic financial products globally, especially in the capital market. The three components of IFSI are Islamic banking (IB), Islamic capital market (ICM) and Takaful.

In terms of development and growth, Islamic banking is ahead of the other two. It has been accepted as a mainstream banking activity. More and more institutions worldwide are entering Islamic capital market, thus rapidly expanding the availability of Islamic capital market products. Islamic capital market can take the form of mutual funds, hedge funds, Sukuk and structured products. As for Takaful, it is still in the formative stages.

As at end May 2008, Liquidity Management Centre in Bahrain, one of the leading Sukuk management centers in the Middle East, had managed over 78 issues amounting to approximately US$24.7 billion. Demand for Islamic financial products is coming from Muslims because of religious reasons, and also from non-Muslims due to financial reasons. Thus, the clientele for Islamic financial products is growing rapidly and now involves the participation of some of the largest financial institutions in the world.

Increasing awareness

In the past, Malaysia had a strong hold on the Islamic financial market. That is now changing, however. The Southeast Asian nation is seeing competition from several countries in the Middle East and Europe, which are coming up with innovative products and substantial capital market activities.

Growing awareness of ethical investment is another reason for the proliferation of Islamic finance activities. The foundation of Islamic finance activities lies in a few basic types of Islamic contract such as Musharakah, Mudarabah, Murabahah, Istisna, Ijarah and Salam. Of these, the two most common types used for equity financing are Musharakah and Mudarabah. Both represent participative finance.

Debt-based financing activities are structured on transactions that revolve around real assets and hence, help reduce the volatility that is inherent in conventional debt-based instruments since they are almost always interest-based and allow exceptionally high leverage, and thus, speculation. At present, ICM instruments are structured based on various types of Islamic contracts and are available for the short, medium and long terms. Some of the largest stock exchanges have indices related to the ICM, thus providing liquidity.

> "Demand for Islamic financial products is coming from Muslims because of religious reasons, and also from non-Muslims due to financial reasons"

Over the last few years, the ICM industry has witnessed tremendous growth and an increase in activities. The depth and breadth of ICM products is showing significant improvement. The formation of international bodies such as the Islamic Financial Services Board and Accounting and Auditing Organization for Islamic Financial Institutions has also contributed to standardization of standards. The products have shown competitiveness in terms of pricing and returns, thus drawing investors' attention (including non-Muslim investors).

There has been constant innovation in the field of Islamic financial products leading to wider acceptance. This has been facilitated by support in legal and regulatory areas, albeit in selected countries. The resilience shown by IFSI is noteworthy, especially amid the crisis seen in conventional banking in several countries. This stability has not gone unnoticed and has been another driving force for the growing popularity of IFSI.

Cross-border participation has allowed ICM products to penetrate new regions and markets as well as provide the much-needed liquidity. According to estimates, IFSI products are available from more than 400 institutions in over 80 countries. IFSI now caters to the fundamental tenet of diversification in investing by offering diversified portfolio selection.

continued

Islamic Capital Market Garnering More Support (continued)

Several risks involved

Like any financial intermediation, IFSI has its share of issues and risks. Apparently, the products do not have direct risk of interest rates, have better disclosures and transparency, provide for deeper participation in financing activities and are ethically better placed and thus, should be less exposed to risks.

However, IFSI has to contend with risks on almost all fronts. Market, credit, operational and liquidity risks are some major risks faced by IFSI. Credit risk is almost always present in the case of ICM.

> "Balancing the returns with the social cause is an extremely difficult task, which has been achieved to great extent by the market players in Islamic finance and thus is commendable"

Asset management, which takes various routes such as through Musharakah and Mudarabah, is always entitled to the share of credit risk since the returns are linked to the performance of the project. They are also exposed to market risk through exposure to commodities and foreign exchange. The investments, which almost always have an underlying commodity, are exposed to fluctuations in commodity prices and thus, to market risk.

Due to the participative nature of investment contracts, the operational risk is higher since the returns depend on the performance of the contract, which in turn is dependent on several external factors along with the competence and performance of the contractor.

Moreover, other issues such as accounting standards are also creating hurdles in the growth of ICM. In countries with no clear tax laws, Shariah compliant funds are subject to unclear taxation rules which result in confusion and, sometimes, double taxation. Shariah rules for equity products and for debt-related products are not universal and, hence, are a source of confusion.

Also, the ICM faces the problem of limited liquidity due to limited market depth. This can prove to be a deterrent in the development of Islamic capital products. Acceptance of products in ICM is a critical success factor which depends on the structuring as well as Shariah approvals. In some cases, issues were not well accepted due to rejection from the market.

Islamic finance believes in equitable distribution of wealth and income and thus, aims to reduce inequality of income and wealth. This is not an easy objective since Islamic investors are also rational investors who are only seeking decent returns on their investment.

Balancing the returns with the social cause is an extremely difficult task, which has been achieved to great extent by the market players in Islamic finance and thus is commendable. However, market forces have brought in some elements of distortion and ambiguity on the interpretations of various rules related to Islamic financial activities, which should be checked and controlled in order to maintain the purity of such activities.

