

Shariah-compliant funds: A whole new world of investment*

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Introduction

The concept of Shariah-compliant investing goes back four decades and yet the sector has only really taken off in the last five years.

A number of structural and behavioural changes in Islamic countries have produced this take-off and the probability is that the sector will now go from strength to strength.

Many asset management firms are currently sizing up the opportunities and this paper aims to help them deepen their knowledge of the sector, understand current developments and navigate through the main challenges of creating a Shariah-compliant fund range.

Written by PricewaterhouseCoopers¹ experts from around the world, this is the third paper in a series aimed at briefing mainstream financial services companies about opportunities in Islamic finance.

¹ PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal identity.

Overview

Why target the Shariah-compliant funds sector?

Muslims represent nearly a quarter of the world's population and yet less than 1% of financial assets are Shariah-compliant². There seems to be a disconnect here that is likely to be rectified in the coming years. Indeed, the funds industry is growing at 15-20%³ a year already, and this may rise as young Muslim populations and communities start to save for later life and as their investment preferences expand. The impetus for the sector is currently being provided by excess savings from oil, which is held in both government and private hands, but also by wider increases in productivity and prosperity. Opportunities for innovative asset management companies have rarely been better.

The second wave: institutional money on the move

Large sukuk issues in recent years have awakened investor interest and created the conditions for much increased institutional investment. There is now both subtle and overt pressure for institutions to support the sukuk market and this has led pension funds and sovereign wealth funds to look at Islamic investment more closely. The dramatic increase in the takaful market and the dearth of products to service it should also present opportunities for asset management firms.

² This calculation is based on total global financial assets of \$140trn ('Mapping Global Capital Markets', McKinsey & Company, 2009) and \$729bn total assets in the Islamic finance industry ('Islamic Finance 2009', International Financial Services London, February 2009).

³ 'Islamic Investment', FTSE Group, 2008.

Launching a fund range: the rules of the game are not the same

There are a number of specific issues that fund managers need to be aware of before they can enter this fast-growing market. These include: proscribed investments, the necessity of appointing a Shariah board and carrying out an audit, the purification of income, asset screening, and custody arrangements and trading agreements. None of these should pose insurmountable problems if the right expertise is employed at an early stage in the fund's development.

Demand for new products intensifying

The relative immaturity of the sector is evident in the incomplete product set. Although most conventional asset classes exist, some require further development to ensure they are fully Shariah-compliant and viable as investment propositions. So while equities and real estate are well established, fixed income funds suffer from a lack of liquidity and inadequate valuation modelling. Some of the techniques used in hedge and private equity funds are also open to question. But solutions are being developed and market participants that are involved in the development phase of funds are likely to derive significant benefits.

Why target the Shariah-compliant funds sector?

Marketing and distribution: creating a presence

Establishing a brand in the Shariah-compliant marketplace is arguably more challenging than in the conventional sector.

Fragmentation of client groups and geographical markets presents difficulties, as does the lack of standardisation of fund types and regulation.

But the deepening of markets in the Gulf Cooperation Council (GCC) region and Malaysia, combined with the gradual launch of funds in many other jurisdictions – such as Ireland, Hong Kong, Luxembourg and the United States – should lead to greater integration and a more homogeneous global market. In addition, global firms have a first-mover opportunity to exploit a certain lack of credibility that pure play Islamic fund managers have in the eyes of central banks and other large institutions. Recognised brand names are likely to attract substantial assets.⁴

Challenges persist, but sector is maturing

There are a number of structural issues in the industry that only time and persistence can resolve. These include the critical issues of fund costs and valuation of assets. Costs are elevated by the need to appoint and remunerate Shariah boards, the necessity of asset screening and a lack of scale in funds, while valuation is clouded by a lack of liquidity in some instruments. As the sector matures, other issues such as attracting and retaining personnel with the appropriate expertise will become paramount. Asset management firms will need to review and renew their approach as the industry develops.

Perhaps the single most important factor behind the powerful growth of the Shariah-compliant funds industry lies in the simple fact that Muslims represent about a quarter of the world's population.

Yet, at the same time, less than 1% of global financial assets are Shariah-compliant in an era of enhanced religious sensibilities.⁵

This implies a great many first-time investors potentially interested in Shariah products as well as many who have dipped a toe in the water and may be ready to invest more.

