

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ



***13th Distance Learning Course: Spring 2011
An Intermediate Course in Islamic Finance***

***“Islamic Instruments for Asset
Management”***

IDB/IRTI DL Program

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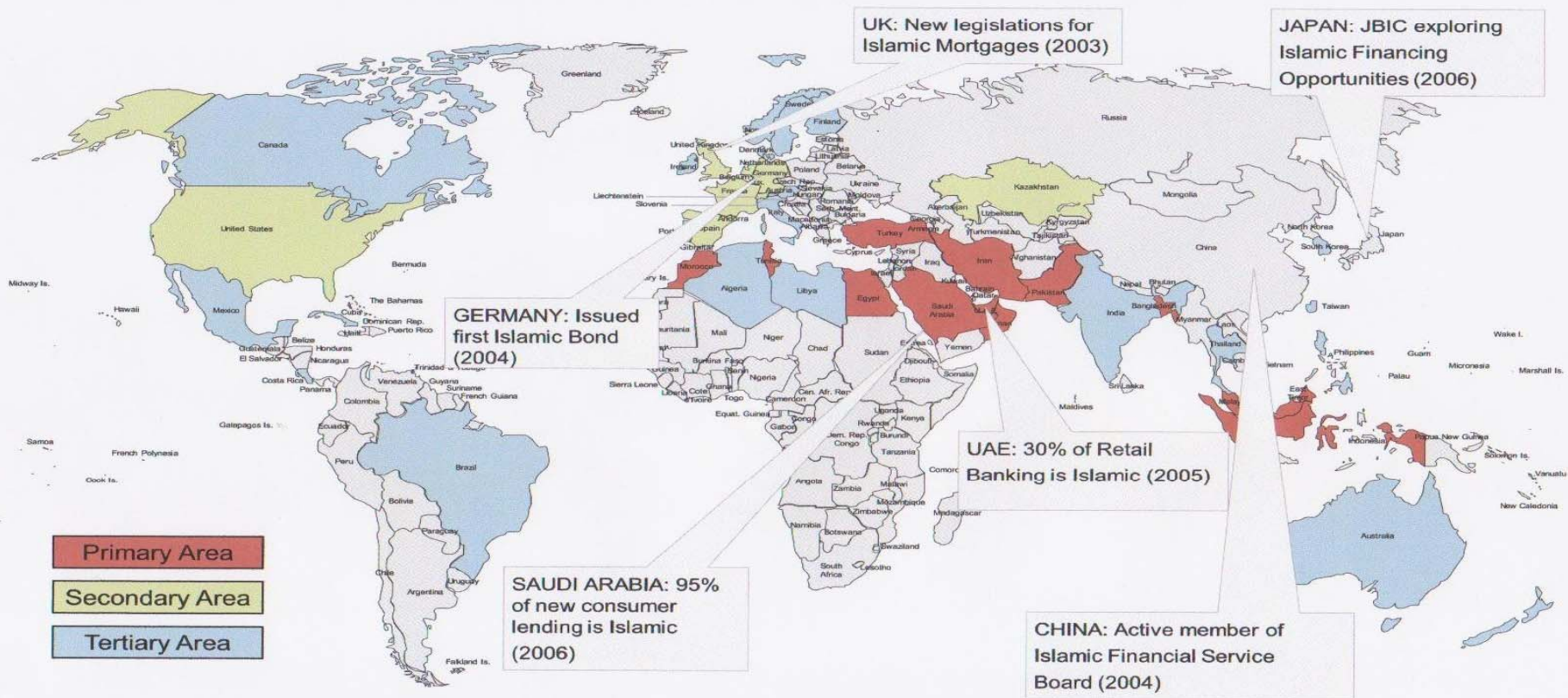
Islamic Financial Systems

- *Islamic Financial System excludes:*
 - **Riba** - a form of usury (packaging Interest rate risk)
 - **Gharara** - a form of deception in trade or trading of risk where asymmetric information and risk profile exists in a contract (Inside trading)
 - **Maysir** – gambling features (high speculation)
- *In addition to the Risk/Return participation features of the Islamic Financial System, above exclusions enhance the internal stabilizing effects of this system by excluding the risks of inefficiencies created by **Gharara** and extra volatilities created by **Maysir***

