Chapter 4. The Islamic Capital Market

The Islamic capital market plays a pivotal role in the growth of Islamic financial institutions. Like any capital market, its primary function is to allow people, companies, and governments with surplus funds to transfer them to people, companies, or governments who need funds. The Islamic capital market functions as a parallel market to the conventional capital market for capital seekers and providers. The Islamic capital market attracts funds from outside as well as inside the market. The international sources might include high-net-worth (HNW) individuals, predominantly Muslims from the oil-rich countries, and others involved in the corporate and business sector. The Islamic capital market does not prohibit participation by non-Muslims, which has increased the growth potential for Islamic products.

Little, if any, consensus exists about the size of the Islamic capital market. Cerulli Associates has estimated the market value of *Shari'a*-compliant assets at year-end 2008 to be US$65 billion, a figure much smaller than often estimated.[10] This amount does not include the market capitalization of equities that are not specifically "Islamic" but in which Islamic financial institutions are permitted to invest (because the business activities of the companies are *Shari'a* compliant). Standard & Poor's (S&P) estimated that as of the third quarter 2008, roughly US$5.2 trillion in market value of *Shari'a*-compliant equities was lost as a result of the global financial crisis that unfolded in 2008.[11] If approximately 40 percent of market value disappeared during the crisis, by inference the current market value would be in the range of US$6 trillion to US$7 trillion. In contrast, as noted, some analysts estimate Islamic banking assets to range between US$500 billion and US$700 billion and expect bank assets to rise to US$1 trillion in 2010 ("Morgan Stanley Says . . ." 2008). Banks have yet to move most of these deposits into managed investments. If the banks require *Shari'a*-compliant products for such investments, the implication is that the Islamic capital market has significant potential for continued growth.

Origin and Growth of the Islamic Capital Market

Although the origins of contemporary Islamic banking and finance may be traced to the early 1960s, the first wave of oil revenues did not wash over the Middle East until the 1970s, when the idea of investing in products conforming to Islamic principles really gained momentum. Individuals in the region began to accumulate large amounts of wealth by the 1980s and began to seek *Shari'a*-compliant financial products in which to invest their savings. Western banks began servicing HNW

[10] De Ramos (2009). This article was in the *CFA Institute Financial NewsBrief* of 9 January 2009.
[11] Lacey (2009).

Muslim clients through their Islamic "windows" and were quickly joined in the marketplace by newly organized Islamic banks eager to participate in the growing faith-based demand for *Shari'a*-compliant financial products. As of the end of 2008, the Islamic capital market has largely resulted from retail, not institutional, demand (De Ramos 2009). Institutional demand has developed, however, as Islamic banks and *takaful* (Islamic insurance) operators have sought to invest their surplus funds in *Shari'a*-compliant instruments that are liquid and have long-term maturities to match the long-term liabilities of these institutions.

Through the 1990s, Islamic banking deposits sufficed to provide the capital demanded by the Islamic financial markets, but demand for funds was quickly outstripping the supply of funds. New Islamic financial products that could compete with the flexibility and innovation of conventional financial products were needed, but two factors hindered the ability of the Islamic capital market to deliver such products. The first was that the conventional financial markets were developing with tremendous speed and in many different directions. Challenged to adapt these new products to *Shari'a*, the Islamic financial markets struggled to maintain a competitive pace. The second factor slowing the pace of Islamic capital market development was the conflict surrounding interpretation of what constitutes *Shari'a* compliance (Iqbal and Tsubota 2006; Khan 2006).

Yet, for the Islamic capital market to achieve sustainability, finding new and competitive products was imperative. Deregulation in several Muslim nations opened the door to the creation of two products largely responsible for the serious growth of the Islamic capital market—*Shari'a*-compliant equity funds and *sukuk* (Islamic bonds) (Iqbal and Tsubota 2006; Khan 2006).

Since 1999, the Islamic capital market has attracted non-Muslim as well as Muslim issuers and investors, and it now includes numerous products that can replicate the returns and characteristics of conventional financial products. In addition to equity and bond products, the market has expanded to include exchange-traded funds, derivatives, swaps, unit trusts, real estate investment trusts (REITs), commodity funds, and a range of Islamic indices and index products. The Islamic capital market comprises active primary and secondary markets that deal in the Islamic products described in this section.

Overview of the Islamic Capital Market

Not all the financial products discussed in this overview are acceptable to all Muslim investors. The controversy over what is and what is not *Shari'a* compliant is a byproduct of the existence of different schools of Islamic thought. No single body is currently in place to mediate these differences of opinion.

The Islamic Equity Market. Islamic equities are shares of *halal* companies—that is, securities of companies operating in activities permissible under *Shari'a* principles and approved and periodically reviewed by *Shari'a* scholars through a process known as Islamic stock screening. For a company to be considered *halal*, the majority of its revenues must be primarily derived from activities other than the trading of alcohol, arms, tobacco, pork, pornography, or gambling or from profits associated with charging interest on loans.

The determination of *Shari'a* compliance rests with the judgment of Islamic scholars. In Malaysia, one of the most innovative providers of financial products, the body of Islamic scholars is the Malaysia Securities Commission *Shari'a* Advisory Council (SAC). Malaysia is one of only a few nations that has established a single governing body for this purpose. Other nations' decision making regarding *Shari'a* screening procedures is much more fragmented. The SAC has enumerated detailed criteria to be used in screening companies for compliance with Islamic principles. The SAC states that non-*halal* activities include manufacturing and trading of non-*halal* goods; banking and financing involving interest or usury; hotels and resorts involved in the sale of liquor or alcoholic beverages; gambling or related activities; and activities involving elements of uncertainty (*gharar*).

The Malaysian stock-screening criteria are similar to the criteria adopted by the *Financial Times* (FTSE) and Dow Jones Islamic Market Indexes series, the major indices that provide Islamic screening filters.[12] An exception, however, is that the Malaysian criteria specifically prohibit companies involved in meat production or sale if the animals are not slaughtered according to Islamic rites. (The major Islamic equity indices are discussed in greater detail later in this chapter.)

Following the approach of these two indices, the SAC determines compliance on the basis of the core activities of a company; it does not exclude a company if a minor portion of its business is derived from involvement in *haram* (not permissible) activities. The SAC has also adopted positive *Shari'a* screening criteria that require that the public perception or image of a company be good and that its core activities have importance to the Muslim *ummah*, the overarching global Muslim community. The company's guiding principles should conform to *maslahah*, the beliefs of Muslims. Companies that serve the non-Muslim community, such as those operated by the Chinese population in Malaysia, are regarded as legitimate for investment purposes as long as their business activities are consistent with activities customarily accepted by Muslims.