The fast-expanding investor base consists of three main groupings. Most of the existing assets are sourced and managed in the GCC and Malaysia. Both represent opportunities for asset management companies, although Malaysia is a well-established and largely self-contained market. The second grouping encompasses Islamic countries or countries with large Islamic populations – such as Indonesia, India and Pakistan – where there is a sizeable, but largely untapped, potential market. After that, Europe and the US, with significant, relatively wealthy Muslim populations are also potentially lucrative markets for

Islamic-compliant product providers. While the number of opportunities is small compared to Muslim-dominated countries, this grouping tends to have high levels of disposable wealth. Banks and wealth managers are starting to launch in the US and Europe to tap latent demand.⁶

Not only is the investor base large and growing, but the types of assets investors are attracted to are also expanding. While assets used to be invested largely in the Middle East region, the economic growth of Islamic countries and the network of business relationships that have developed in recent years have opened investors' eyes to new investment opportunities.

Figures for the growth of the Shariah-compliant asset management industry reveal how quickly this interest is turning into concrete action. The market for Islamic investment products is growing at about 15-20 per cent a year and equity fund assets alone are forecast to jump from \$15bn in 2008 to \$53bn by 2010.⁷

⁴ Evidence gathered from conversations with PricewaterhouseCoopers client base.

⁵ This calculation is based on total global financial assets of \$140trn ('Mapping Global Capital Markets', McKinsey & Company, 2009) and \$729bn total assets in the Islamic finance industry ('Islamic Finance 2009', International Financial Services London, February 2009).

⁶ 'Islamic banks in the United States: breaking through the barriers', *NewHorizon*, April-June 2009.

⁷ 'Islamic Investment', FTSE Group, 2008.

Besides the sheer volume of potential investors, a number of other factors have driven the industry forward in recent years. In the GCC, the demand for oil has produced record sales in the last five years and created large amounts of excess cash. But growth in the region is not predicated on oil alone: significant structural changes have taken place in many countries that have encouraged entrepreneurship and investment. The infrastructure development in many parts of the region in recent years has been little short of breathtaking.

This wave of investment has led to powerful growth in the retail and institutional financial services sector as wealth has trickled down from governments and government agencies to private business owners and individuals. Some of the wealth that has built up in public and private hands has already been deployed in Shariah-compliant assets.

Promisingly, Muslim communities and populations have a high proportion of young people in the workplace⁸ and this group is among the most enthusiastic adopters of Islamic products. This augurs well for the long-term growth of Shariah finance in general and Shariah-compliant funds in particular as this group of new 'baby boomers' starts to save for retirement.

And positive structural changes have helped produce a beneficial economic cycle in the region. So while the International Monetary Fund predicts a contraction in the global economy in 2009, growth in the MENA region is forecast to be a healthy 2.6% in 2009 and 3.6% in 2010.

Alongside this huge potential demand, there is a dearth of suitable products, as demand for well-managed and genuinely compliant products outstrips supply.

The global financial crisis has proved a setback for asset gatherers of all kinds in all marketplaces, but it is possible Shariah-compliant funds may derive a long-term benefit.

Conventional Western funds are less trusted by some investors after their managers failed to stem losses, and it is likely that more money will be invested with local institutions. Some of this will undoubtedly flow to Shariah-compliant funds.

Although growth was slow to take off in Shariah-compliant funds in the 1970s and 1980s, the industry has produced a commendable annualised growth rate of 26% per annum⁹ in terms of the number of funds launched over the last decade. An inflection point can be observed between 2002 and 2003. There are multiple reasons for this, both tangible (an increase in petrodollar liquidity, an investment shift favouring reinvestment in the GCC, as well as maturing capital markets) and intangible (customers' greater understanding and acceptance of the products, and a generational change in terms of market participants).

The exact size of the industry is not clear since many funds are distributed by private placement. But we do know that funds are being launched across the globe by a wide variety of fund providers as Islamic populations and Islamic communities in non-Islamic countries begin to make their purchasing power felt. There is ample reason to believe this trend will continue.

⁸ The World Bank estimates that India and the other South Asian countries will be the second-largest suppliers of migrant labour by 2050 with, respectively, an increase of 68 million and 89 million people in the labour force of those between the ages of 15 and 39. In the Middle East and North Africa (MENA) region, the increase in the labour force in the same age group is estimated to be 44 million.

⁹ 'Key Trends in Islamic Funds', EurekaHedge, June 2008.