Islamic Financial Systems

Islamic Finance Global Coverage

Islamic Finance has a strong footprint in the Middle East and South-east Asia



Source: HSBC Amanah – IF Relevance & Growth, Kuwait Finance House – Asian Economic Outlook & Prospects for IF

Date: June, 2007

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Islamic Financial Systems

- *General features of IFIs as of the end of 2010 :*
 - ✓ ***Market potential is above 1.5 billion Muslims***
 - ✓ ***Assets under mgt. above \$1000 billion USD***
 - ✓ ***Liquid Assets of above \$400 billion USD***
 - ✓ ***Market growth projection of 10%-15% annually***

Islamic Financial System Structure



- *The fundamental difference between conventional and Islamic financial system, from a risk perspective, is in the nature of risk sharing.*
- *Financing based on Islamic concepts changes the nature of risks faced by Islamic institutions. For example, while the conventional banks assure fixed rates on deposits, regardless of whether the banks make profits or losses, the Islamic banks offer no such guarantees*
- *Risks and Returns in Islamic Financial System are **shared, distributed and spread out** to various degrees by the parties of interest*

Islamic Financial System Structure



- *Risk and Returns are not concentrated independently or totally mitigated to certain products, areas, sectors, countries or even regions*
- *One can not strip (separate) Risk or Return packages from the underlying economic activity or physical assets and price or sell them independently as it is done in the Non-Islamic Financial Engineering procedures (examples such as IOs/POs, CDO's and Non-embedded Options and ...)*
- *Risk and Returns are inseparable issues and to various degrees accompany one another in Islamic Financial Products. They must be managed jointly*



Islamic Financial Markets

- ***Islamic Money Market***

- ✓ *Is a Market where, by means of Islamic principals, short term (under two years) liquidity and surplus funds are directed towards where liquidity deficits exist*
- ✓ *It is a Market where you invest your excess liquidity and borrow to satisfy your liquidity needs, by means of Islamic principals*

- ***Islamic Capital Market***

- ✓ *Is a Market where, by means of Islamic principals, medium to long term (above two years) savings or investments are directed towards where medium to long term funding needs exist*



Islamic Instruments for Asset Management

- *Asset Classes*
- *Trading Issues*
- *Selection Criteria's*
- *Investment Objectives*
- *Benchmarking Issues*
- *Investment Structures*
- *Shariah Supervisory Issues*
- *Regulatory Issues*
- *Risk Management Issues*



Asset Classes

- ***Profit & Loss Based Instruments***
 - *Musharakah Based*
 - *Trade Based*
- ***Derivative Based Instruments***
- ***Securitized Based Instruments***
- ***Structured Based Instruments***



Asset Classes

Profit & Loss Based Instruments

- *Musharakah Based Instruments Include:*
 - ✓ ***Mudarabah Contract***, a supplier of short term money capital contracts with a working partner on the basis of sharing the resulting profits
 - ✓ ***Musharakah Contract***, is a medium to long term partnership whereby two or more parties supply capital and participate in the profits or loss and management
 - ✓ ***Diminishing Musharakah Contract***, is a medium to long term partnership whereby one of the partners undertakes to buy the other partner's share gradually until he owns the entire project. This process consists of partnership in the sale and purchase between the two partners.



Asset Classes

Profit & Loss Based Instruments

- *Musharakah Based Instruments Include:*
 - ✓ **Muzara'a Contract**, is a contract between an owner of a piece of agricultural land and a farmer for farming it in return of a percentage of its crop. The IFI provides farmers land (to which is possessed by the IFI itself) for cultivation on crop sharing.
 - ✓ **Musaqat Contract**, this is a form of Muzara'a Contract. In this case, the IFI provides farmers orchards, gardens or trees (which is possessed by the IFI) for harvesting on crop sharing.



Asset Classes

Profit & Loss Based Instruments

- *Trade Based Instruments Include:*
 - ✓ **Murabaha Contract**, is a sale agreement under which the seller purchases goods desired by a buyer and sells them to the buyer at an agreed marked-up price, with payment being deferred
 - ✓ **Salam Contract**, the term Bai-Salam means advance payment or forward buying. The salam contract is the sale of a good to be delivered to the purchaser at a future date, which is set at the time of the contract. This is a trade transaction contract and not a loan contract. This type of financing is most often used when a manufacturer needs capital to manufacture a final product for the buyer. In return for paying in advance, the buyer receives a more favorable price (i.e. splits the profit margin with the manufacturer).



