

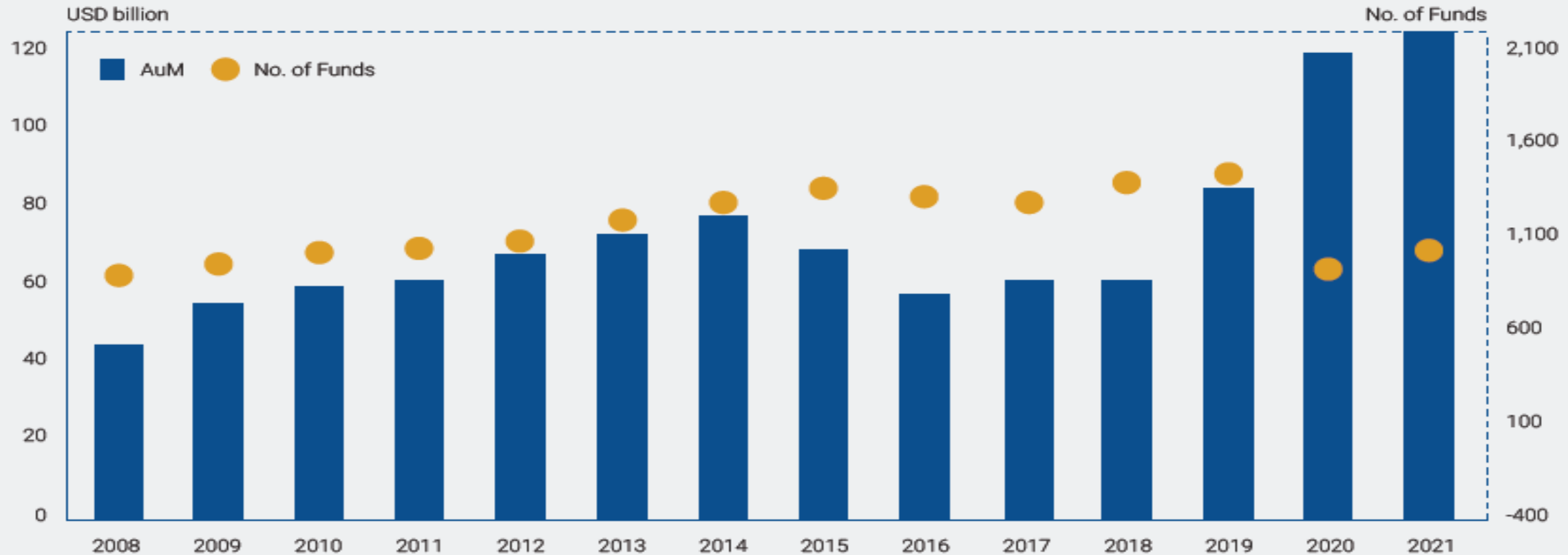
ISLAMIC EQUITY MARKET AND FUNDS

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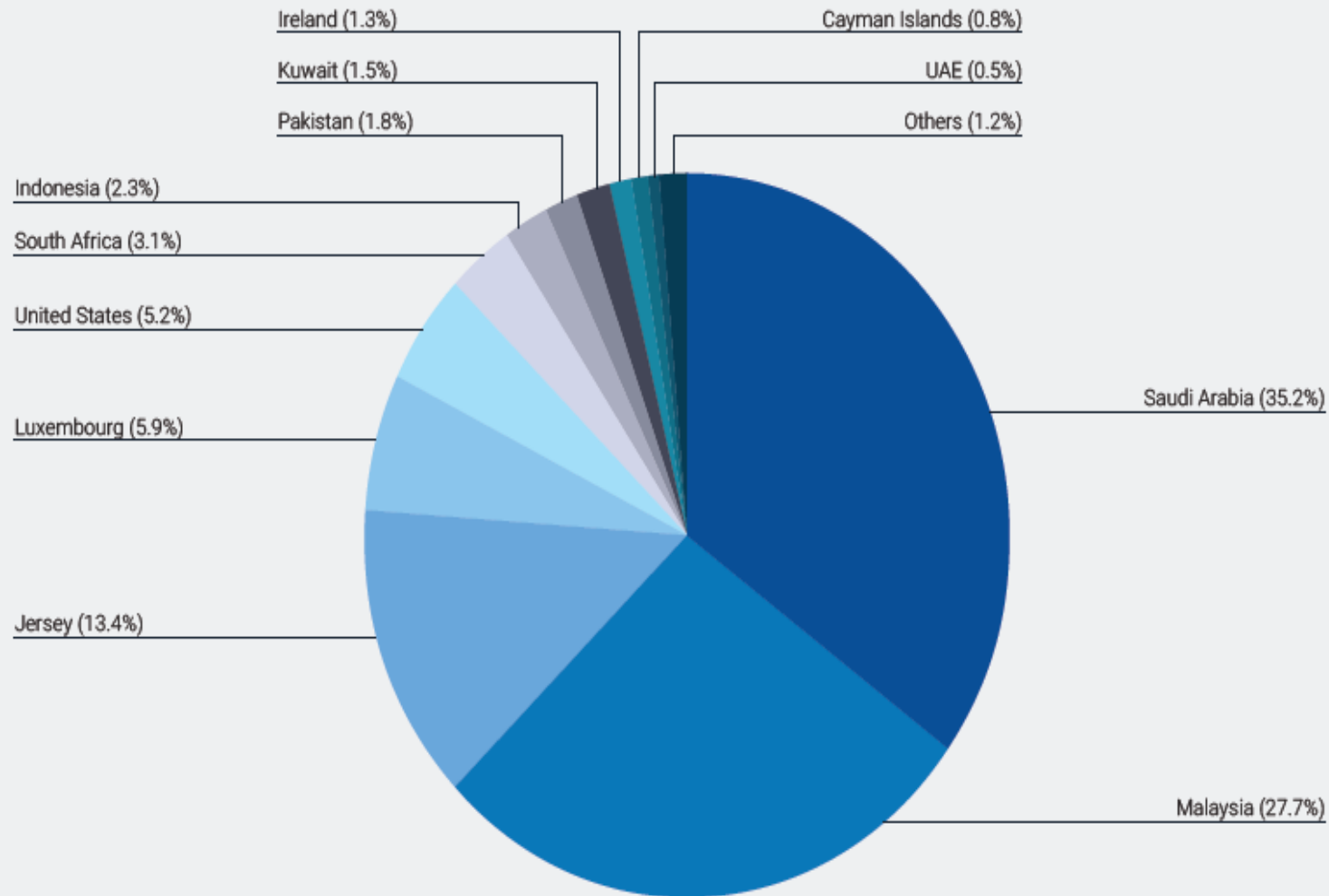
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- Islamic Collective Investment Fund
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Chart 1.3.2.1 Growth in Assets under Management and Number of Islamic Funds (2008–21)



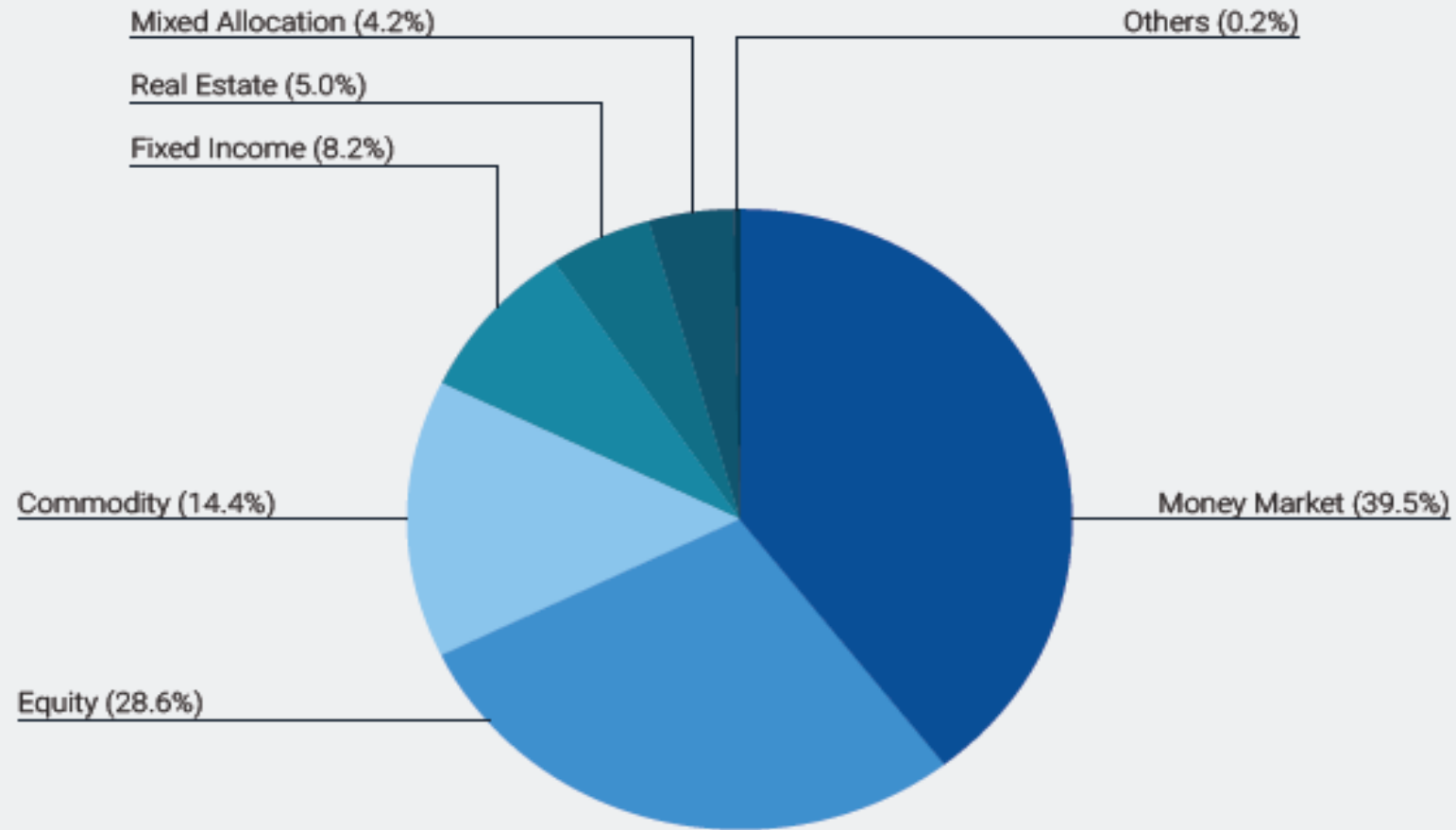
Source: IFSB estimates based on data from Refinitiv for 2019–21.³⁸ Data for the years 2008–18 are from Bloomberg database as per previous reports. Data from Iran are excluded due to limited data availability.