The second wave: institutional money on the move

Shariah-compliant funds have a long history. They first appeared in the late 1960s in Malaysia and in the mid-1970s in the Middle East region.¹⁰ Their creation was driven mainly by individuals, who were attracted by the idea of faith-based investments.

High net-worth individuals (HNWs) were among the early adopters, and this group still has a high propensity for Islamic products today. Since the size of this group is forecast to grow faster in the MENA region than elsewhere, this bodes well for Islamic investing.¹¹

Institutional investment, which dominates inflows into the conventional fund sector, has been relatively slow to follow. However, there is now strong evidence that institutions – such as sovereign wealth funds, central banks, pension funds, takaful, wealth management firms and private banks – will provide a second wave of investment in the sector. They are led by governments, which have launched a number of recent sukuk issues: Indonesia launched a \$650m sukuk in April 2009; Singapore had a \$200m issue in January and nearly \$14.9bn in total was issued in 2008. This includes issues from public sector entities and from a small number of private companies. So there is subtle political pressure to support these issues and increase their liquidity. Therefore, public pension funds and endowments are starting to invest in Shariah-compliant funds. For similar reasons, sovereign wealth funds – whose main non-financial investing criteria used to be ethical investing – are also sizing up the opportunity.

Takaful companies are also a potential driver of future growth. Moody's predicts that global takaful premiums will rise to \$7bn by 2015.¹² The market now comprises some 130 companies¹³ in both Muslim and non-Muslim

(including Western) countries. Takaful insurers are required to invest in Shariah-compliant products where possible. With the dearth of short-term Shariah-compliant assets, however, many takaful insurers are forced to invest in conventional assets in order to meet the regulatory constraints of the countries they are domiciled in. The opportunity to attract these assets is clear.

Governments have not always been so helpful in promoting Shariah investment. Kuwait, for instance, did not permit the licensing of Islamic products until 2004.¹⁴ So changes that have taken place at government level are significant.

In short, there is growing pressure for banks, insurers, pension funds and sovereign wealth funds to include Shariah products in their portfolio mix. Asset management firms that can offer them not only gain entry to a high-growth market, but also gain a foothold in a new region into which conventional products may also be sold.

At the same time, they will be able to meet demand from non-Islamic investors for Shariah-compliant funds. This category of investor is interested in gaining access to some less accessible geographical markets that are not covered in the conventional fund universe, but which may offer substantial growth potential.

¹⁰ http://www.usc.edu/dept/MSA/economics/islamic_banking.html

¹¹ '12th Annual World Wealth Report', Merrill Lynch and Capgemini, June 2008.

¹² 'Middle East Insurance set for continued expansion', Moody's, Feb 2008.

¹³ 'Islamic Finance Outlook', Standard & Poor's, April 2007.

¹⁴ 'Islamic Banking: a unique differentiation strategy for Gulf', Standard & Poor's, November 2004.

Launching a fund range: the rules of the game are not the same

As we have seen, the market environment is potentially beneficial for Shariah-compliant funds and the prospective client base is expanding. Many asset management firms are now launching, or planning to launch funds.

This process does, however, involve increased complexity vis-à-vis the creation of a conventional fund. The fund promoter needs to acquire knowledge of Shariah law, of the processes involved in appointing a Shariah board, and a number of other issues. And, as is often the case with a young and growing industry, the rules and regulations are often ill-defined and require a skilled hand to navigate. But those firms that persevere and come to terms with the complexities are likely to be well rewarded.

Proscribed investments

A Shariah fund must ensure that the underlying businesses in which it holds securities are Shariah-compliant. A Shariah fund's offering document will spell out the Islamic-based investment restrictions. The fund may not invest in any businesses whose underlying activities are involved in any non-halal items. The investment manager of a Shariah fund cannot, for example, include any companies involved in the following sectors:

- Alcohol;
- Tobacco;
- Pork;
- Adult entertainment industry;
- Gambling;
- Weapons;
- Conventional banks and insurance companies.

In addition, a Shariah fund may not invest in interest-bearing instruments. It may not invest in conventional derivatives (although there is ongoing debate over this)¹⁵ and may not sell short. These restrictions will clearly impact certain strategies.

¹⁵ 'Derivatives in Islamic Finance', Andreas Jobst, *Islamic Economic Studies*, Vol 15, No 1, September 2007.