Asset Classes

Profit & Loss Based Instruments

- *Trade Based Instruments Include:*
 - ✓ ***Istisna Contract***, is a contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job. An example would be for the purchase of a house to be constructed, payments are made to the developer or builder according to the stage of work completed. Istisna contract opens the way to a number of new possibilities of business contracts including some forms of futures contract trading of processed commodities, as it permits deferring of both ends of the contract: delivery as well as payment.



Asset Classes

Profit & Loss Based Instruments

- *Trade Based Instruments Include:*
 - ✓ ***Ijara or Leasing Contract***, where the utility of a particular property (*a Real, Valuable, Identified and Quantified physical asset and not a consumable asset*) for a clearly defined time is transferred from the owner to another person in exchange for an agreed rental payments



Asset Classes

Derivative Based Instruments

- *Derivative Based Instruments include:*
 - *Salam and Istisna contracts can also be considered as Islamic derivative instruments. They are very similar to Forward contracts with upfront cash or margin based payments*
 - *Islamic contracts such as; **Al-Khiyar Shart**, **Al-Khiyar Ayb** and **Al-Khiyar Fasgh** or **Bai Urbun** all have option like features and can be used for risk management purposes in Islamic Asset & contracts*
 - *Al-Khiyar contracts in Islam all have combination or embedded option like features*



Asset Classes

Securitized Based Instruments

- *Securitized Based Instruments include:*
 - *Short Term Sukuks that are traded in the official exchanges (secondary market trading). They can provide the necessary instruments and facilities to resolve the liquidity problems faced by most Islamic Financial Institutions*
 - *Short Term Sukuk instruments include:*
 - ✓ *Ijara Sukuk (under two years)*
 - ✓ *Musharakah Sukuk (under two years)*
 - ✓ *Mudarabah Sukuk*
 - ✓ *Salam Sukuk*
 - ✓ *Istisna Sukuk*



Asset Classes

Securitized Based Instruments

- *Securitized Based Instruments include:*
 - *Medium to Long Term Sukuks that are traded in the official exchanges (secondary market trading). They can provide the necessary means and facilities to resolve the Capital Market Instruments liquidity and hedging problems faced by most Islamic Financial Institutions*
 - *Medium to Long Term Sukuk instruments include:*
 - ✓ *Ijara Sukuk*
 - ✓ *Musharakah Sukuk*
 - ✓ *Mudarabah Sukuk*
 - ✓ *Other combination structures*



Asset Classes

Sukuk Instruments

- ✚ The primary condition for issuance of Sukuk is the existence of assets on the balance sheet of the issuing entity that wants to mobilize financial resources*
- ✚ The identification of suitable assets is the first and most important step in the process of issuing Sukuk certificates*
- ✚ Sukuk are Sharia-compliant bonds. The main difference between sukuk and bonds is that sukuk holders take direct ownership of an underlying asset or pool of assets, whereas a bond is purely the financial debt of the issuer. Sukuk do not pay interest; rather they generate a return through actual economic transactions in the form of sharing or leasing the underlying assets. Nonetheless, in most other aspects sukuk and conventional bonds are similar.*



Asset Classes

Structured Based Instruments

- *Mudarabah, Musharakah, Murabaha, Ijara and other viable Islamic financial contracts and receivables can be securitized, combined and structured such that their liquidities are enhanced or their risks are reduced, immunized, shared or transferred (Islamic Financial Engineering)*
- *Combination or embedded options in Islam are valid forms of contracts and could be used more effectively in liquidity enhancements, risk management and securitization designs*
- *Any form of Islamic Structured Based Instruments must exclude:*
 - **Riba** - a form of usury
 - **Gharara** - a form of deception in trade or trading of risk where asymmetric information and risk profile exists in a contract
 - **Maysir** – gambling features

Trading Issues

- *Trading for others - Ok*
- *Trading for self - Ok*



Trading Issues

- **Hedging - Ok**

It is used to immunize or insure the value of an asset

- **Speculating – Conditional Ok**

It is used to take advantage of price disparities of an asset in one market. It helps stabilizing and causing price equilibrium of an asset in one market

- **Arbitraging – Conditional Ok**

It is used to take advantage of price disparities of an asset in several markets. It helps stabilizing and causing price equilibrium of an asset in several markets