The *Shari'a* stock-screening criteria used by Malaysia's SAC, as well as other screening entities, are essentially qualitative, but some quantitative criteria are also used. Quantitative criteria include, for example, the calculation of certain financial ratios, such as the proportion of interest-bearing debt to assets or total debt to the average market capitalization of the company over a period of 12 months. (In Malaysia, screening by financial ratios is not used.)

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[12]Descriptions of the FTSE *Shari'ah*-compliant indices can be found at www.ftse.com/Indices/index.jsp. A guide to the Dow Jones Islamic Market Indexes can be found at www.djindexes.com/mdsidx/?event=showIslamic.

The Islamic equity investment market is growing at a much faster rate than the overall Islamic sector as a whole because it started from a lower base. The total of funds under management in the Islamic finance sector is estimated at US$1 trillion. Only about an estimated US$20 billion of this is in equities, however, which is modest in comparison with the conventional equity sector with its market capitalization of almost US$2 trillion. Global conventional equities are about US$20 trillion, even after the crash (Parker 2008a).

Malaysia is seen as aggressive in listing Islamic equities; more than 80 percent of the stocks listed on the Bursa Malaysia are classified as *Shari'a*-approved by the SAC. These securities have a total market capitalization of 426.4 billion Malaysian ringgits (RM), or US$129 billion, which is 64.2 percent of the total Malaysian stock market as of December 2008 (Ngadimon 2009). In Kuwait, Islamic and *Shari'a*-compliant companies make up 57 percent of the country's total market capitalization ("Islamic, Sharia Firms . . ." 2009). Despite the recent huge decline in the financial markets, Islamic equity funds have been attracting global investors and more and more financial institutions are offering such funds to meet investor demand.

Islamic Bond (*Sukuk*) Market

One of the fastest growing sectors in the Islamic capital market is the *sukuk*, or Islamic asset-backed bond, market. The *sukuk* market grew at about an 84 percent per year compound rate between 2001 and 2007 and was estimated to have a market value of US$80 billion to US$90 billion before the 2008 market crisis (Cook 2008). Over the first eight months of 2008, global *sukuk* issuance totaled roughly US$14 billion, down from US$23 billion for the same period a year earlier, mainly because of the global credit crunch ("Sukuk Issuance . . ." 2008). *Sukuk* are issued primarily by corporations, although sovereign issuers are becoming more common than in the past. About half of outstanding *sukuk*, mainly large U.S. dollar–based issues and Malaysian debt, are actively traded in the secondary market.

Sukuk are a relatively new financial instrument, first issued in the late 1990s. *Sukuk* were created in response to a need for *Shari'a*-compliant medium-term to long-term debt-like instruments that would have good liquidity in the marketplace (Iqbal and Tsubota 2006). The word "s*ukuk*" is the plural of the Arabic word "*sakk*," which means "certificate," so *sukuk* may be described as certificates of trust for the ownership of an asset, or certificates of usufruct. *Sukuk* differ from conventional bonds in that they do not pay interest. Islam forbids the payment of interest, but a financial obligation or instrument that is linked to the performance of a real asset is acceptable.

Sukuk returns are tied to the cash streams generated by underlying assets held in special purpose vehicles (SPVs). The cash stream can be in the form of profit from a sale, profit from a rental, or a combination of the two. The conventional asset securitization process is used in structuring *sukuk*. An SPV is created to acquire the assets that will collateralize the *sukuk* and to issue financial claims on those assets over the defined term of the *sukuk*. A trust financing, or *mudharabah*, contract is used to create the SPV, otherwise known as a special purpose *mudharabah* (SPM). The asset collateral must be *Shari'a* compliant (Iqbal and Tsubota 2006). *Sukuk* are, therefore, monetized real assets that enjoy significant liquidity and are easily transferred and traded in financial markets. A *sukuk* issue can be structured in a variety of ways and can offer fixed- and variable-income options.

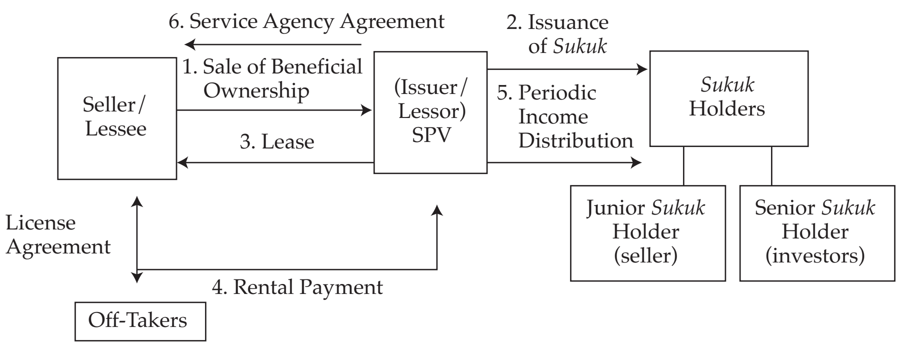
Several classes of assets typically collateralize *sukuk* issues. The first class has financial claims arising from a spot sale (*salam*) or a deferred-payment (*bai' mu'ajjal*) and/or deferred-delivery (*bai' salam*) sale. These securities are typically short term in nature, ranging from three months to one year, and are used to finance commodity trading. Because the risk-and-return characteristics of the structure are somewhat delinked from the risk-and-return characteristics of the underlying asset, the Gulf Cooperation Council (GCC) countries (see Exhibit 1.2) hold that trading these *sukuk* in the secondary market involves *riba*; hence, it is prohibited. Therefore, *salam*-based *sukuk* are typically held to maturity (Iqbal and Tsubota 2006).

A second class of assets that collateralize *sukuk* is leased, or *ijarah*-based, assets. The cash flows generated by the lease-and-buyback agreement, a combination of rental and principal payments, are passed through to investors. *Ijarah*-based *sukuk* have medium- to long-term maturities (Iqbal and Tsubota 2006), carry a put option, and can be traded in the secondary market. This type of *sukuk* has gained increasing acceptance by *Shari'a* scholars, particularly those from Middle Eastern countries. Recent successful issues include those by the Malaysian-based companies Al-'Aqar Capital (RM500 million, or US$153 million) and Menara ABS (RM1.1 billion, or US$337 million).