Shariah boards

Shariah funds must also appoint a Shariah board to provide guidance to the directors of the fund and to the investment manager on matters of Shariah law and, in particular, whether the proposed investments of the fund are Shariah-compliant. This is often not a simple matter because different scholars hold sway depending on the jurisdiction. It is important for the branding of the fund to select the appropriate scholar. In essence, this selection is part of the marketing mix. For new or sophisticated types of funds, the best-known names are often sought. But with just 20 or 30 well-known names worldwide, obtaining access to them can be problematic. However, if a firm is launching a vanilla equity fund, the selection of scholars is less critical since the underlying securities are less likely to prove controversial.

There is a minimum of three and sometimes five scholars on a board. Scholars don't always agree, as there are many different schools of thought within Islam and each has distinct viewpoints on Islamic principles. However, these differences are resolvable within the fund context and are unlikely to impede the growth of the industry overall. Another challenge is that of language, as many Middle Eastern scholars work solely in Arabic while the global marketplace requires scholars fluent both in Arabic and Western languages such as English or French.

Shariah audit

Shariah-compliant funds have to be audited on an annual basis to ensure that they are adhering to Shariah principles. The audit is carried out either by the scholars or an outside party, although best practice leans towards the latter because of the perceived conflict of interest. Indeed, some investors have started to question if potential conflicts of interest may impact the integrity of the assets and the whole fund strategy.

Purification

Income generated by a Shariah-compliant fund must also be 'purified' as it is often unavoidable that some of the income generated by the underlying companies in which a Shariah fund invests will include some form of non-halal income such as interest.¹⁶ The Shariah board's input is again necessary in determining the types of income that need to be purified. The amounts purified should, under Islamic finance principles, be donated to charity. There are a number of different ways to purify 'tainted' income. One way that purification is achieved in the funds industry is where fund administrators calculate a Shariah-compliant net asset value (NAV), where the proportion of non-Shariah-compliant income is determined at each valuation point. This non-compliant income is then disbursed to an Islamic charity that has been chosen by the investment manager and approved by the Shariah board.

¹⁶ 'Understanding Islamic Finance', Muhammad Ayub, John Wiley and Sons 2008.

Screening

Securities screening is a further issue. It is important for all funds, but a particular issue for index funds that invest in large numbers of securities. The aim of these funds is to make the process systematic so that mistakes are avoided and resources conserved. Much resource is currently being devoted to developing a global automated system. The challenge for such a system is that all stocks are deemed non-compliant until proven otherwise. Screening methodology and processes need to be transparent and auditable if they are to be accepted by the Islamic community. Quantitative methods are often used to analyse a wide range of business and financial variables affecting Shariah status, ranging from the company's issuance of preference shares to its holding of derivatives instruments. The second stage usually involves the manual analysis of a firm's accounts and reports where the financial data providers give insufficient information. With so many variables and so many possible methodologies for assessing them, the issues are far from clear-cut and some screening methodologies exclude companies that others would allow. Is it acceptable, for instance, for an airline to earn 2% of its profits from selling duty-free alcohol to passengers?

Custody

Although the custodian of a Shariah-compliant fund does not itself need to operate along the lines of an Islamic bank, it must service the Shariah-compliant fund without violating Shariah principles. Funds are not allowed to receive interest offered by time deposits or to enter into repo contracts. So the assets must either be placed in a non-interest-bearing account or in a commodities contract with a bank. This involves a simultaneous purchase and sale, which allows the fund to earn a return.

Custody issues are complicated by the lack of shareholder registers for many Shariah-compliant securities. In the post-Madoff era, custodians are wary of being held legally responsible for assets of which the existence is not completely assured. This demands an innovative approach to the fund-custodian relationship.

Trading

Similarly, in the case of a failed trade, an interest charge would normally apply to the client in a conventional fund structure. But this cannot take place in Shariah finance, so an alternative process is required, such as the imposition of a fee.

Demand for new products intensifying

A full set of products has yet to be launched in either the retail or institutional marketplaces. This is because techniques are still at a relatively early stage and many products are still in development.

This is an opportunity for asset management firms to enter the market at this early stage and help to develop new products that could drive the sector to greater heights. The types of products available mirror, unsurprisingly, those in the conventional fund market.