Chart 1.3.2.2 Islamic Fund Assets by Domicile (%) (2021)



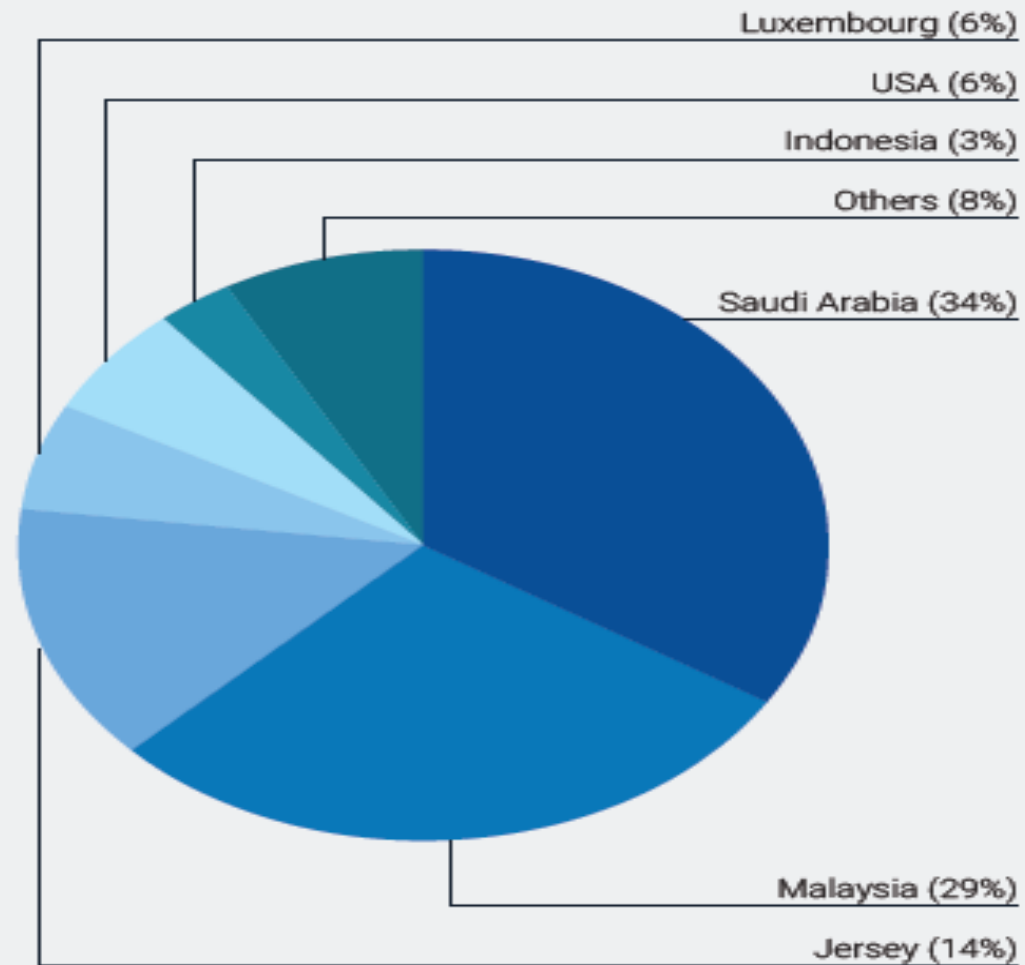
Source: IFSB estimates based on data from Refinitiv and regulatory authorities. Data for Iran are not included due to limitations in data availability.

Chart 2.2.2.2 Islamic Fund Assets by Asset Class (2021)



Source: IFSB estimates based on data from Refinitiv.

Saudi Arabia, Malaysia Dominate Islamic AuM



4Q21 figures on USD terms | Source: Fitch Ratings. Lipper

What is Islamic Fund Management?

- Refers to the professional management of investors' fund or money in a portfolio of securities, an asset or a class of assets by fund managers, in accordance with Shariah principles to achieve specified financial objectives
- Usually fall under the umbrella of 'collective investment schemes' (CIS) which can take the form of Islamic unit trusts, mutual funds, investment trusts or other appellations
- The various types of Islamic funds include myriad financial solutions ranging from conservative investments to more aggressive plans for capital growth.
- Some of these solutions not only focus on wealth accumulation and capital preservation, but may also favour tax-incentive funds that promote long-term investments and inter-generational wealth transfer

What is Collective Investment Funds?

- A trust based scheme that comprises a pool of assets that is managed by a collective investment scheme manager (previously known as the collective investment scheme management company)
- It is about a group of people having one investment objective (common investment interest) coming together to invest in a particular investing portfolio
- The world of collective investments is so vast that it can be overwhelming as there are many types of funds.

Cont'd

- Each investor has a proportional stake in the CIS portfolio depending on how much money he or she contributed.
- In lieu of his participation, he will be issued “unit” which refers to the portion or part of the CIS portfolio that is owned by him.
- Each unit represents a direct proportionate interest in every asset in the portfolio. The investor will purchase units in the relevant fund and the amounts he or she will receive depend on the amount invested and the ruling NAV price (net asset value).

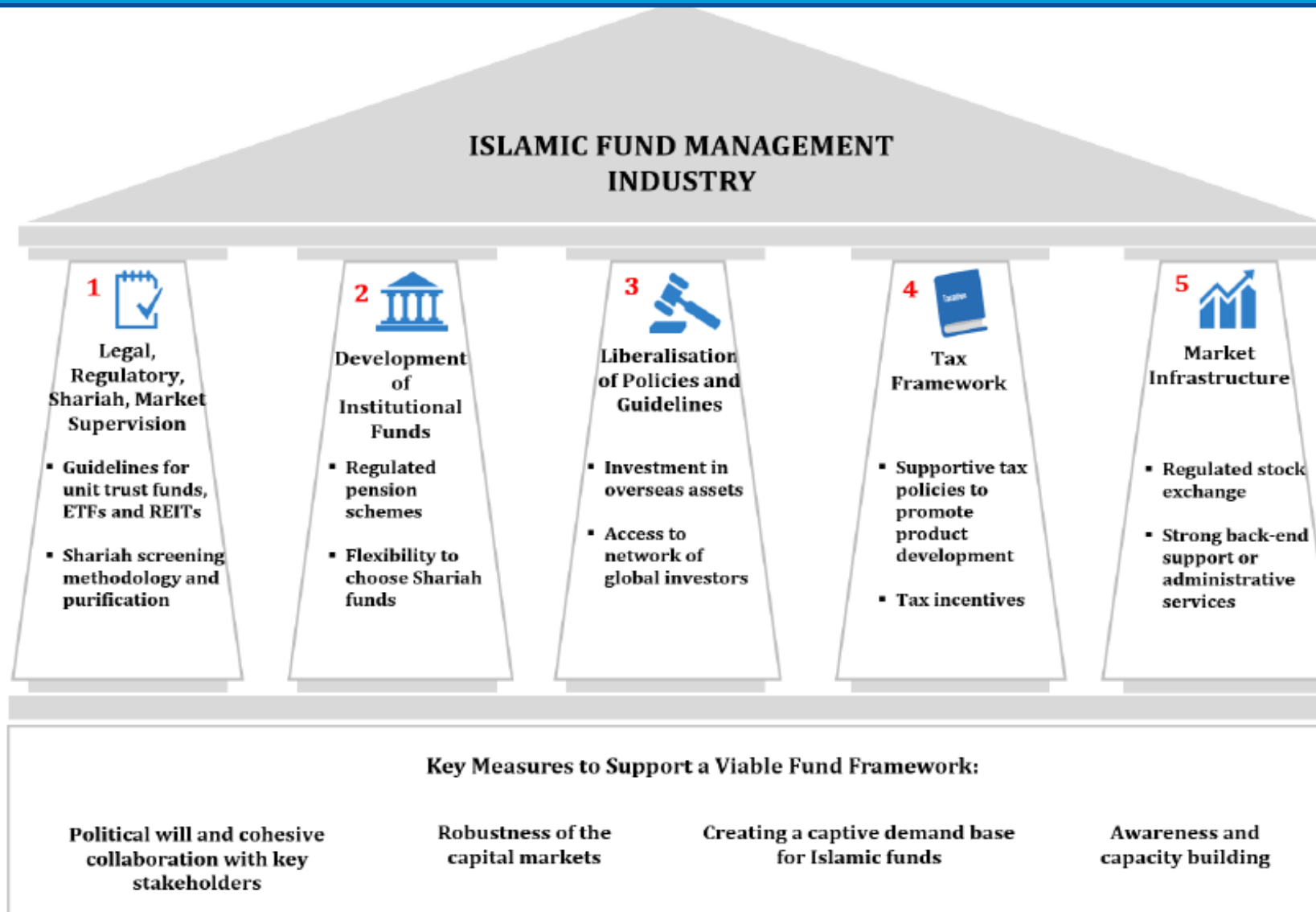
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- CIS is considered less risky due to the diversification of the investments that the CIS has.
- Instead of investing alone in a particular investment, in CIS, the money of thousands of individual investors, who share a common investment objective, is pooled together to form a CIS portfolio.
- The CIS portfolio manager uses this pool to buy a diversified portfolio of investments in one or more asset classes.
- The individual investors do not have day-to-day management of the CIS.
- Instead, the management is done by the appointed manager

Types of Collective Investment Fund

- Various forms of CIS
- These schemes invest in a variety of investment instruments
- Examples of CIS:
 - Mutual Funds / Unit Trust Funds
 - Close-End Funds
 - Real Estate Investment Funds (REITs)
 - Exchange Traded Funds
 - Etc
- In some countries, SPs can also be registered as CISs if certain conditions are fulfilled
- CISs vis-a-vis Private Placement