The structure of the *ijarah sukuk* is depicted in **Figure 4.1** and consists of the following steps:

1. The seller sells the assets to the issuer for a purchase price based on the value of the assets.

Figure 4.1. Structure of *Ijarah Sukuk*

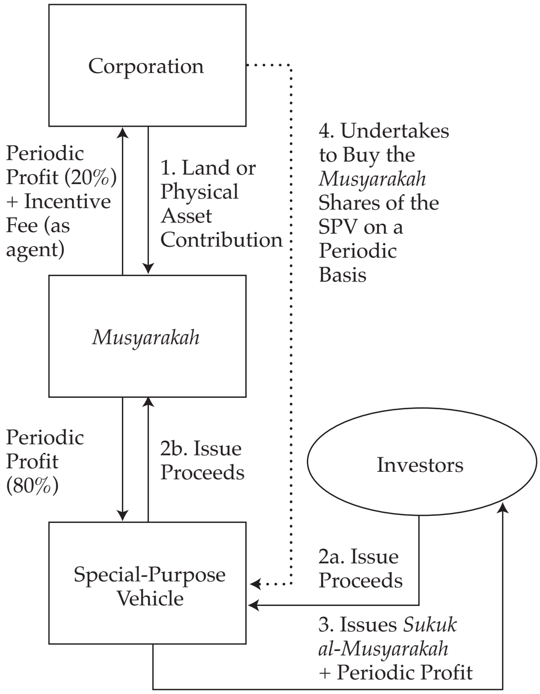


2. To finance the purchase, the issuer raises *sukuk* of an equivalent amount through a combination of senior and junior *sukuk*. The senior *sukuk* are subscribed to by the investors, whereas the junior *sukuk* are solely subscribed to by the seller. (The *sukuk* represent the beneficial rights in the assets whereby the *sukuk* holders have an undivided proportionate beneficial interest in the assets. The issuer declares a trust via a trust declaration over the assets for the benefit of the *sukuk* investors. The *sukuk* investors, therefore, have a pro rata undivided beneficial ownership of the assets.)
3. Subsequent to the purchase, the issuer leases the acquired assets to the lessee under *ijarah* agreement(s) for an *ijarah* term of up to, perhaps, eight years.
4. The lessee makes *ijarah* rental payments to the issuer from the income received from the "off-takers" (tenants/customers of the financed project) arising from the license agreement.
5. The *ijarah* rental payments for the assets received by the issuer from the lessor are then distributed to the *sukuk* holders as a periodic income-distribution payment in proportion to their holdings in the *sukuk*.
6. The seller, in the capacity of service agent, enters into a service agency agreement with the issuer to provide major maintenance services and to maintain insurance for the assets.

A third class of assets used to collateralize *sukuk* is an asset supported by a *musyarakah* (joint venture) contract; these issues are called "investment *sukuk*" or "*sukuk al-musyarakah*." The structure, which is depicted in **Figure 4.2**, involves the issuer entering into a joint-venture *musyarakah* agreement with another party (the investor) and incorporates the use of an SPV. *Musyarakah* involves a partnership arrangement between two parties or more to finance a business venture to which all parties contribute capital, either in cash or in kind, for the purpose of financing the venture (refer to Chapters 2 and 3).

The bulk of *sukuk* have been issued in the Middle East and Malaysia, although the German state of Saxony and the World Bank have also issued *sukuk*. Malaysia offered the first sovereign *sukuk* in 2002. In March 2008, the first sovereign *sukuk* were listed on the London Stock Exchange (LSE) by Bahrain, which chose the LSE for listing its second *sukuk* issue (the first having been issued in Luxembourg in 2004) in order to encourage European and conventional investors to buy the *sukuk*. More than 50 percent of the issue was bought by European investors, with the remainder purchased primarily by banks based in the Middle East. The US$350 million Bahrain issue raised the market value of *sukuk* listed on the LSE to US$11 billion (Al Maraj 2008). In addition to Bahrain and Malaysia, Qatar and Pakistan have also issued sovereign *sukuk*. *Sukuk* have also been issued in the United States, with the first issue being that of the Texas-based oil and gas company East Cameron Partners—a US$166 million deal in June 2006.

Figure 4.2. Structure of *Sukuk Al-Musyarakah* Contract



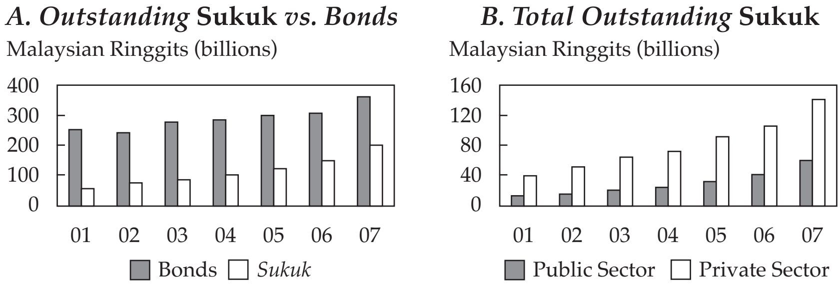
Source: Haneef (2005).

The majority of *sukuk* are issued in U.S. dollars, have maturities of three to five years, and have, each, a total issue size of only several hundred million dollars. Most are not rated by any of the big three rating agencies. When *sukuk* are rated, however, the depth of analysis is often handicapped by a lack of transparency. As a result of small issue size and limited ability to assess creditworthiness, most *sukuk* offer little secondary market liquidity. The NASDAQ Dubai, with 20 issues totaling US$16 billion as of year-end 2008, is the largest *sukuk* listing platform.[13]

Nearly 70 percent of global outstanding *sukuk* have originated in Malaysia. **Figure 4.3** depicts the growth of the Malaysian *sukuk* market from 2001 to 2007. In 2007, the Malaysian market accounted for about half of the US$51.5 billion *sukuk* issued. The Malaysia Securities Commission approved 22 *sukuk* issues worth RM17.7 billion, or US$5.5 billion, in the first half of 2008, which accounted for 31 percent of total corporate bond issuance approved in Malaysia during the period.

[13] See the NASDAQ Dubai at www.nasdaqdubai.com/home/home.html.