Selection Criteria's

- *Qualitative Criteria's; exclusion of instruments, contracts or assets that have more than 5% influence from the following types of businesses:*
 - ✓ *Riba based activities such as Non-Islamic Banks*
 - ✓ *Alcoholic beverage productions*
 - ✓ *Pork and related products productions*
 - ✓ *Gambling, Casino and Lottery related activities*
 - ✓ *Pornography and related activities*
 - ✓ *Weapons production*
 - ✓ *Tobacco and related activities*
 - ✓ *Questionable Biological related activities — Human Cloning*



Selection Criteria's

- *Quantitative Criteria's; not to invest or do direct business with firms that have the following financial structures:*
 - ✓ *Total debt to trailing 12 months average market capitalization is greater or equal to 33%*
 - ✓ *Cash and interest bearing securities divided by trailing 12 months market capitalization is greater or equal to 33%*
 - ✓ *Accounts receivables divided by trailing 12 months total assets is greater or equal to 45%*



Investment Objectives

- *Maturity Based*
 - ✓ *Short term*
 - ✓ *Medium term*
 - ✓ *Long term*
- *Cash flow Based*
 - ✓ *Growth or Capital Gains*
 - ✓ *Income or Dividends*
 - ✓ *Growth & Income*



Investment Objectives

- *Liquidity Based*
 - ✓ *High liquidity*
 - ✓ *Medium liquidity*
 - ✓ *Low Liquidity*
- *Risk Based*
 - ✓ *High risk; based on geography, asset type and ..etc*
 - ✓ *Medium risk; based on geography, asset type and ..etc*
 - ✓ *Low risk; based on geography, asset type and ..etc*



Benchmarking Issues

- *Benchmarking is required as a point of reference for pricing the riskiness, determining opportunity costs, relative value and performance of the Islamic Financial Instruments*
- *Currently Non-Islamic benchmarks such as “Libor” are used for benchmarking Islamic Financial Instruments*
- *There are no generally accepted Islamic Financial Instrument benchmarks available. BMA, DIFC (Sukuk Index), Labuan, Dow Jones (DJ Islamic Index), FT, HSBC (Sukuk Index) all have tried to develop different sector based benchmarks and the effort continues*
- *The problem is the lack of a harmonized, global and active Islamic Financial Exchange platform for IPOs and Secondary market trading of Islamic Financial Instruments*



Benchmarking Issues

Dow Jones Islamic Market Indexes

- *To determine their eligibility for the Dow Jones Islamic Market IndexesSM, stocks are screened to ensure that each meets the standards set out in the published methodology.*
- **Industry Screens**
 - *Alcohol*
 - *Pork-related products*
 - *Conventional financial services*
 - *Entertainment*
 - *Tobacco*
 - *Weapons and defense*
- **Financial Ratio Screens**
- **All of the following must be less than 33%:**
 - *Total debt divided by trailing 24-month average market capitalization*
 - *The sum of a company's cash and interest-bearing securities divided by trailing 24-month average market capitalization*
 - *Accounts receivables divided by trailing 24-month average market capitalization*



Benchmarking Issues

Dow Jones Islamic Market Indexes

- **Global and Regional Indexes**

Following are some of the more-commonly referenced global and regional indexes within the Dow Jones Islamic Market IndexSM family:

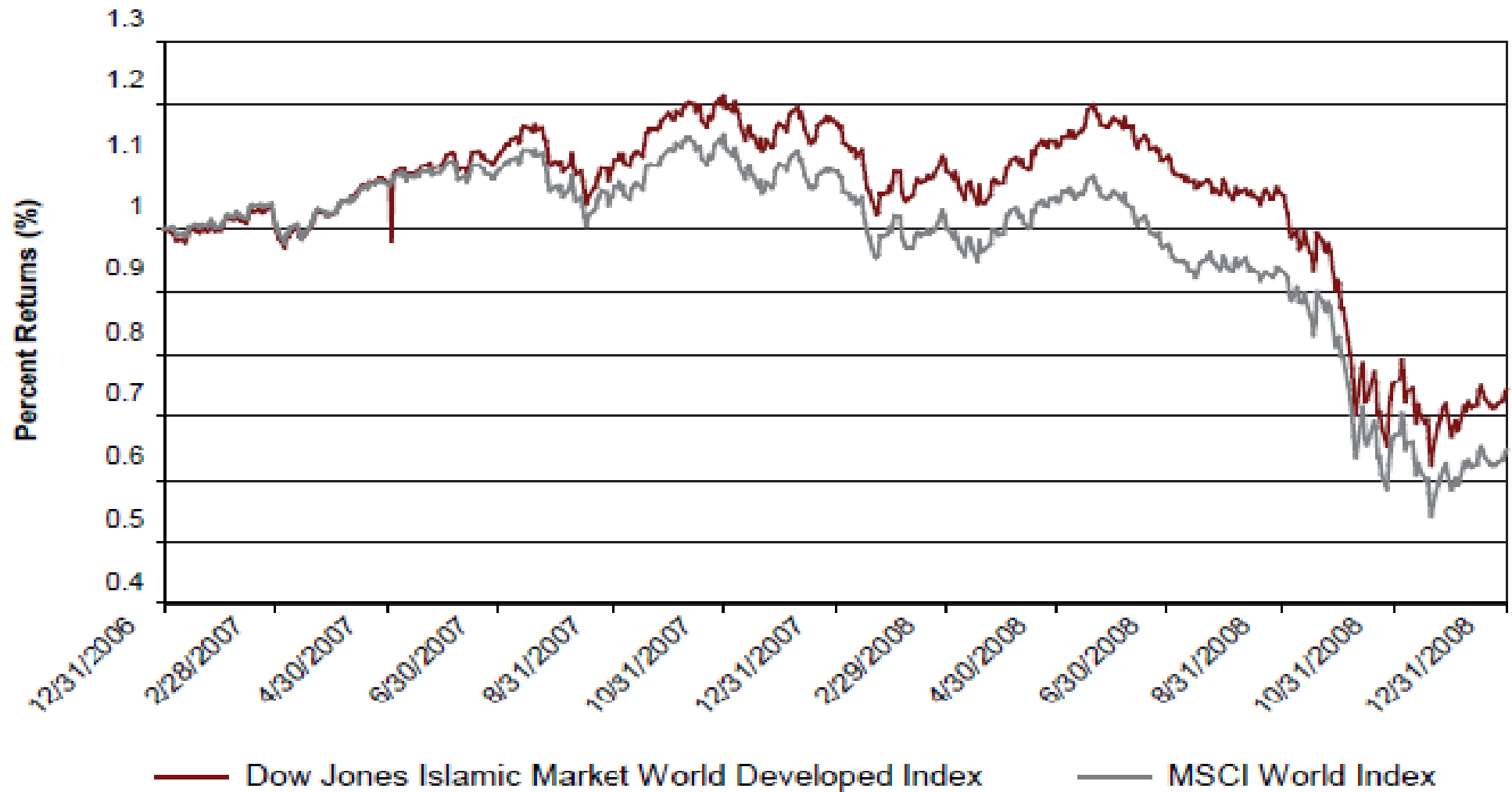
- *Dow Jones Islamic Market World IndexSM*
- *Dow Jones Islamic Market Global ex-U.S. IndexSM*
- *Dow Jones Islamic Market Developed Markets IndexSM*
- *Dow Jones Islamic Market Emerging Markets IndexSM*
- *Dow Jones Islamic Market Americas IndexSM*
- *Dow Jones Islamic Market Asia/Pacific IndexSM*
- *Dow Jones Islamic Market Europe IndexSM*
- *Dow Jones Islamic Market Middle East & Africa IndexSM*
- *Dow Jones Islamic Market GCC IndexSM*

- **Country Indexes**

- *The Dow Jones Islamic Market IndexSM family includes 69 country indexes*



Dow Jones Islamic Market World Developed Index versus MSCI World Index Total Return in USD



Source: Aka, 2009



Investment Structures

- *For individual investments; through different asset classes that are available*
- *For pooled investments; different types of Fund structures can be designed and listed in various exchanges:*
 - ✓ *Creation of a Limited Liability Company (LLC) or (SPV)*
 - ✓ *Governance Structure through proper relationships between:*
 - *Board of Directors*
 - *Audit Committee*
 - *Shariah Committee*
 - *Fund Managers*
 - ✓ *Transparency, Accountability through the development of codes of conduct, compliance programs and due diligence structures for the Funds*