Building Blocks to Sustain the Long-Term Growth of Islamic Fund Management



Source: RAM

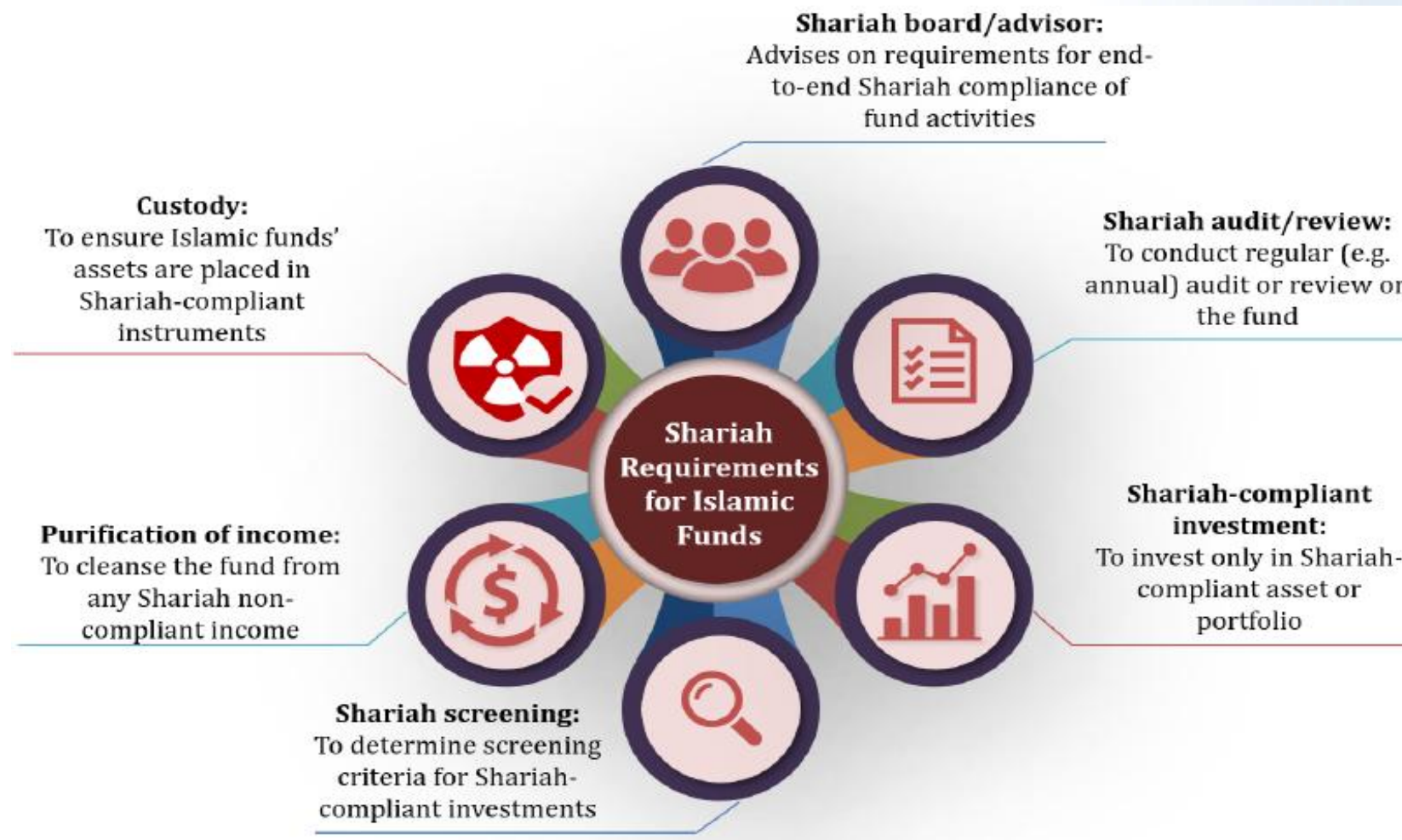
Islamic Collective Investment Fund

- Collective Investment Fund that subscribes to the principles of Shariah in the operations and investments of the Fund.
 - Operations
 - Investments
 - The needs for Shariah Advisers/ committee

Asset Classes in ICIS

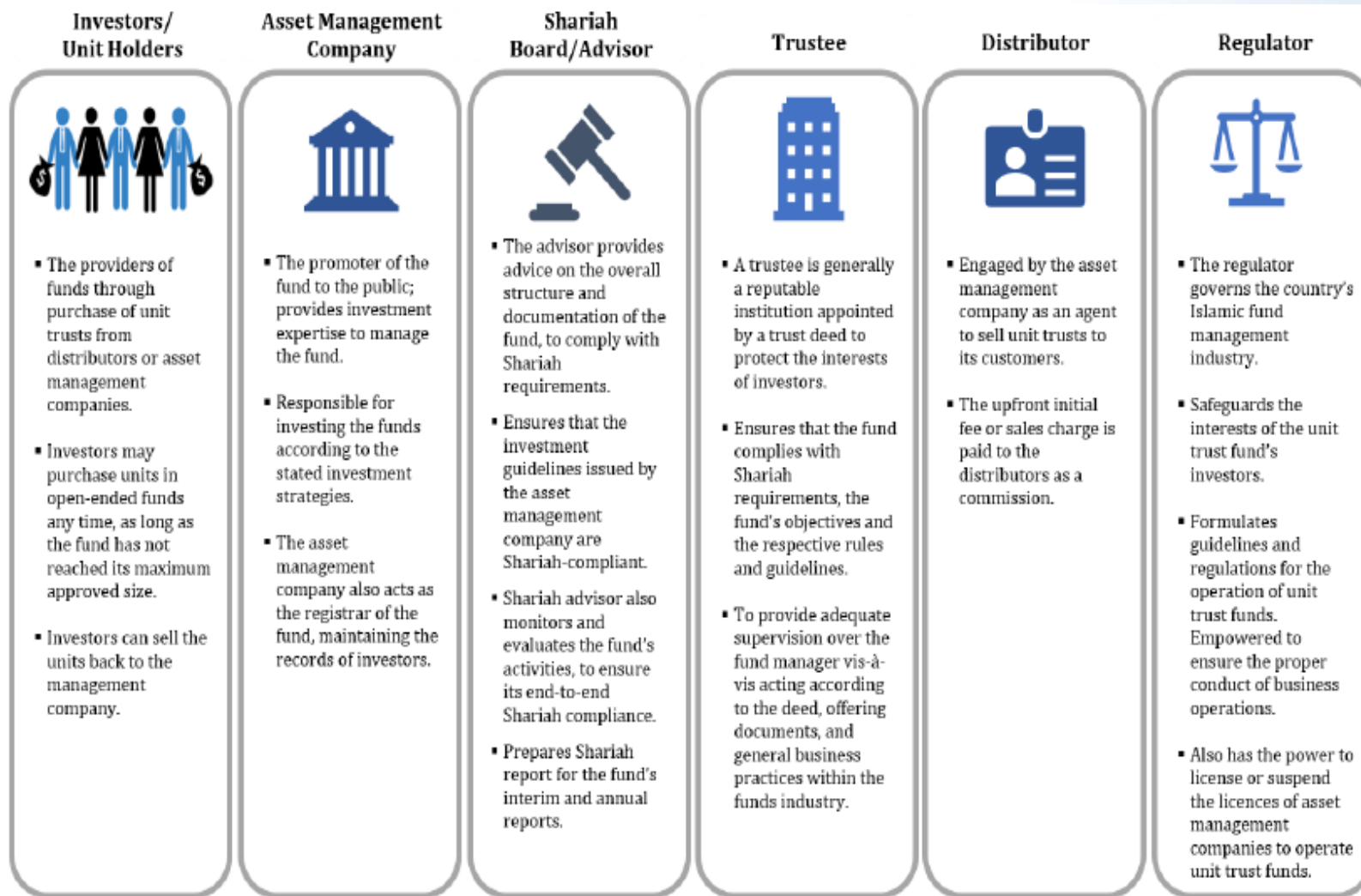
- ICISs have a variety of investment spectrum.
- It can have a single asset class (such as only equities), bond or a mixed asset classes (sometime also called balance fund).
- Its combination is also varied and can be customised depending on the investment objective o a particular CIS.
- Among the most important instruments:
 - Islamic Money Market
 - Islamic Equities
 - Islamic Sukuk.
 - Islamic ETF
 - ETC

Basic Shariah Requirements in the Establishment of Islamic Funds



Sources: Adapted from PWC (nd), ISRA

Parties Involved In Islamic Fund Management & Their Roles



Sources: Adapted from ISRA (2015), Khalid (2017), ISRA, RAM

Instruments used in Islamic Funds

- Ordinary Shares
- Preference Shares
- Participating Shares
- Loan Stock / Islamic Notes
- SAFE

Ordinary Shares

- **Ordinary Shares:** Give holders the rights of ownership in the company, such as the right to share in the profits, the right to vote in general meetings and to elect and dismiss directors.
- Obligations of ownership are also conferred and this may result in the loss of an investor's money if the company is unsuccessful
- Ordinary shares usually form the bulk of a company's capital and have no special rights over other shares.
- In the event of liquidation, ordinary shares rank after all other liabilities of the company.

Preference Share

- Preference shares as defined under the Companies Act 1965 means a share by whatever name called, which does not entitle the holder thereof to the right to vote at a general meeting or to any right to participate beyond a specified amount in any distribution whether by way of dividend, or on redemption, in a winding up, or otherwise.
- However, preference shares provide a specific or fixed dividend that is paid before any dividends are paid to ordinary shareholders, and take precedence over ordinary share in the event of liquidation.
- The distribution of the specific or fixed dividend is subject to the issuer meeting certain conditions, including:
 - (a) there is enough reserve/profit for dividend to be declared in the first instance;
 - (b) relevant amount of tax credit under Section 108 of the Income Tax Act 1967; and
 - (c) must be made in the form of cash.
- A non-cumulative feature of preference shares means that where dividend is not distributed in any one particular year, it cannot be carried forward to the following

Types of Preference Share

- Participating preference shares are entitled to participate in the profits beyond the fixed dividends, by way of an additional fluctuating dividend if the company is successful.
- Cumulative preference shares are preference shares which, apart from having a preferential right to receive a fixed dividend ahead of ordinary shares, also carry the right of any arrears of the preference dividends which may have built up.
- Non-cumulative preference shares are preference shares which are not entitled to any arrears in dividends.
- Redeemable preference shares may be redeemed by the company at a stated redemption price on advance notice of a period of time. It is usual to set a redemption price above the par value to compensate the owner for the involuntary loss of his investment.
- Convertible preference shares are preference shares which carry the right to be made convertible, at the option of the holder, into another class of shares, normally into ordinary share

Participating Shares

- Participating Shares: Gives the holders of the shares, same equal rights, in dividend distribution & surplus sharing in the case of liquidation and winding up of the Fund
- Normally will employ GP and LP, where the GPs are normally the sponsor (to set up the Company) and LPs are the investors.
- GP will be appointed as manager to manage, and be paid management fees & Performance Fees (this can be in various ways)

Islamic Notes

- Can be issued to existing Shareholders.
- Conventionally, equivalent to conventional Loan Stock (ICLUS, RCLUS, RULS etc.)
- Can be convertible, non-convertible, secured, unsecured, redeemable, irredeemable.
- Can be issued with in the form of renounceable rights, and added with warrant as “sweetener”.
- Warrant can be detachable or non-detachable
- Shariah Issues

SAFE

- A **simple agreement for future equity** (SAFE) is an agreement between an investor and a company that provides rights to the investor for future equity in the company similar to a warrant, except without determining a specific price per share at the time of the initial investment.
- The SAFE investor receives the future shares when a priced round of investment or liquidity event occurs.
- SAFEs are intended to provide a simpler mechanism for startups to seek initial funding.
- In essence, a SAFE instrument involves making an upfront investment, with a future conversion into equity at a valuation to be determined at that time based upon the occurrence of a future funding round, which can incorporate an optional conversion cap and/or conversion discount.