Figure 4.3. *Sukuk* Issuance in Malaysia, 2001–07



Source: Bank Negara Malaysia (2008).

Islamic Derivatives Market

A derivative, a financial instrument whose value is a function of the value of another asset, typically takes the form of a contract in which the investor promises to deliver, or take delivery of, an asset at a specific date and at a specific price. Conventional derivatives include call and put options, futures, forwards, and swaps and are used for hedging, arbitrage, and speculation. Islamic finance allows derivatives for the first two purposes—hedging and arbitrage—but prohibits their use for speculation or gambling (*maisir*). As long as *riba* (interest) and *gharar* (uncertainty) are avoided, the Islamic derivative structure used in hedging and arbitrage enjoys significant freedom of design.

The size of the Islamic derivative market is not known but is quite small. The development of Islamic derivative products will bring effective risk management to Islamic financial market participants.

Islamic derivative products include the structured *murabahah* deposit, structured options that operate on the principle of *wa'd* (promise), profit rate swaps, and cross-currency swaps, such as the foreign exchange (FX) *wa'd* (a *Shari'a*-complaint FX option) and the Islamic FX outright (a *Shari'a*-compliant FX forward contract that locks in the price at which an entity can buy or sell a currency at a future date).

Islamic derivatives are based on contracts that are supported by the principles of *bai' salam*, *bai' istisna*, or *urbun*. *Bai' salam* allows delivery of an asset at a future date at today's price and is similar to a forward contract except that in a *bai' salam* contract, only one party is deferring his or her obligation under the contract. *Bai' salam* requires that the asset be defined in quantity, quality, and workmanship and that the delivery date be fixed. The asset must be tangible, with the exception of gold and silver because these precious metals are regarded as money. Neither contracting party may rescind the contract unless the asset controlled by the contract is found to be defective.

A *bai' istisna* contract is a deferred-sale (a manufacture per specifications and sale) contract in which the price of an asset is paid in installments as the contract term progresses. The *bai' istisna* contract is typically used to finance manufactured assets and, unlike the *bai' salam* contract, can be canceled unilaterally if the manufacturing process has not yet begun (see Chapters 2 and 3 for details).

Urbun refers to a sale in which the buyer deposits money in advance with the seller as partial payment and agrees that if the buyer cancels the contract, the deposit will be forfeited and kept by the seller. If the buyer eventually decides to proceed with the transaction, the payment terms are reduced by the amount of the initial deposit. Some schools of Islam, such as Hanafi, Shafi'i, and Maliki, find *urbun*-based contracts unacceptable on the ground that they involve *gharar* (uncertainty). The Hanbali school, however, believes an *urbun* transaction is *halal* (permissible).

Islamic Swap Market

The Islamic swap market is a subset of the overall Islamic derivative market. A swap is a derivative instrument that is used to transfer risk. The two major Islamic swap structures are the profit rate swap, which is similar to a conventional interest rate swap, and a cross-currency swap. Total return swaps are also being used.

Profit Rate Swap. The Islamic profit rate swap is used as a hedge against fluctuations in borrowing rates. The swap is an agreement to exchange fixed for floating profit rates between two parties and is implemented through the execution of a series of underlying contracts to trade certain assets under the *Shari'a* principles of *bai* and *bai' bithaman ajil* (see Chapter 3 for the mechanics of these contracts). **Figure 4.4** depicts the structure of an Islamic profit rate swap.[14] Each party's payment obligation is computed from a different pricing formula. The notional principal is never exchanged because it is netted out under the principle of *muqasah* (set-offs) (Sukri and Hussin 2006).

The profit rate swap gives Islamic investors a tool to help them match financing rates with investment return rates, lower their costs of funding, restructure an existing debt without altering their balance sheets, and manage exposure to interest rate movements.

The first Islamic profit rate swap was pioneered by CIMB Islamic in 2005. In 2007, Deutsche Bank closed a US$500 million profit rate collar swap with Dubai Islamic Bank, which stretched the boundaries of Islamic derivative products farther than ever before.

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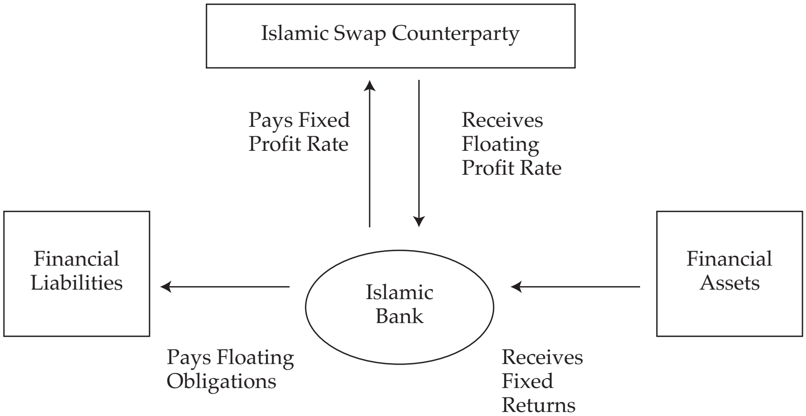
[14]The presentation by Ghani (2004) entitled "Islamic Profit Rate Swap: Its Mechanics and Objectives" on the Resources page of the Islamic Interbank Money Market website (http://iimm.bnm.gov.my/index.php?ch=20&pg=66) contains excellent information about the structure of profit rate swaps, including additional figures.

Figure 4.4. Structure of Islamic Profit Rate Swap



Source: Ghani (2004).

Cross-Currency Swap. The Islamic cross-currency swap is a vehicle through which investors can transfer the risk of currency fluctuation that is inherent in their investment or inventory positions. The structure involves two simultaneous *murabahah* transactions—one is a term *murabahah* and the other, a reverse *murabahah* (see Chapter 2 for the mechanics of a *murabahah*-based contract). The parties to the swap agree to sell *Shari'a*-compliant assets to each other for immediate delivery but on deferred-payment terms in different currencies.

The first cross-currency swap was done in July 2006 for US$10 million between Standard Chartered Bank Malaysia and Bank Muamalat Malaysia.