Investment Structures

- *Types of Funds:*
 - ✓ *Commodity Funds (short term); Metals, Oil and ...etc*
 - ✓ *Murabaha Funds (short term); cost plus trading and closed end*
 - ✓ *Equity Funds (long term); IPOs, OTCs and ...etc*
 - ✓ *Ijara Funds (long term); purchase and leasing real assets such as real estate, oil rigs, aircrafts and ..etc*
 - ✓ *Sukuk Funds (short/long term); portfolio of Sukuk securities*
- *Most Islamic Funds are listed in DIFC, Bahrain, Labuan, Luxemburg and Dublin*



Shariah Supervisory Issues

- *Shariah Supervisory Structure:*
 - ✓ *Could be an individual supervisor, a committee or a supervisory board*
 - ✓ *It is advisable to have at least 3 reputable Shariah scholars as members with one local member*
 - ✓ *The supervisor or board should report to the board of directors with clear and transparent responsibilities*
- *Shariah Supervisory Responsibilities:*
 - ✓ *Approve the funds offering memorandum, Article of Association, Other policies & procedures including counterparty agreements*
 - ✓ *Provide general advise on Shariah compliance issues*
 - ✓ *Develop suitable criteria's for the selection process, investment objectives, benchmarks and monitoring procedures*
 - ✓ *Monitoring the fees charged by the Fund*



Shariah Supervisory Issues

- *Shariah Supervisory Responsibilities:*
 - ✓ *Advise on Non-Shariah compatible incomes and how to deal with them*
 - ✓ *Prepare Annual Shariah Audits and reviews for the investors*
- *Shariah Supervisory Compensations:*
 - ✓ *Annual retainers*
 - ✓ *Payments for special works*



Regulatory Issues

- *There is no uniform and coordinated Islamic Financial Instrument regulation in place*
- *Each country has developed its own regulatory framework. Regulatory compliance in one country is not necessarily accepted by another country*
- *Saudi Arabia, Bahrain, Dubai are all trying to create the proper regulatory structures, laws and procedures for proper supervision and regulation of Islamic Financial Instruments, but they have not been very effective*
- *Islamic Financial Services Board (IFSB) and AAOIFI are the two institutions that have tried to provide a harmonized regulatory and financial reporting standard for the supervision of the Islamic Financial Instruments and Systems. Their efforts must be supported further*

Risk Management Issues

In accordance with Basel II Standards



- *Islamic Financial Instrument Risks Include:*
 - **Financial Risk**
 - ✓ **Credit Risk** (Z, Credit Scoring Systems ...)
 - ✓ **Market Risk** (Var Analysis, Duration Matching through Sukuk Issuance)
 - **Interest Rate, ROR or Inflation Risk** (Duration Matching)
 - **Currency Risk** (Var Analysis)
 - **Price Risk** (Var Analysis)
 - ✓ **Liquidity Risk** (Var Analysis, LGAP, Sukuk Issuance)
 - **Operational Risk** which Includes Compliance, Legal & Reputation Risks and ...etc



Risk Management Issues

- *One can manage risk through the following routes:*
 - **Risk Avoidance** or elimination (Conservative approach)
 - **Risk Reduction** by sharing, transferring, syndication, partial selling, diversification, collateralization or securitization (Managing)
 - **Risk Acceptance** (Aggressive approach)

Risk Management Issues



	<i>Mudarabah</i>	<i>Musharakah</i>	<i>Diminishing Musharakah</i>	<i>Murabaha</i>	<i>Salam</i>	<i>Istisna</i>	<i>Muzara'a</i>	<i>Musaqat</i>	<i>Ijara or Leasing</i>
<i>Maturity</i>	S	M/L	M/L	S	S/M	S/M	S	S	M/L
<i>Asset Type</i>	PA/ CA	PA	PA	PA/ CA	PA/ CA	PA/ CA	CA	CA	PA
<i>Cash flow Structure</i>	Bu	Is/Bu	Is/Bu	Bu	Bu	Is	Bu	Bu	Is/Bu
<i>General Risk Type</i>	FR/ OP	FR/ OP	FR/ OP	FR/ OP	FR/ OP	FR/ OP	FR/ OP	FR/ OP	FR/ OP

Long-L, Medium-M, Short-S, None-N, Yes-Y, Physical Asset-PA, Consumable Asset-CA, Installment Basis-Is, Bullet-Bu, Financial Risk-Fr (Credit Risk-CR, Market Risk-MR, Liquidity Risk-LR), Operational Risk-OP, High-H, Low-L