IRIS

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Comparison of REITs and I-REITs

By Samer Merhi

Until 1960, when the US Congress passed the Real Estate Investment Trust Act, only high net worth individuals and well-established companies were able to invest in real estate projects.

The Act aimed to provide an opportunity for small investors to pool their money, forming a strong and powerful unit. The unit invests in real estate assets and the investors share the returns. For example, 100 investors with £5,000 (US$9,775) each together in one pool have a similar impact as an individual or a company worth £500,000 (US$977,658).

To enhance investor benefits, the legislation exempted real estate investment trusts, or REITs, from corporate income tax. In the beginning, the law required the REIT to appoint a third party to provide management and property leasing services. However, the law as it stands today allows the REIT to provide these services through its subsidiaries.

There are three types of REITs: (i) equity REITs; (ii) mortgage REITs; and (iii) hybrid REITs.

Equity REIT refers to the equity holders, shareholders or the equity owner of the type of REIT which is responsible for trading (buy and sell), refurbishing and developing the property acquired.

While equity REITs borrow monies secured by their assets, i.e. its real estate properties, mortgage REITs provide loans and mortgage financing in addition to trade (buy and sell) mortgages.

Hybrid REITs are the combination of equity and mortgage REITs.

In order to benefit from the tax-exemption legislation, every REIT must maintain the following characteristics:

1. A minimum of 100 shareholders.
2. A maximum of 50% of the outstanding shares concentrated in the hands of five or fewer shareholders.
3. A minimum distribution, i.e. 90% of its annual taxable income as dividends to the shareholders (excluding capital gain).
4. A minimum of 75% of its assets allocated in real estate, mortgage finance, shares in other REITs, cash or government securities.
5. A minimum 75% of its gross income derived from rents, mortgage interest or capital gains from the sale of property.
6. A minimum of 95% of its gross income derived from rents, mortgage interest, and capital gains from sale of the property, dividends, interest and gains from securities sales.

Failure to maintain any of the above characteristics would subject the REIT to income tax, either on all or part of its earnings.

> "Hybrid REITs are the combination of equity and mortgage REITs"

The Islamic REIT (I-REIT)

In November 2005, the Securities Commission of Malaysia (SCM) revealed the first guidelines for Islamic REITs (I-REITs), approved by its Shariah Advisory Council. This opportunity provided new assets, not to mention an instrument for investors seeking Shariah compliant investments mainly in real estate without the necessity of direct ownership of the property. The first I-REIT was listed by the Main Board of Bursa Malaysia on the 10th August 2006.

The guidelines are restricted to the businesses permissible under the Shariah. The rental activities prohibited are financial services based on interest; gambling/gaming; manufacture or sale of Shariah banned products or related products; insurance; entertainment activities that are non-permissible according to the Shariah; manufacture or sale of tobacco-based products or related products; tenant(s) operating non-permissible activities; stockbroking or share trading in Shariah non-compliant securities; and hotels and resorts.

Guidelines for I-REITs

- Rental of real estate by I-REIT for non-residential purposes

Acquiring real estate with existing tenant(s); the tenant(s) must operate permissible activities according to the Shariah. In case a tenant is found to operate non-permissible activities, the fund manager must separate its rental from the total rentals. These rental incomes derived from non-permissible activities must be donated to charities.

The Shariah Advisory Council of the SCM set a benchmark of non-permissible rentals to total rentals by 20% where the fund manager should not invest in this REIT in case it

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Comparison of REITs and I-REITs (continued)

exceeds the benchmark (being a non-Shariah compliant REIT), moreover and in order to protect the image of the I-REIT, it is not permitted to own real estate even if the percentage of non-permissible rentals to the total rentals is still below the benchmark (20%).

The benchmark can be calculated based on the ratio of the area allocated to non-permissible activities versus the area of total rentals, depending on the I-REIT's Shariah committee recommendation for properties that do not involve space usage.

- All investments, deposits and financing must be Shariah compliant for the I-REIT.
- Insurance

All I-REIT activities must comply with the Shariah and that include the insurance on its real estate. I-REITs must use the Islamic insurance instrument "Takaful" to insure its assets. The Shariah Advisory Council of the SCM allows the use of conventional insurance schemes in the event Takaful schemes are not provided.

- Forward sales or purchases of currency for risk management

The Shariah Advisory Council of the SCM permitted I-REITs to participate in forward sales or purchases of currency encouraging dealing with Islamic financial institutions using the promise concept of Wa'ad (only one party is obligated to fulfil his promise/responsibility — the party that is bound is the party that initiates the promise).

Finally, investing in REITs and/or I-REITs is an alternative to direct property acquisition with the advantages of being less risky, more tax-efficient, a more diversified real estate portfolio, no management and/or leasing service knowledge needed; more liquid assets could be traded on the stock exchange market and it provides an opportunity to small and medium-scale investors.

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REDmoney Group

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