Islamic Unit Trusts

An Islamic unit trust is similar to a conventional unit trust in the United Kingdom and an open-end mutual fund in the United States except that the Islamic unit trust invests only in *Shari'a*-compliant securities; that is, the unit trust manager gives precedence to securities (stocks or bonds) of Islamic banks and financial institutions, securities of companies operated in accordance with Islamic principles, and securities included in Islamic equity indices. Islamic mutual funds (unit trusts) vary by investment type and financing method (*murabahah*, *musyarakah*, *bai' salam*, *bai' istisna*, or *ijarah*); field of investment (public works, real estate, or leasing); period of investment (short, medium, or long term); risk involved (low, medium, or high risk); and whether they are open or closed funds (Tayar 2006).

The contract governing the exchange of units between the unit trust manager and the investor usually conforms to the principle of *bai' al-naqdi* (buying and selling on a cash basis). When an investor purchases a unit of the trust, the investor is actually sharing pro rata with other investors in ownership of the assets held by the trust. The manager receives a management fee under the concept of *al-ujrah* (or fee) for managing the unit trust.

An equity unit trust is the most common type of Islamic unit trust, but corporate and sovereign *sukuk* (bond) unit trusts are also available. Certain equity unit trusts invest in assets that closely track a particular index and are known as "index trackers." Specialist unit trusts invest in a single industry or similar group of industries. Balanced funds incorporate both equity and *sukuk* securities and are rebalanced periodically to retain the initial asset allocation. Islamic fund managers have less autonomy than conventional fund managers because they are usually accountable to a *Shari'a* committee or adviser who rules on the screening criteria for stock selection and how the criteria are to be interpreted in changing market conditions and company circumstances.

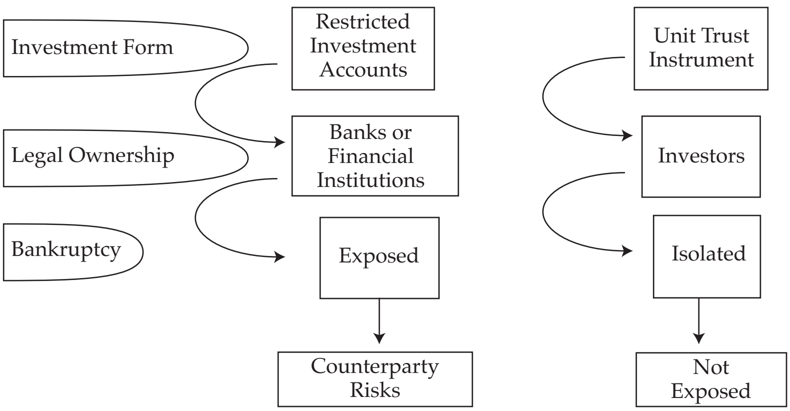
Muslims can, of course, make investments directly and manage their own portfolios rather than investing indirectly through fund management groups and incurring management charges. The search costs are higher for Muslim direct investors, however, if they want to satisfy themselves that the companies or businesses they are investing in are acceptable under *Shari'a*.

In addition, Islamic unit trusts may offer a better risk profile than Islamic investment products that expose investors to the counterparty risk of a bank ("Islamic Unit Trusts" 2007). For example, investors who place their money in restricted or *mudharabah* investment accounts, in which legal ownership lies with the bank, are exposed to the risk that the counterparty bank will go bankrupt. A unit trust structure in which investors own a pro rata share of the investment portfolio, however, does not expose the investor to such counterparty risk. **Figure 4.5** compares the two forms of investment account.

The first Islamic equity unit trust, Tabung Ittikal Arab-Malaysian, was established in Malaysia in 1993 (AMMB 2006). In recent years, growth in the equity funds market has been strong, particularly in Malaysia because of the country's tax incentives and favorable regulatory environment, although Saudi Arabia is the largest Islamic equity funds market in terms of asset size and number of funds. According to Cerulli Associates, as of year-end 2008, approximately 500 *Shari'a*-compliant fund products were in the market, totaling US$35 billion (De Ramos 2009).

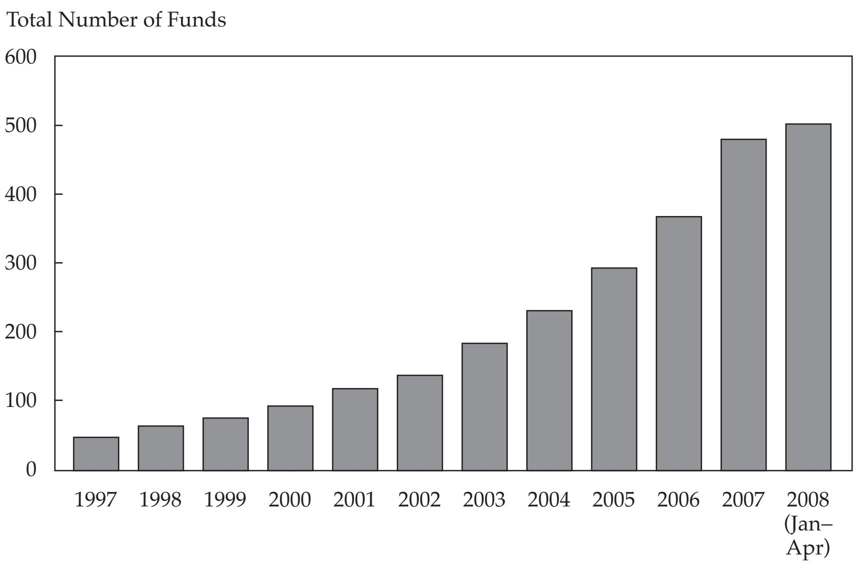
These data are consistent with data provided by Eurekahedge, which reports that the number of Islamic unit trust and investment funds stood at 504 worldwide as of April 2008, with total assets under management (AUM) at US$33.9 billion. **Figure 4.6** shows that over the past decade (December 1997–April 2008), the number of Islamic funds worldwide grew at an annualized rate of 26 percent. In 2007, 111 new funds entered the market, up from 77 new entries in 2006.

Figure 4.5. Comparison of *Mudharabah* Investment Account and Islamic Unit Trust



Source: "Islamic Unit Trusts" (2007).

Figure 4.6. Growth in Islamic Unit Trusts, 1997–April 2008



Source: AmBank Group (2008).

The global Islamic fund industry is dominated by Saudi Arabia and Malaysia, which account for, respectively, 26 percent and 25 percent of the total number of funds as of April 2008. In terms of AUM, the two countries together held nearly three-quarters (US$24.5 billion) of the market.[15] In terms of number of funds, the countries with the next largest presence are Kuwait (15 percent market share), the United Arab Emirates (7.7 percent), and Indonesia (5 percent); in terms of AUM, the market share was Kuwait (10 percent), United Arab Emirates (6 percent), and Indonesia (less than 1 percent).