KISS: Keep It Simple Securities

- This instrument has been created specifically to protect the interests of investors
- It is an agreement made between an investor and the company.
- The investor invests money in the company, and in exchange receives the right to purchase shares in a future equity round when it occurs.

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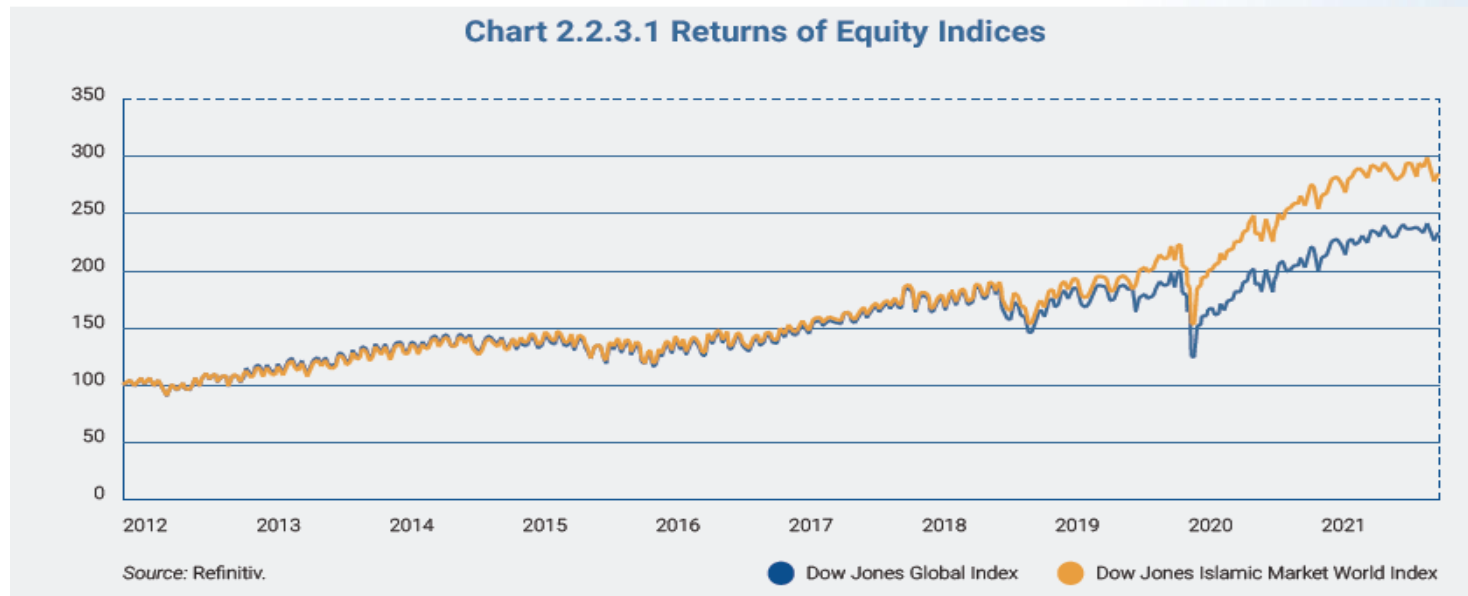
- Two types of KISS convertible notes:
 - Debt version: With interest rate and a maturity date – This version tracks a convertible debt structure more closely, as it contains the interest rate and the maturity date clause.
 - Equity version: Without interest or maturity date – This one is a middle ground between a convertible note and a SAFE convertible note.
 - It does not accrue interest and does not contain a repayment clause at a maturity date.
 - Due to this, it is normally the most attractive kind of convertible security among many companies.

Some Examples of Islamic Funds

- Islamic Equity Funds
- Islamic ETFs
- Islamic REITs
- Islamic Hedge Funds

Islamic Equity Funds

- Equity funds invest heavily in the stocks of listed companies.



- Islamic Equity Indices continued to outperform their conventional equivalents

Shariah Principle in Equity Market

- Direct shareholding is the main form of participation in the equity market
- The share certificate signifies a form of capital contribution in a company / partnership
- This contribution is in the form of musharakah or mudarabah
- The shares can be sold at any price as it represents the assets owned by the company

Cont'd

- The profit for the investors can be in the form of capital gain, or dividend, or both.
- Investment in Ordinary Share is a direct contribution to and ownership of the business and as such, is acceptable subjected:
 - The investments must be in business acceptable to Shariah → the needs for stock screening process
 - There should not be guaranteed fixed return tied to the investments
 - Shareholding is the main underlying investment activity.

EQUITIES SCREENING FOR SHARIAH COMPLIANCE

- Screening is important to identify companies whose activities are compliant to Shariah.
- Ownership leads to control/management issue. Investors are deemed to be the 'owners' and therefore are responsible for the conduct of the company.
- Islamic Investors (either through direct investors or through intermediary or vehicle) are 'religiously' accountable for the conduct of the company.
- To ensure whether a company is Islamically acceptable for investment, a proper shariah screening procedure must be adopted to determine acceptability of a particular company, in its compliance to Shariah in term of the conducts of the company

AAOIFI Shariah Standard (1)

Fundamental	Standard
Primary activities must comply with Shariah	Issuance of share is permitted if the objectives for which the corporation was established are lawful according to the Sharia (AAOIFI Shar: 21 :(2/1)
No preference share	It is not permissible to issues preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits (AAOIFI Shar: 21 :(2/6)
Fundamentally, dealing in riba' whatever small is not allowed	The fundamental rule is that of prohibition of acquiring shares of and transaction (investment and trading) in the shares of corporations hat sometimes undertake transactions in riba' and other prohibited things even when their primary activity is lawful(AAOIFI Shar: 21 : (3/4)
Exemption	 but for rule of subscription and transactions (investment or trading) are exempted with the following conditions AAOIFI Shar: 21 : (3/4)

AAOIFI Shariah Standard (2)

Fundamental	Standard
Statement in Annual report that the primary activities are shariah compliant	That the corporation does not state in its memorandum of association that one of its objectives is dealing in interest, or dealing in prohibited things like pork (swine) and other things (AAOIFI Shar: 21 : (3/4/1).
Amount of loan raised based on interest (not more than 30%)	That the collective amount raised as loan on interest whether long-term or short-term debt does not exceed 30% of the market cap (total asset – English version) of the corporation with the knowledge that raising loans on interest is prohibited whatever the amount (AAOIFI Shar: 21 : (3/4/2)
Amount of money deposited with conventional account must not more than 30%	That the collective amount deposited in interest bearing account, be it in short term or long term deposits, does not exceed 30% of the market cap of the corporation with the knowledge that opening interest bearing account is prohibited whatever the amount (AAOIFI SharL 21: (3/4/3) – only in Arabic version
Aggregate of non compliance income (not more that 5%)	That the amount of income generated from the prohibited component does not exceed 5% of the total income of the corporation irrespective of the income being generated through interest bearing investment, by undertaking a prohibited activity, by ownership of a prohibited asset or in some other way. If the explanation about some type of revenue is not complete then an effort is to be made for its identification by exercising caution (AAOIFI Shar: 21 : (3/4/4)

AAOIFI Shariah Standard (3)

Fundamental	Standard
Composition of the companies (if the asset are all in debt)	It is not permitted to undertake trading in the shares of a corporation if the entire assets of the corporation are composed of debts, unless the rules for dealing in debts are observed (AAOIFI Shar: 21 :(3/18)
Mixed assets Revised by Standard No. 59 (bay al-dayn: 8/1)	 If the assets of a corporation are composed of tangible assets, benefits, cash and debts, the rule for trading in the shares of such a corporation will differ according to the primary asset, which conforms to the objective of the corporation and its usual activity. If its purpose of activity pertain to trading in tangible assets, benefit and rights, trading its shares is permitted without taking into account the rules of sarf or transaction in debts , with a condition that the market value of all its tangible assets, benefit and right must not fall below 30% of the total asset of the corporation, including tangible asset, benefit, right, cash and cash equivalent (i.e. receivable, current account, bond and debt in the hands of others) irrespective of their size as in such a case these are secondary. If however, the objective of the corporation and its usual activity is dealing in gold, silver and currencies (sarrafah), it is obligatory to undertake trading in its shares in the light of the rules of sarf ((AAOIFI Shar: 21 :(3/19).

AAOIFI Shariah Standard (4)

Fundamental	Standard
Cleansing of income	It is obligatory to eliminate prohibited income specific to the share that is mixed up with the earnings of the corporations, and this in accordance with the following (AAOIFI Shar: 21 : (3/4/5):
1) Cleansing on the stockholder. 2) Only on dividends, not on capital gain	The elimination of prohibited income is obligatory on one who is the owner of the share, whether an investor or a trader, at the end of the financial period, even if the payment is due at the time of issuance of the final financial statements whether quarterly, annual or for other period. Accordingly, elimination is not obligatory for one who sells the shares before the end of the financial periods (AAOIFI Shar: 21 : (3/4/5/1).
Dividend only	The subject matter of elimination is the prohibited income specific to the share whether or not the profits have been distributed and whether or not the corporation has declared a profit or suffered a loss (AAOIFI Shar: 21 : (3/4/5/2).