Real estate is a significant part of asset allocation in the Islamic world and accounts for some of the largest Shariah-compliant funds. Some real estate funds are structured as company vehicles in which shareholders can participate. These are seen by some firms as a simpler and more effective way to attract investors. It is hard to predict with certainty which products could take up the slack if real estate suffers a prolonged slowdown. We may see investment funds putting more emphasis on commodities, for example.

As recovery (and possibly inflation too) gets underway, equities may also return to favour. Equity investment represents over half of the total of all Shariah funds already and this may rise.

This, in turn, may give a boost to the growing exchange-traded funds (ETFs) sector, which seems to have been less troubled by the recent global financial crisis than many other sectors. Although asset values have fallen as a result of falling markets, new money continues to pour in. This is mainly due to the fact that exchange-traded funds have high transparency, low costs, high liquidity and high risk diversification. They are also tax efficient. ETFs are small in terms of assets but have made significant inroads and there are now over a dozen available. Indexation is an area that will see further growth as there has been a wide array of sector- and country-specific indices developed recently (from many of the major index providers).

Fixed income, a staple of the conventional fund space, is immature in the Shariah context, mainly because there are so few sukuk issues. In fact, money market funds are in greater use than fixed income funds. There is also a lack of clarity about the duration of instruments in some Shariah-compliant fixed interest funds. Funds often invest in a wide range of maturities, with no clear information for investors on the overall aims of the fund.

Private equity is emerging as a viable vehicle but there are issues concerning carry that have not been entirely resolved. In mainstream private equity funds, a fund manager is paid a fee on the committed capital and also receives a performance fee. This cannot apply under Shariah law, but other fee structures are available and the private equity model is starting to gain traction.

For example, in the US, large private equity funds are currently showing an interest in creating platforms that will appeal to both Western and Islamic investors, while meeting stated internal rates of return and hurdle rates on returns.

Hedge funds are probably the most controversial fund structure of all. In fact, opinions range from total opposition to the concept of a hedge fund under Shariah law to those who believe not only that hedge funds are legitimate but that most strategies are admissible. Reports suggest that just a small handful of single strategy funds have actually been set up. Those hedge funds that do exist do not disclose their short-selling methods (where employed), so doubts over their credibility remain. Short-selling is a difficult technique in a Shariah fund and, unlike for conventional funds, represents intellectual property – a competitive edge in itself. In general, scholars will only agree to short-selling if it is clear that the fund is merely mitigating risks – and this is hard to prove. However, using constructive thinking, a number of promoters have been able to develop hedge funds in partnership with Shariah scholars that offer effective investment techniques while abiding by Shariah law.

Marketing and distribution: creating a presence

In the conventional funds market, a number of firms have been successful in creating recognisable brands with global reach.

In the Shariah-compliant fund market few, if any, firms have managed to overcome the challenges in launching and sustaining a widely recognised brand. Any firm achieving this would undoubtedly lay claim to leadership in the sector.

The obstacles lie in the fragmented nature of the markets and the lack of standards and regulation that would enable funds to be distributed across borders and to be readily comparable to investors.

There is, for instance, as yet little real segmentation between retail, high net worth and institutional funds. Fund structures are loose – and it is not always clear if a fund offering is in fact a joint venture (Musharaka) created by a bank or a pooled fund.

A handful of very large real estate funds exist, but creating a large fixed income fund for distribution across a region would be troublesome because of the sparse secondary trading in sukuk issues.

Distribution across borders is further complicated by the differences in interpretation of Shariah laws between the different Islamic schools. Where there are major differences of interpretation between countries, separate funds with bespoke Shariah boards may be needed to meet investor requirements in those countries. In the Middle East, for example, securities regulations vary from one Emirate to the next. There are some nascent industry bodies – such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) – but large entrants to the industry will need to become active in the development of these bodies to further the standardisation that is necessary for the industry to continue to flourish.

Until that happens, funds will tend to be launched on a country-by-country basis to serve local marketplaces. Currently, about 40% of funds are domiciled in Saudi Arabia (18%) and Malaysia (22%).¹⁷ Malaysia is the only country with a robust unit trust industry, following the creation in the 1970s of a national unit trust for indigenous people. It has also developed industry infrastructure, such as the Shariah Advisory Council (SAC) established by the country's Securities Commission. Its screening criteria are applied to the FTSE Bursa Malaysia EMAS Shariah Index.