In the three-year period from 2005 to 2007, Saudi Arabia, Malaysia, and Kuwait hosted the launch of the greatest number of new funds, with Kuwait's total rising from 7 new funds in 2005 to 24 new funds in 2007. Saudi Arabia dominated in 2005 with 19 new funds, but in 2007, it dropped to third place, with 17 new funds, behind Malaysia and Kuwait with, respectively, 26 and 24 funds.

Equity funds are the most popular type of Islamic fund. Of the 504 funds existing as of April 2008, more than half (278) were equity funds, and they had total AUM equal to US$18.3 billion. The money market and commodity trading fund mandate was a distant second at 70 funds (14 percent) with AUM of nearly US$11 billion (32 percent). Jockeying for third place were balanced funds (with the number of funds at 55 [11 percent market share] and AUM of approximately US$1.1 billion [3 percent market share]), real estate and private equity funds (at 45 [9 percent] with AUM of approximately US$2.3 billion [6.7 percent]), and debt funds (at 36 [7 percent] with AUM of approximately US$1.1 billion [3 percent]).

Table 4.1 shows the number of new funds launched, by mandate, from 2000 through the first four months of 2008. In 2007, money market and commodity trading funds were the most popular type of new fund. Although the total number of new funds has risen dramatically over the past several years, the breakdown of new issuance by type of fund has remained relatively consistent. In 2007, equity funds made up 63 of the total 112 funds launched, thus making this category the most popular for number of funds launched.

As of April 2008, fund investments were geographically distributed as follows. Investments in the Middle East/Africa region dominated, with 155 funds and US$22 billion in AUM (64.8 percent of the total Islamic fund asset size of US$34 billion). Asia Pacific funds totaled 184 (36.5 percent) with AUM of US$5 billion (roughly 15 percent). In third place were funds with a global mandate, which consisted of 117 funds (23 percent) with AUM of US$4.9 billion (roughly 15 percent), and in fourth place were funds with investments in North America, which consisted of 32 funds (6.35 percent) with AUM of US$1.5 billion (roughly 5 percent). Europe and the emerging markets represented, respectively, 11 funds with AUM of US$143 million and 5 funds with AUM of US$260 million.

[15] Data in this section are from AmBank Group (2008).

Table 4.1. Islamic Mutual Funds Launched, by Mandate: 2000–April 2008

Calendar Year	Equity	Money Market and Commodities Trading	Balanced	Real Estate and Private Equity	Debt Securities	Others
2000	0	2	1	2	1	13
2001	1	5	6	1	3	9
2002	0	3	3	1	1	10
2003	2	5	9	4	5	22
2004	1	7	6	7	4	21
2005	1	8	7	9	8	28
2006	4	5	9	6	5	48
2007	6	17	9	8	8	63
2008 (Jan to Apr)	2	3	7	1	1	10

Source: AmBank Group 2008.

Table 4.2 shows the changing regional mandates of newly established funds from 2000 through the first four months of 2008. In 2007, the most popular new mandate was the Asia Pacific region, with 38 new funds out of a total of 111 launched—nearly one-third of all new funds. The second most popular mandate was global, followed by Middle East/Africa funds.

Islamic Exchange-Traded Funds

An exchange-traded fund (ETF) is an open-ended fund composed of quoted securities—stocks or bonds—that are selected to closely mimic a benchmark, rather like an index-tracking mutual fund. Unlike an index mutual fund, an ETF is bought and sold on an exchange. The price of an ETF should closely track the weighted

Table 4.2. Islamic Mutual Funds Launched, by Geographical Area

Calendar Year	Asia Pacific	Emerging Markets	Europe	Global	Middle East/ Africa	North America
2000	5	0	4	7	0	3
2001	14	0	1	2	7	1
2002	8	0	0	4	6	0
2003	17	0	4	11	13	2
2004	23	0	1	6	13	3
2005	23	1	4	29	0	4
2006	28	2	2	16	25	4
2007	38	2	8	36	27	0
2008 (Jan to Apr)	8	1	8	2	4	0

Source: AmBank Group 2008.

net asset values of its portfolio of securities throughout the trading day. An Islamic ETF is structured exactly like a conventional ETF except that the benchmark used in constructing the fund is an index of *Shari'a*-compliant securities; that is, the index includes only those securities that have passed Islamic filters to ensure that companies are primarily engaged in permissible business activities and do not have high levels of debt.

Islamic ETFs made their debut in February 2006. Although it is a nascent market, Islamic ETFs have been issued by several major players in the global capital markets, such as iShares, BNP Paribas Bank, Daiwa Asset Management, and Deutsche Bank. As of year-end 2008, the three iShares ETFs totaled US$25.8 million.[16] **Exhibit 4.1** lists several major Islamic ETFs. JETS (Javelin Exchange Traded Shares), which is the first Islamic ETF expected to be issued in the United States and is to be made available by Javelin Investment Management and the Dow Jones Islamic Market (DJIM) International Index Fund, has been filed with the U.S. SEC and is anticipated to be launched on NYSE Arca in early 2009.[17]

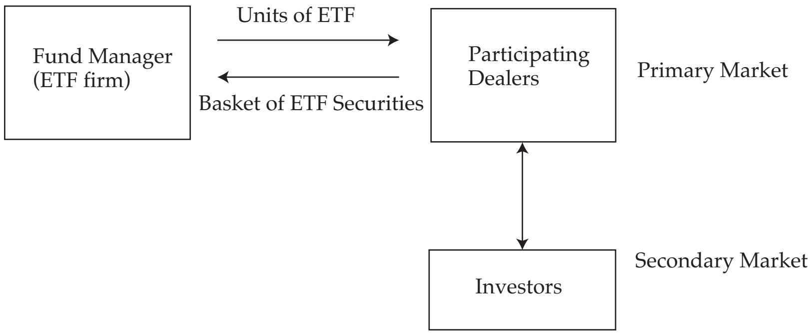
Figure 4.7 illustrates the structure of an ETF. Participating dealers or market makers deliver the exchange-traded securities selected for the ETF to the fund manager in exchange for units in the ETF. The ETF units, representing an ownership interest in the basket of securities, are then sold to investors via an exchange. When ETF units are redeemed, market makers return them to the fund manager in exchange for a proportionate share of the basket of securities.