AAOIFI Shariah Standard (5)

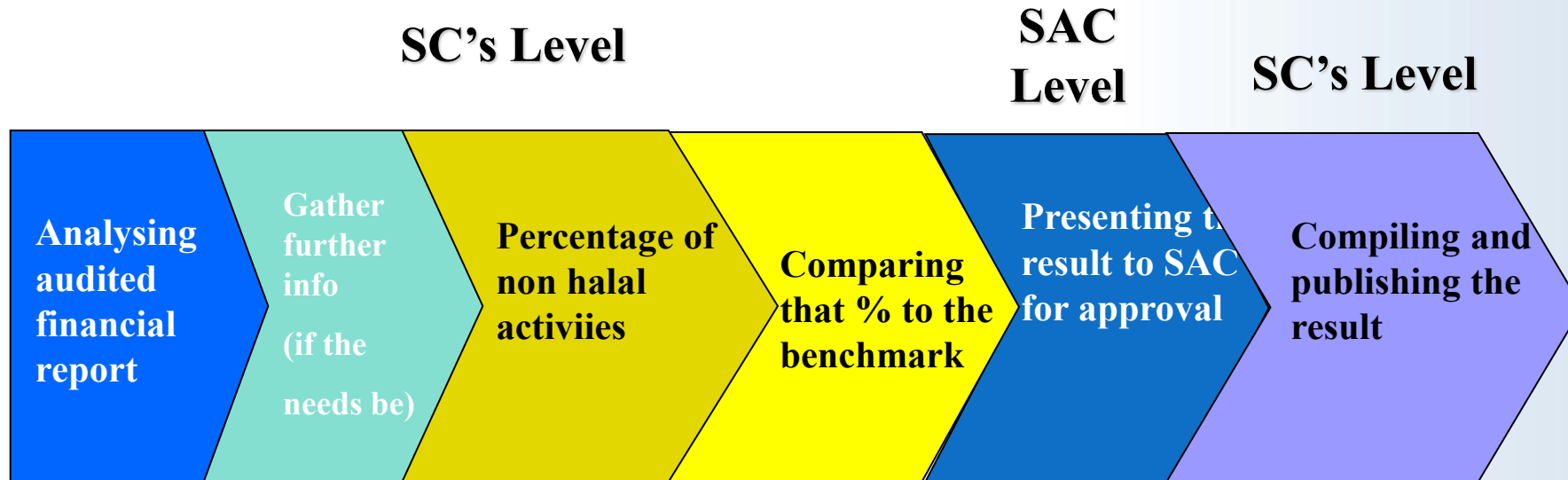
Fundamental	Standard
Obligation is on the stockholder only	Elimination is not obligatory for the intermediary, agent or manager out of part of their commission or wages, because this is their right in lieu of the work they have undertaken (AAOIFI Shar: 21 : (3/4/5/2)).
What to be purified?	The figure, whose elimination is obligatory on the person dealing in shares, is arrived at by dividing the total prohibited income of the corporation whose shares are traded by the number of shares of the corporation , thus, the figure specific to each share is obtained. Thereafter the result is multiplied by the number of shares owned by the dealer individual, institution, fund or another and the result is what is to be eliminated as an obligation. (AAOIFI Shar: 21 : (3/4/5/4)).

AAOIFI Shariah Standard (6)

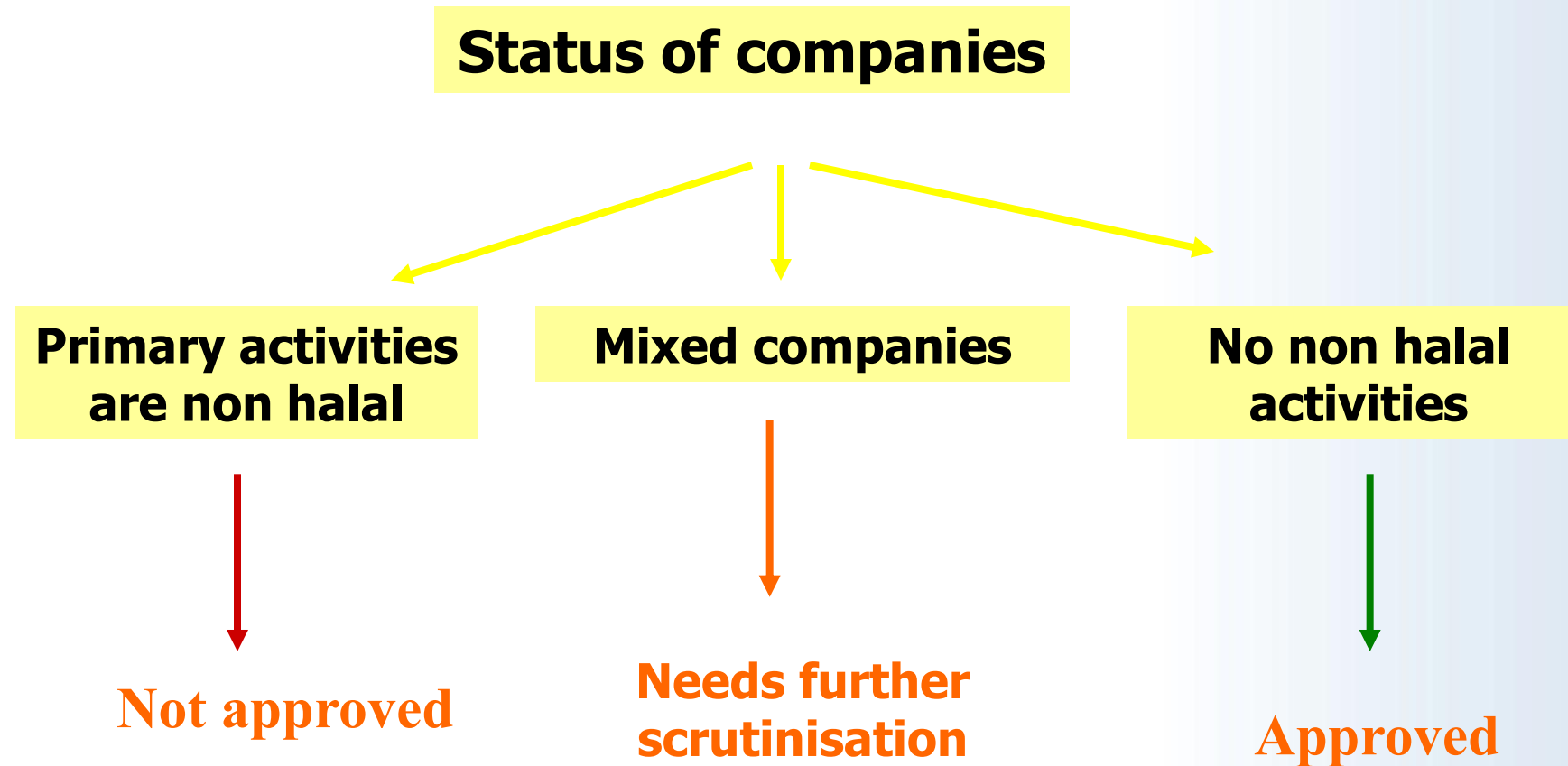
Fundamental	Standard
Who is responsible for cleansing? Individual, manager, intermediation (broker)?	The responsibility for elimination of the prohibited component of the income, for the benefit of all, falls upon the institution in case it is trading for itself or in case it is managing the operations. In the case of intermediation, however, it is bound to inform the person dealing in them of the mechanism for elimination of the prohibited component so that he can undertake it himself. The institution may offer these services, with or without a charge, for those dealers who desire them AAOIFI Shar: 21 : (3/4/5/6).
Obligation to undertake such cleansing process	It is necessary to observe these rules , throughout the period of participation or trading. If the rules cannot be applied, it is obligatory to give up such investment (AAOIFI Shar: 21 : (3/4/6).
Cannot use the prohibited income	It is not permissible to utilise the prohibited component in any way whatsoever nor is any legal fiction to be created to do so even if this is through the payment of taxes (AAOIFI Shar: 21 : (3/4/5/5).

Stock Screening Process at SC

SAC of SC has published guidelines in determining the compliance of certain stock or otherwise.



Status of Companies



Non Halal Activities

- Operation of conventional financial institution and interest (*riba*) based activities such as banking, hire purchase, factoring.
- Penalty charges
 - Late payment penalty charges for leasing
 - Late payment penalty charges for easy payment schemes
- Conventional insurance
- Stockbroking business /share trading
- Dividends received from non-halal investment (Non-Syariah approved securities)

Cont'd

- Gambling
- Manufacturing /selling non-halal food and beverages such as liquor, pork and meat not slaughtered according to Islam.
- Manufacturing /selling products related to non-halal food and beverages such as:
 - Feeds for pig
 - Rental for liquor outlet and non-halal foods
 - Bottle, box for liquor
 - Label and sticker for liquor

Cont'd

- Advertising for liquor, cigarette and gambling activities including external advertising, billboard, electronic medium advertising advertising in newspaper and magazine.
- Organising and operating immoral entertainment activities such as concert, pub, disco and karaoke center.
- Manufacturing /selling and providing services for non-Islamic religion related products such as praying services and products, cemetary, burial and funeral packages.
- Manufacturing /selling and distribution of cigarette.
- Operation of theme park

Cont'd

- Operation of hotel dan resorts
- Massage parlour
- Operating cinema
- Producing song album, recording and providing education related to music.

Analysis To Mixed Companies

- **1st Phase: Quantitative analysis**

Comparing the % of the contribution of non halal activities to:

- 1.0 TO
- 2.0 PBT

- **2nd Phase: Qualitative analysis**

Analysis on:

- Image of the com
- Public needs for such companies (maslahah)
- Custom ('urf)
- Umum balwa (unfavourable widespread situation affecting most people and is difficult to avoid)
- Fasad al-zaman (widespread corruption of time)

1st phase: Quantitative analysis

Acquire Info on :

1. TO
2. PBT

- 1. TO & PBT of the non halal activities (subsidiaries)**
- 2. Profit contribution from non halal activities (assoc. companies)**
- 3. Interest income**
- 4. Dividend & non halal investment**

The Percentage:

- 1. TO & PBT of the non halal activities to TO & PBT of the com.**
- 2. Profit contribution from non halal activities (assoc. companies) to PBT of the com**
- 3. Total interest income to the TO of the con**
- 4. Dividend & non halal investment to the PBT of the com**

Comparing the % to the benchmark

**Not Shariah approved securities if the % of TO and PBT (which is the higher)
Is above the allowed benchmark**

Business Activity Benchmarks

- 5% Benchmark:
 - conventional banking;
 - conventional insurance;
 - gambling;
 - liquor and liquor-related activities;
 - pork and pork-related activities;
 - non-halal food and beverages;
 - Shariah non-compliant entertainment;
 - interest income from conventional accounts and instruments;
 - tobacco and tobacco-related activities; and
 - other activities deemed non-compliant according to Shariah.

Business Activity Benchmarks (2)

- 20% Benchmark
 - share trading;
 - stockbroking business;
 - rental received from Shariah non-compliant activities;
and
 - other activities deemed non-compliant according to Shariah.

Financial Ratio Benchmarks

- **i) Cash over Total Assets**
 - Cash will only include cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments will be excluded from the calculation.
- **ii) Debt over Total Assets**
 - Debt will only include interest-bearing debt whereas Islamic debt/financing or *sukuk* will be excluded from the calculation.
- Both ratios, which are intended to measure *riba* and *riba*-based elements within a company's balance sheet, must be lower than 33%.

2nd Phase: Qualitative analysis

- ❖ SAC will also take into consideration other factor before final resolution is made
- ❖ As such, a company may still be considered as non halal even though it has passed the quantitative analysis.



- ✓ Image
- ✓ Public needs (maslahah)
- ✓ *Custom*
- ✓ *umum balwa* (common plight)
- ✓ Right of non-muslim
- ✓ etc

S & P Dow Jones Indices Shariah's Methodology

- Consist of two stages:-
 - 1) Primary Business of the Company
 - To exclude from the index universe any industry group that represents an incompatible line of business.
 - 2) Scrutinizing Business revenue sources for the company. Companies classified in other industry groups also may be excluded if they are deemed to have a material ownership in or revenues from prohibited business activities or over leveraging.

First Stage

- ❑ Determining primary activities of the company
- ❑ Non permissible activities:-
 - 1) Alcohol
 - 2) Cloning
 - 3) Advertising and Media, with the following exceptions:
 - Media and advertising companies generating revenues in excess of 65% of total income from the GCC countries
 - News Channels
 - Newspapers
 - Sports Channels

Cont'd

4) Financial Institutions EXCEPT: Islamic Banks or Islamic Financial Institutions or Islamic Insurance Companies. Defined as a company having:-

- Shariah Committee to supervise all activities
- All investments of the company are Islamic
- Passes accounting based screens

5) Gambling

6) Pork

7) Pornography

8) Tobacco

9) Trading of gold and silver as cash on deferred basis

2nd Stage: Accounting-Based Screens

- ❖ Three areas of focus are leverage, cash, and the share of revenues derived from non-compliant activities

- ❖ Note: Such accounting based screens are not applicable to companies which are run on a fully Shariah compliant basis and such companies shall be considered compliant. Such companies may be characterized by (the list below is indicative, non-exhaustive and reviewed on a case to case basis):
 - Having a Shariah Supervisory Board
 - All transactions (business and financial) are in accordance with Shariah principles
 - Incorporated and managed in a fully Shariah compliant manner

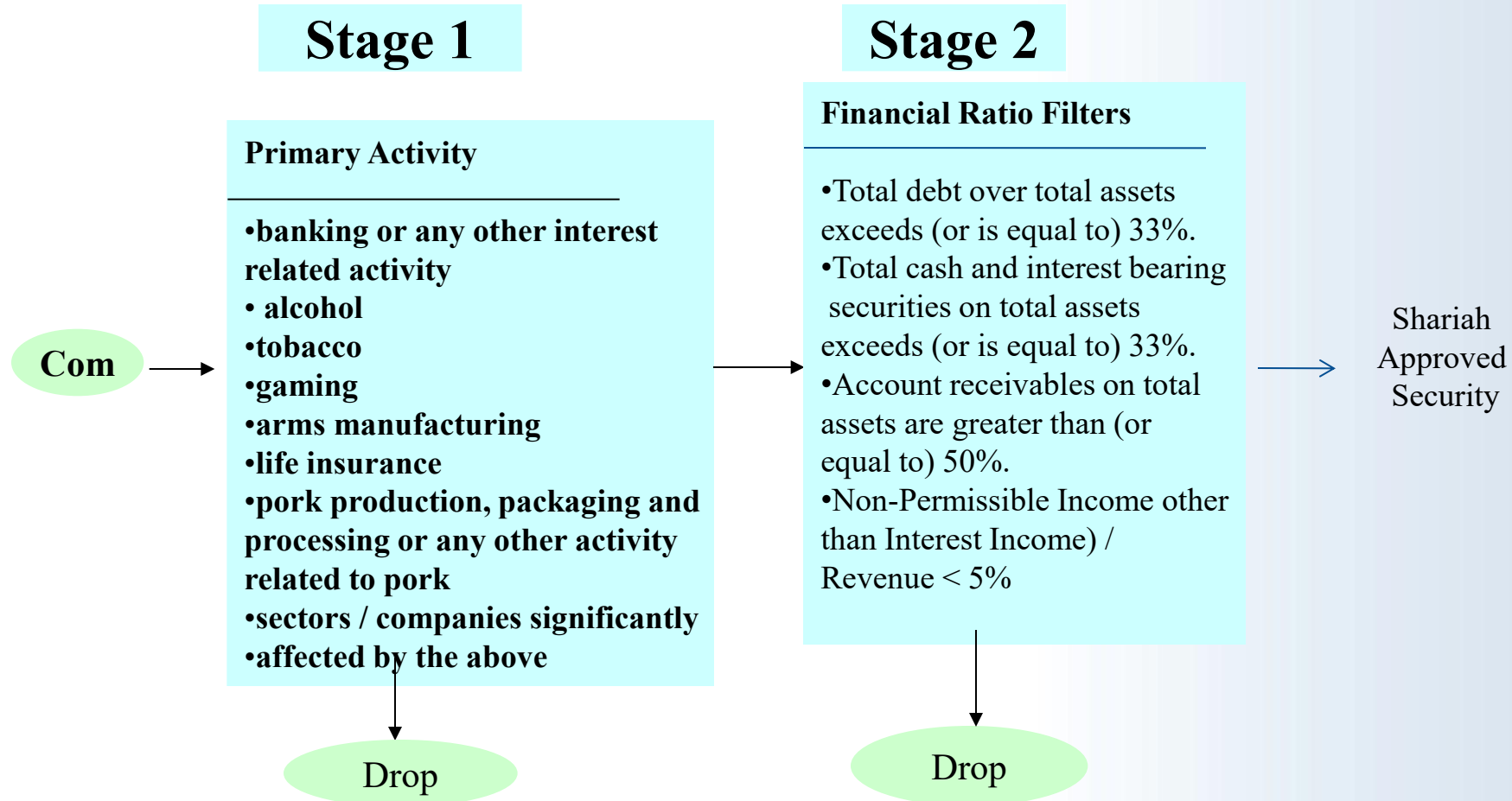
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- 1- Leverage Compliance. This is measured as:
 - - Debt / Market Value of Equity (36 month average) < 33 %
- 2- Cash Compliance. Certain rules related to cash holdings must be met. These are:
 - - Accounts Receivables / Market value of Equity (36 month average) < 49 %;
 - (Cash + Interest Bearing Securities) / Market value of Equity (36 month average) < 33%
- 3- Revenue Share from Non-Compliant Activities.
 - In certain cases, revenues from non-compliant activities can be tolerated, if they comply with the following threshold:
 - (Non-Permissible Income other than Interest Income) / Revenue < 5%
- 4. Dividend Purification Ratio. This ratio is provided to investors for purification purposes, it is calculated as:
 - Dividends * (Non Permissible Revenue / Total Revenue)

The FTSE Global Islamic Index Series

- To identify and track a global Islamic Compatible universe of publicly traded equities in a manner analogous to indices which identify and track the relevant universe of publicly traded equities, that have no restriction imposed by Islamic Shariah precepts in the selection process.
- In essence it is an Islamic Stock market indicator

Screening Process for FTSE Global Islamic Index Series



MSCI Islamic Index

- Business Activities:
 - Alcohol: distillers, vintners and producers of alcoholic beverages, including producers of beer and malt liquors, owners and operators of bars and pubs.
 - Tobacco: cigarettes and other tobacco products manufacturers and retailers.
 - Pork related products: companies involved in the manufacture and retail of pork products.

Cont'd

- Conventional Financial Services: commercial banks involved in retail banking, corporate lending, investment banking; companies involved in mortgage and mortgage related services; providers of financial services, including insurance, capital markets and specialized finance; credit agencies; stock exchanges; specialty boutiques; consumer finance services, including personal credit, credit cards, lease financing, travel-related money services and pawn shops; financial institutions primarily engaged in investment management, related custody and securities fee-based services; companies operating mutual funds, closed-end funds and unit investment trusts; financial institutions primarily engaged in investment banking and brokerage services, including equity and debt underwriting, mergers and acquisitions; securities lending and advisory services institutions; and insurance and reinsurance brokerage firms, including companies providing property, casualty, life disability, indemnity or supplemental health insurance

Cont'd

- Defence / Weapons: manufacturers of military aerospace and defence equipment, parts or products, including defence electronics and space equipment.
- Gambling / Casino: owners and operators of casinos and gaming facilities, including companies providing lottery and betting services.
- Music: producers and distributors of music, owners and operators of radio broadcasting systems.
- Hotels: owners and operators of hotels .
- Cinema: companies engaged in the production, distribution and screening of movies and television shows, owners and operators of television broadcasting systems and providers of cable or satellite television services.
- Adult Entertainment: owners and operators of adult entertainment products and activities.
- Any other activity that may be informed from time to time by the Sharia Advisors.

Cont'd

- 2) Financial Ratio:
- $\text{Total Interest Bearing Debt} / \text{Average Market Capitalization} = \text{Up to } 33\%$
- $\text{Sum of cash and interest-bearing securities} / \text{Average Market Capitalization} = \text{Up to } 33\%$
- $\text{Sum of Accounts Receivables (including pre-payments) and cash} / \text{Average Market Capitalisation} = \text{Up to } 70\%$
- The Average Market Capitalization is calculated as the average of month-end market capitalization of the security for the last 36 months.

Cont'd

- Any Security which has an income from prohibited activities (including interest income) is 5% or more, that security would be considered an non-compliant

Remarks on the Screening of Shariah Index (1)

- Though the way certain benchmarks and financial ratios is different, all index-providers agree that all the underlying stock for the index construction must be screened to determine whether they are Shariah Compliant or otherwise

Issues 2: What is the most suitable Denominator of the index?

- DJIMI: Market Capitalisation, e.g. debt to market cap
- FTSE: Asset, e.g. debt to asset
- S & P : Average market value of equity
- Yasaar: Total Asset
- Which one is the most suitable method to determine the market valuation of the company?

Issue 3: Purification of Income

- Deducting from the return of an investment, if source (s) of the income comes from non-Syariah compliant activities.
- Primarily from interest earnings and/or non halal activities.

Deduct or inform

- Practice of most fund: Inform the portion that needs to be disposed. Individual will dispose
- Some equity fund cleanse before distribute. E.g. Oasis International Equity Fund.
- In case that the fund dispose before distribute:
 - The charity account is managed independently by a group / committee of people from Shariah Compliance and Audit department under the direct supervision of any member from the Shariah Board or full Shariah Board.
 - Specific approval is acquired from the Shariah Board for disbursement to any charitable institute

ISLAMIC UNIT TRUSTS

- An open-end collective investment that invests its pooled fund in Shariah-approved equities, bonds and money market including direct business ventures, unquoted securities, etc.
- Therefore, stock screening process and criteria (as discussed above) is very important

Islamic Unit Trust Funds must be “True-to-label”

The fund is managed and administered in accordance with Shariah principles.

**Shariah
Committee/Adviser must**

- **Provide expertise and guidance in all matters relating to Shariah principles**
- **Consult with the SC**
- **Scrutinise the fund's compliance, interim and annual reports**

Shariah Construction of Islamic Unit Trust

- The legal relationship between the management and the investor can be that of:
 - Agency (wakalah)
 - Commission (ju'alah)
 - Mudarabah
- The legal relationship between the investors among themselves is that of musharakah.