Exhibit 4.1. Principal Islamic ETFs

DJIM Turkey ETF	DJIM Turkey	Bizim Menkul	Feb 2006/Istanbul
EasyETF DJIM Titan 100	DJIM Titan 100	BNP Paribas	Feb 2007/Zurich
MSCI World Islamic	MSCI World Islamic	iShares	Dec 2007/London
MSCI Emerging Markets Islamic	MSCI Emerging Markets Islamic	iShares	Dec 2007/London
MSCI USA Islamic	MSCI USA Islamic	iShares	Dec 2007/London
MyETF DJIM *Malaysia Titans 25*	DJIM *Malaysia Titans 25*	CIMB	Jan 2008/Kuala Lumpur
Db x-tracker DJIM Titan 100	DJIM Titan 100	Deutsche Bank	Aug 2008/London
Diawa FTSE Shariah Japan 100	FTSE Shariah Japan 100	Daiwa Asset Management	Jun 2008/Singapore

[16] See the iShares website at http://us.ishares.com/home.htm.
[17] Rosenbaum (2008).

Figure 4.7. Structure of ETF



The advantages of ETFs from the investor's viewpoint include tax efficiency, low cost, transparency, trading flexibility, and diversification. ETFs are often used as a hedging instrument as well as a means to obtain access to an asset class cheaply and quickly.

Islamic REITs

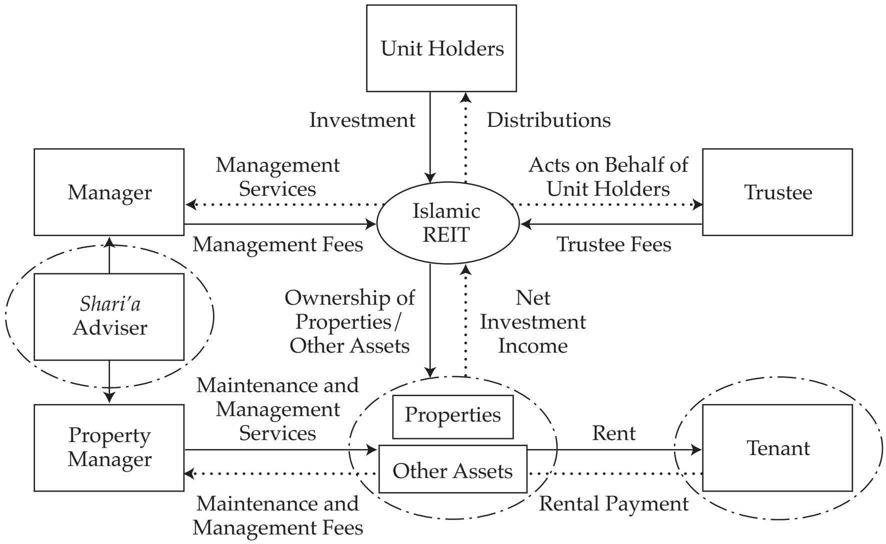
Islamic REITs (I-REITs) are similar to conventional REITs. They are typically structured as property trusts except that they must hold investments that adhere to the principles of *Shari'a*. This requirement means that lease financing (*ijarah*) is used in lieu of an outright purchase of property. The economic, legal, and tax ramifications are effectively the same as in a conventional REIT.

An Islamic REIT invests primarily in physical real estate, but it may also hold *sukuk*, private companies whose main assets comprise real estate, *Shari'a*-compliant securities of property and nonproperty companies, units of other I-REITS, *Shari'a*-compliant short-term deposits, and cash. I-REITs vary from country to country. The Malaysia Securities Commission defines an I-REIT as "an investment vehicle that proposes to invest at least 50 percent of its total assets in real estate, whether through direct ownership or through a single purpose company whose principal asset comprises a real asset" (Securities Commission 2005). The structure of an Islamic REIT is illustrated in **Figure 4.8**.

The key benefits of I-REITS are similar to those of conventional REITs and include the following advantages over physical properties (Jaafar 2007):

- higher current yields because of the requirement to distribute at least 90 percent of income annually,
- lower transaction costs and greater liquidity because most REITs are listed and traded on stock exchanges,
- scalability, unlike property investment companies, and
- diversification across properties with different lease periods and geographical locations.

Figure 4.8. Structure of an Islamic REIT



Source: Jaafar (2007).

I-REIT returns are earned through rental income, capital appreciation of physical property, and securities held as investments. I-REIT investments must be reviewed, monitored, and approved as complying with *Shari'a* principles by a *Shari'a* committee or adviser. In addition, an I-REIT is required to use a *takaful* (Islamic insurance) scheme to insure the real estate. The Malaysia Securities Commission permits up to 20 percent of REIT rental income to be derived from nonpermissible, or non-*Shari'a*-compliant, activities.

The first Islamic REIT, the Malaysian Al-'Aqar KPJ Healthcare REIT, was launched in Malaysia in 2006 with initial issuance of US$130 million (Lerner 2006). Malaysia was the first country, in 2005, to issue *Shari'a*-compliant REIT guidelines. Malaysian issues are listed and traded on Bursa Malaysia and may also be dual listed (that is, listed on Bursa Malaysia and on another exchange). They are liquid securities that trade as any other stock trades. Having been in existence for only two years, the Islamic REIT market still remains quite small.

Islamic Commodity Funds

An Islamic commodity fund, like all Islamic financial products, must comply with *Shari'a* principles; therefore, commodity fund transactions are governed by the following rules (Usmani, no date):

- The commodity must be owned by the seller at the time of sale because short selling is not permitted under *Shari'a* but forward sales, allowed only in the case of *bai' salam* and *bai' istisna*, are permitted.

- The commodity traded must be *halal* (permissible), which means that dealing in, for example, wine and pork is prohibited.
- The seller must have physical or constructive possession (that is, actual control without actually having physical control) of the commodity to be sold.
- The price of the commodity must be fixed and known to the parties involved.
- Any price that is uncertain, or that is determinable by an uncertain event, renders the sale invalid.

The performance of commodity prices in the years leading up to the 2008 bull market peak has been attributed to favorable demand conditions for raw materials and, in most cases, inelastic supply responses because of years of underinvestment in production capacity. This bull market was followed by an extremely sharp commodity price decline in 2008–2009, illustrating how volatile and unpredictable commodity prices are.

The advantage of a commodity fund is that it is not highly correlated with equity and fixed-income asset classes. Hence, it acts as a diversifying asset, particularly when the other assets held are equities and bonds (but commodities did not diversify equity risk in 2008–2009). A commodity fund aims to provide investors with regular income over the life of the fund—income that is linked to the performance of commodities through investments that conform with *Shari'a* principles. The commodity funds generate income from the potential appreciation in commodity prices.

Islamic Indices

The Dow Jones Islamic Market Index and TII-FTSE Islamic Index, launched in 1999 and 2000, respectively, were the first global Islamic benchmarks. Since that time, Morgan Stanley Capital International (MSCI) and S&P have also developed Islamic indices.

In 2006, S&P began offering the S&P 500 Sharia Index, the S&P Europe 350 Sharia Index, and the S&P Japan 500 Sharia Index. At the initial launch of the S&P series, 295 stocks in the S&P 500 Sharia were deemed to be *Shari'a* compliant; 139 stocks, in the S&P Europe 350; and 286, in the S&P Japan 500. In 2007, MSCI entered the market with three indices—the MSCI Emerging Markets Islamic Index, MSCI USA Islamic Index, and MSCI World Islamic Index.

S&P followed the launch of their three broad indices with a series of narrower indices in 2007. The S&P/International Financial Corporation Investable GCC indices include six *Shari'a*-compliant country indices (one for each of the six Gulf Cooperation Council countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE), a composite that excludes Saudi Arabia, and a composite that includes Saudi Arabia. The S&P Pan Asia Shariah Index includes *Shari'a*-compliant securities in China, Hong Kong, India, Malaysia, the Philippines, Singapore, South Korea, Taiwan, and Thailand. To be included, a stock must have at least US$1 billion in float-adjusted market capitalization, and to expedite the *Shari'a* screening process, only the top 15 stocks in each country are evaluated.

By year-end 2008, the Dow Jones Islamic Market Index family had expanded to incorporate 70 indices at the regional, country, industry, and market-capitalization levels, including the markets of the United States, Europe and the Eurozone, the Asia Pacific region, the BRIC countries (Brazil, Russia, India, and China), and Canada, among others.[18]

The FTSE family of Islamic indices at year-end 2008 included the global FTSE Shariah All-World Index of large- and mid-cap stocks, begun in 2007, and the FTSE regional family of *Shari'a*-compliant indices, which includes (1) the first of the FTSE SGX (Singapore Stock Exchange) index series—namely, the FTSE SGX Asia Shariah 100 Index, which was launched in 2003 and includes 50 of the largest Japanese companies and 50 of the largest companies from Singapore, Korea, Taiwan, and Hong Kong; (2) the FTSE DIFX (Dubai International Financial Exchange) index series (soon to be renamed to reflect the Dubai exchange's new name, NASDAQ Dubai), which were the first tradable indices in the GCC region and which include the FTSE DIFX Kuwait 15 Shariah Index and FTSE DIFX Qatar 10 Shariah Index; and (3) the FTSE Bursa Malaysia index series, which includes the FTSE Bursa Malaysia EMAS (Exchange Main Board All-Shares) Shariah Index and the FTSE Bursa Malaysia Hijrah Shariah Index.

The Jakarta Islamic Index, which contains 30 companies listed on the Indonesia Stock Exchange, has been available since 2000.

Table 4.3 compares the quantitative screens of the four major Islamic index families.

Table 4.3. Quantitative Screens of Major Islamic Index Families

Financial Category	DJIM	FTSE	S&P	MSCI
Debt	33% / Trlg 12m avg mkt cap	33% / Total assets	33% / Mkt value equity	33.33% / Total assets
Receivables	33% / Trlg 12m avg mkt cap	50% / Total assets	49% / Mkt value equity	70% / Total assets
Cash	33% / Trlg 12m avg mkt cap	33% / Total assets	33% / Mkt value equity	33.33% / Total assets

Note: "Trlg" stands for "trailing."

Source: Mansor (2008) from "Guide to the Dow Jones Islamic Market Indexes" (November 2007), "Ground Rules for the Management of FTSE Shariah Global Equity Index Series Version 1.2" (March 2008), "S&P Shariah Indices Index Methodology" (June 2007), and "MSCI Islamic Index Series Methodology" (April 2007).

[18] An overview of the Dow Jones Islamic Market Indexes may be found at www.djindexes.com/mdsidx/?event=showIslamicOverView.

These indices are not accepted as *halal* by all Islamic scholars. Because the screening criteria allow debt ratios of up to 33 percent, certain Islamic scholars argue that accepting the indices is akin to declaring a food *halal* if it contains only a small quantity of pork.

Continued Growth in the Islamic Capital Market

Financial products that barely existed a few years ago have now penetrated the broad Islamic capital market. But some products, such as Islamic hedge funds, remain controversial in large portions of the Muslim community, which view hedge fund activities as simply simulating short selling in ways designed to be compatible with *Shari'a*. The five schools of Islam vary in their definition of what complies with *Shari'a*, which raises a key obstacle to the creation of universally acceptable Islamic hedging schemes.

Nevertheless, two investment firms, Barclays Capital and Shariah Capital, have launched a *Shari'a*-compliant hedge fund product that replicates shorting by using the *urbun* contract—that is, a sale in which the buyer deposits money in advance (Parker 2008b). In Islamic finance, an asset should be owned before it is sold, meaning that an investor cannot borrow shares from a brokerage house or a bank and sell them in the market for an eventual gain. In the *urbun* arrangement, the trader who wishes to short a stock can put a sell order through the brokerage house, which then records the transaction as a purchase, not a loan. This process establishes ownership of the asset before sale to the market, and thus, the arrangement is *Shari'a* compliant. The mechanics of this structure are different from conventional shorting, but the economic effect is similar to that of a conventional short sale.

Despite the controversy, lack of standardization, and fledgling size of many capital market sectors characterizing the Islamic capital market today, the market is likely to continue to grow as the demand for Islamic investment products expands. The drivers of growth are a mixture of heightened investor awareness of the market, a broad range of products and their increasing availability, and increased interest in Islamic investing. Rising wealth levels in oil-rich nations also create a demand for investment products that can generate returns that are competitive with those of conventional, or Western, products.