ISLAMIC REAL ESTATE INVESTMENT TRUST

Type of Real Estate Investments

- ◆ **Direct Investments**
- ◆ **Indirect Investments or Real Estate Funds**
- ◆ **Time-Share concept**
- ◆ **Sale & Leaseback funds**
- ◆ **Land Banking**
- ◆ **Real Estate Securities**
- ◆ **Real Estate Investment Trusts (REIT)**

Real Estate Investment Trusts

- Investment vehicle that invests or proposes to invest most of investment in real estate or real estate related investment
- The investors (known as unitholders) pool their money in a common fund that will be used by the Manager to buy property and other authorized investments as specified by certain guidelines which vary from one jurisdiction to another

Islamic REITs

- An Islamic REIT is a collective investment scheme in real estate, in which the tenants operate permissible activities according to the Shariah
- An Islamic REIT must also ensure that all forms of investment and financing instruments comply with the Shariah”

Source: SC Guidelines for Islamic REITs

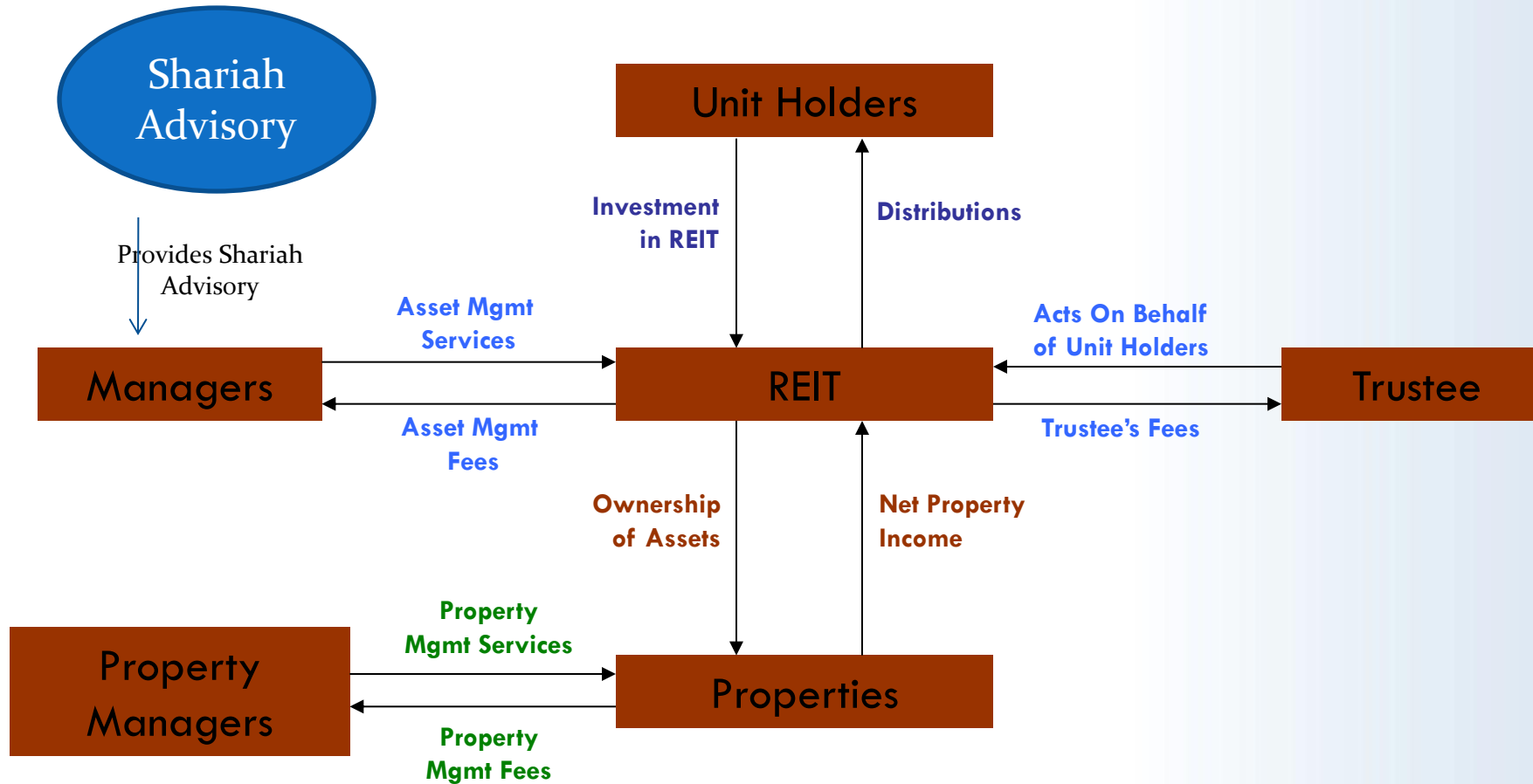
Islamic REIT Vis-à-vis Conventional REIT?

- | | |
|--|---|
| <ul style="list-style-type: none">• Fundamentally – not much difference• Objective, administration and structure of an Islamic REIT – very similar to Conventional REIT• Key difference – how the incomes of the Islamic REIT are derived and how the fund is being managed, e.g:<ul style="list-style-type: none">• type of tenants; and• proportion of rental income derived from the tenants | <ul style="list-style-type: none">• Islamic REIT – tenants in a property acquired must operate in businesses that comply with Syariah principles• Conventional REIT – no such requirement• Islamic REIT – fund must be managed in Shari`ah compliant manner• Conventional REIT – no such requirement |
|--|---|

Structuring And Managing Islamic REITs

- The structuring of Islamic REITs will be the same like the conventional REITs except for the Shariah Guidelines and principles that must be followed in:
 - 1) Contracts and principles used.
 - 2) Managing the REITs:
 - Utilization of the real estate must be Shari`ah compliant, including tenancies & sub-tenancies
 - Financing of the acquisition / development of the real estate should be Shari`ah Compliant
 - Investment of cash / liquidity must be made in Shari`ah compliant instruments
 - Insurance scheme for protecting the real estate should also be Shari`ah compliant

Simplified Structure



GUIDELINES ON ISLAMIC REITs

- On 21 November 2005, SC further released the Guidelines for Islamic Real Estate Investment Trust, in an effort to facilitate further development of new Islamic capital market products.
- The first Islamic REITs Guidelines in the world
- An Islamic REIT must comply with both Guidelines – the Guidelines for Islamic REITs (November 2005) & the general SC Guidelines on REITs (January 2005)

Shariah Parameters of i-REITs in Malaysia

An i-REIT investments, operations & management must be monitored, reviewed and approved by the appointed Shariah Adviser. The areas of concern are:

**Rental of
Real Estate**

**Investment,
Deposit
& Financing**

**Insurance/
Takaful**

**Forward sale/
Purchase of
currency**

Shariah Parameters on Rental

- Generally, tenants of a property acquired by an Islamic REIT must operate permissible activities in accordance with Shari`ah principles
- As such, Islamic REITs are not allowed to invest in any activities which are considered non Shariah compliant businesses

Rental from activities considered as non-permissible

- 1. Financial services based on riba (interest);
- 2. Gambling/gaming;
- 3. Manufacture or sale of non-halal products or related products;
- 4. Conventional insurance;
- 5. Entertainment activities that are non-permissible according to the Shariah;
- 6. Manufacture or sale of tobacco-based products and related products;
- 7. Stock broking or share trading in Shariah non-compliant securities; and
- 8. Hotels and resorts
- Other activities deemed non-permissible to Shariah (Ijtihad)

Rental of real estate by i-REITs for business purposes:

- 1) Acquiring real estate with existing tenant(s)
 - Tenant(s) operates permissible activities according to the Shariah
 - If tenants operate non-permissible activities:
 - Percentage of rental from non permissible activities should not exceed 20% of the i-REIT turnover
 - i-REIT is not permitted to own a real estate where **ALL** the tenants operate non-permissible activities even though % of rental do not exceed 20%

Illustration:

TO ABC Trust (Islamic REIT) : RM700,000
Shariah non-compliant rental for XYZ building :

Tenants	Rental (annual)
Gambling outlet	RM2,000 X 12 months = RM24,000
Liquor outlet	RM5,000 X 12 months = RM60,000
Tobacco related business outlet	RM6,000 X 12 months = RM72,000
Total Shariah non-compliant rental	RM156,000

Benchmark for Shariah non-compliant rental : 20% to turnover of Islamic REITs

Calculation : **RM156,000 / RM700,000 = 22%**

Therefore ABC Trust **is not allowed** to acquire XYZ building

Cont'd

- 2) Renting out real estate to new tenant(s):

Shariah Adviser must advise the i-REIT fund manager not to accept new tenant(s) whose activities are fully non-permissible

Cont'd

- Rental by tenants operating mixed activities (permissible & non-permissible activities):
 - Calculation will be based on the ratio of area occupied for non-permissible activities to the total area occupied
 - For activities that do not involve the usage of space, such as service-based activities, the calculation will be based on *Ijtihad* of the appointed Shariah Adviser

Illustration

The calculation for the non Shariah compliant rental (paid by tenant) operating mixed activities

Rental for supermarket : RM12,000 (monthly)

Total area rented out for supermarket : 10,000 sqf

Area allocated for sale of liquor : 1,000 sqf

Ratio of area used for sale of liquor to total area for supermarket :

$$\frac{1,000}{10,000} \times 100 = 10\%$$

Therefore, the rental from non-permissible activities (sale of liquor) is 10% of the total rental paid by supermarket

$$10\% \times \text{RM12,000} = \text{RM1,200 (monthly)}$$

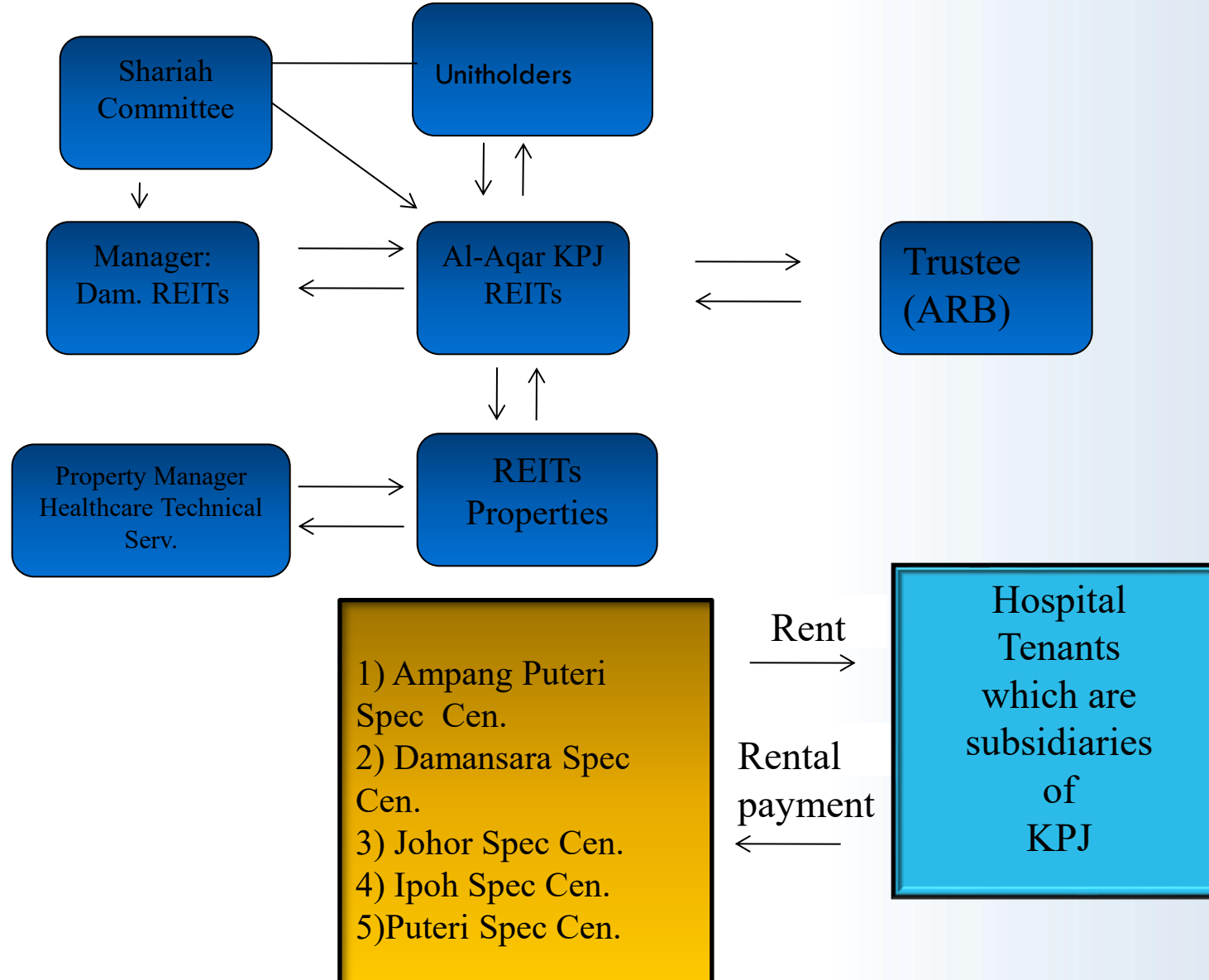
Other

- Investment, Deposit & Financing
- All forms of investment, deposit and financing instruments comply with Shariah requirements
- Insurance/Takaful
 - Takaful schemes to insure the real estate
 - If Takaful schemes are unavailable to provide the insurance coverage, then the i-REIT is permitted to use conventional insurance schemes with the approval from the Shariah Adviser

Cont'd

- Forward Sale & Purchase of currency for risk management
 - Permitted to participate in forward sale and purchase of currency
 - Encouraged to deal with Islamic FIs
 - If the Islamic REIT deals with Islamic financial institutions, then it will be bound by the concept of *wa'd* (only one party is obligated to fulfil his promise/responsibility). The party that is bound is the party that initiates the promise.
 - However if the Islamic REIT deals with conventional financial institutions, it is permitted to participate in the conventional forward sales or purchases of currency.

I-REITs Structure (al-Aqar KPJ REIT)



ISLAMIC ETF

Definition of ETF

- Simply understood as index fund which is traded like stock.
- An open-ended investment fund that tracks a particular index.
- It combines the characteristics of a closed-end fund and that of a share, i.e. it is structured as a unit trust fund with the units listed and traded on the exchange similar to shares.
- However, it differs from share and unit trust fund in many ways as shown in the next slide

ETFs: best of stocks and unit trusts

	ETFs	Stocks	Unit Trust
Nature	Units that represent underlying basket of stocks	Shares	Units that represent underlying basket of stocks
Traded on Exchange	✓	✓	✗
Redemption	Purchases and sales of the funds' shares only take place in the secondary market	Purchases and sales of the shares take place in the secondary market	Redemption with the fund
Diversification	✓	✗	✓
Price Transparency	✓	✓	✗
Traded Through broker	✓	✓	✗
Management Fees	< 1%	0	1-2% for index fund
Brokerage	0.6%	0.6%	0
Sales Charge	0	0	3-5%
Cash settlement	T+3	T+3	Upfront

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Types of ETFs

- From the perspective of the underlying:
 - Equity ETFs
 - Fixed Income ETFs
 - Commodity ETFs
 - Currency ETFs
 - Multi-asset ETFs
 - Alternatives ETFs
 - Sustainable ETFs

- From the perspective of Investment Strategies:
 - Common ETFs
 - Leveraged ETFs
 - Inverse ETFs

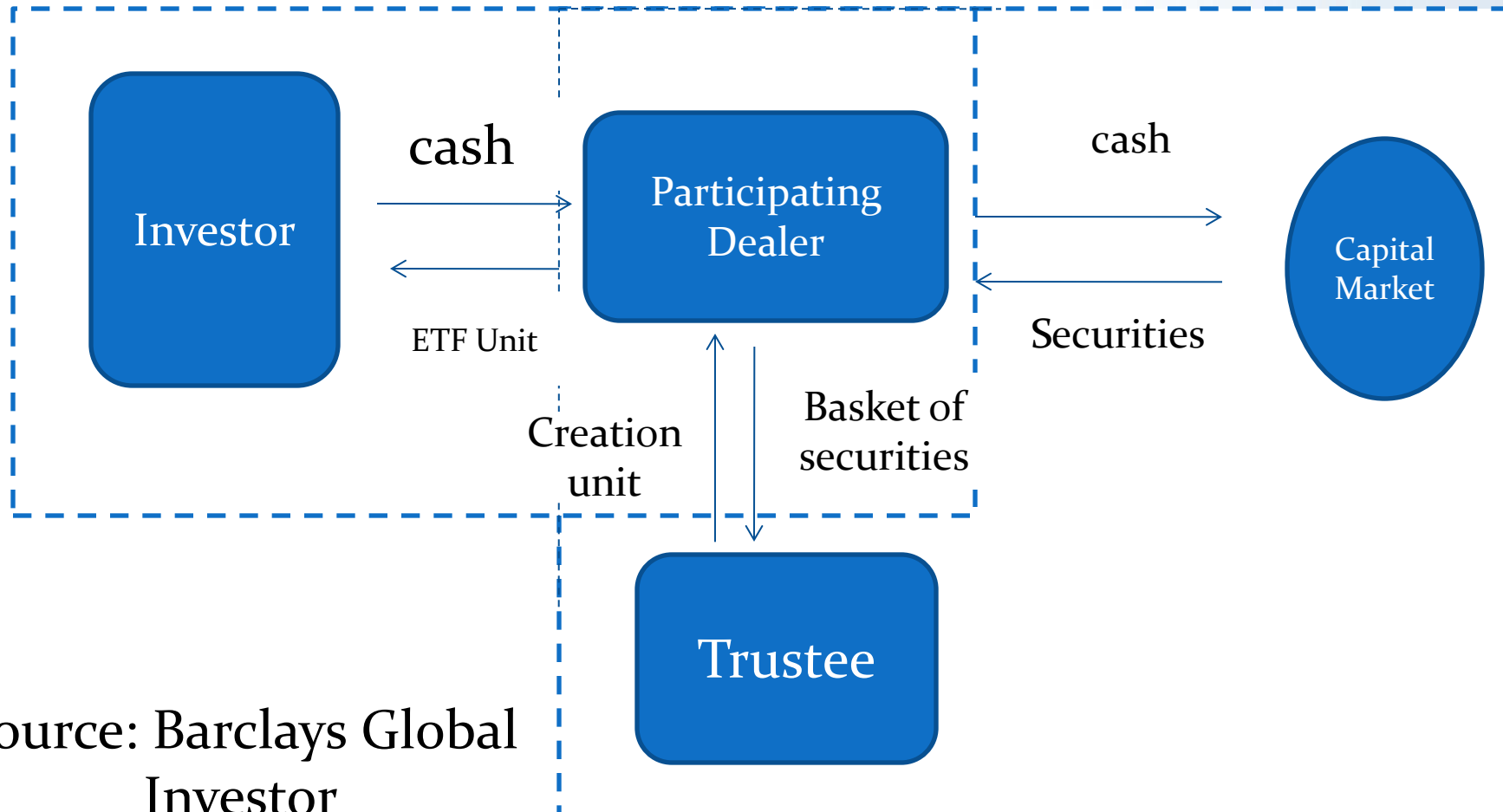
Shariah Analysis on In-kind Practice

- The unique feature of ETF, from Shariah perspective on ETF is on the In-kind creation and redemption practice.
- A further scrutiny to the creation and redemption in-kind is not a sale contract. It is just about unitising the basket of share into creation unit

Cont'd

- Hence, ETF unit is in fact representing the index basket valued at certain price.
- Therefore, when these units are sold on secondary market, they are in fact representing the value of the index basket.
- What if the NAV is different from the price of the unit. Is it allowed to sell the unit different from its NAV?

Primary Market vs. Secondary Market



Source: Barclays Global Investor

Shariah Issues in ETFs

- How to classify ETFs, as a share or a fund?
- What are the Shariah implication on this?
- Should we allow ETFs which have not explicitly disclosed that they are meant to be Shariah compliant?
 - Should we treat it as shares?

Future Trends and Issues

- ESG, SRI → FTSE for Good (Islamic), Arabesque
- AI, Digital, Fintech & Algorithm based investing
- Carbon Trading Funds & ETFs
- Crypto Fund and Crypto ETFs.
- Should we allow for Islamic funds to invest indirectly in non-Shariah compliant underlyings? E.g:
 - Non Shariah compliant leasing funds
 - Credit funds- Trade finance funds
 - Credit Mortgage funds
 - Mixed underlyings

Key Challenges in Islamic Funds

- Sufficient regulation in many jurisdiction
- Time to market
- AI, Digital, Fintech, Algorithm based investing
- Disclosure & Customer protection.
- LOLA & launching by non market operators
- Human Capital
- Higher Transaction Cost
- Smaller Universe: e.g: ETFs.
- Returns vis-à-vis conventional

Thank you very much
WASSALAM