Middle East states such as the UAE and Saudi Arabia also have thriving fund sectors, but infrastructure is far from complete. A host of new entrants, such as Singapore, Indonesia, Bahrain, Hong Kong and Pakistan, have also launched offerings, and Luxembourg and Ireland started Islamic fund listings in 2007 and 2008. The listings in Luxembourg and Ireland follow the enthusiastic take-up in Europe of a number of sovereign sukuk, which have stimulated interest in Shariah-compliant products. And in Hong Kong, the government will this year submit a proposal clarifying the arrangements for stamp duty, profits tax and property tax on Islamic products to facilitate their expansion.

In addition, a number of asset management companies in India are launching Islamic mutual funds in 2009. The Securities and Exchange Board of India (SEBI) is still concerned over a few issues, such as the conduct and the screening process of these funds, but this should not impede the launches. There are also strong capital flows into the MENA region from Islamic investors.

This spread of activity and the growing synergies between the various regions bode well for the eventual integration of the industry globally.

By way of evidence, firms are already starting to use Malaysia as a hub to serve the south-east Asian market. A number of Kuwaiti funds have been licensed in Malaysia to sell funds, mainly to HNWs. Singapore is also looking at the opportunity; for example, an Islamic ETF has gained a listing in Singapore.

There is also the potential to build upon structures that have been developed in the conventional fund world. A number of Shariah-compliant funds have been created as Undertakings for Collective Investments in Transferable Securities (UCITS) products, for instance. UCITS is a strong retail brand, which was developed in the EU but is recognised throughout the world – with the current exception of North America. But funds need to convince the European regulator that the underlying securities are sufficiently liquid, which is not always the case. Also, in the Middle East, equities in some jurisdictions cannot be owned by outside investors so a foreign-domiciled fund cannot own them directly. However, there are methods to overcome this, such as the use of swaps, which are permissible under some schools of thought, and capital guaranteed notes.

As synergies are created and the shape of the industry comes to resemble more closely the conventional fund sector, so existing asset management brand names are likely to come to the fore. One of the main reasons for this is that central banks and other large institutions have indicated that some existing Islamic funds and fund providers lack credibility.¹⁸ While pure play Islamic houses are sometimes ahead of the game in terms of local knowledge and religious principles, there is some doubt over their ability to run funds on a large scale with all the incumbent infrastructure. Existing brand names, many of which are headquartered in the US and Europe, have developed systems, processes and practices that are more consistent with the needs of large, sophisticated institutions. Increasingly, they are likely to leverage their brands to market themselves to such large investors and, potentially, attract the lion's share of new assets flowing to the sector.

¹⁷ Key Trends in Islamic Funds, EurekaHedge, 2008.

¹⁸ Evidence gathered from conversations with PricewaterhouseCoopers client base.

Challenges persist, but sector is maturing

As would be expected in a young industry, a number of structural issues remain that asset management firms and their clients alike need to recognise and address.

Two of the most critical revolve around the cost of running funds and the difficulty of valuing assets.

Concerning fund costs, there are few relevant studies to date on the Islamic fund universe, but anecdotal evidence suggests that Shariah-compliant funds add single-digit basis points to the cost of funds. The costs relate partially to the setting up and financing of Shariah boards. The best-known scholars can receive total compensation in the millions of dollars per year – a cost that the conventional fund industry does not have to bear. The screening process can also be expensive, depending on the type of asset the fund invests in. In addition, the lack of scale in many funds magnifies the effect of costs.

However, the impact of such costs should start to reduce as the average fund size increases and economies of scale are found across the industry.

Valuation issues centre on the fact that not all issues trade on secondary markets, particularly in the fixed income sphere. In that case, it is hard to evaluate what represents true and fair value. There is certainly an opportunity for innovative investment firms to develop new models to help resolve this issue.

However, as time goes on and the markets become deeper and more liquid, a solution should automatically present itself.

Equally, as the market develops and products expand, there will be increased demand for human resources, for people with key skills. At the same time, specific Islamic expertise – while still important – is likely to become subordinated to investing and business expertise as the sector matures. People skilled in sales, back office and product development will be in demand, just as they are in the conventional fund space. The ability to attract and retain such people is already becoming a key issue.

Conclusion

It can be argued that the challenges in launching and developing a Shariah-compliant fund business mirror those in conventional asset management.

However, the solutions can sometimes be different and there is no substitute for experience in this market.

For asset management firms with ambitions to enter this new, high-growth market, the market environment has rarely been as enticing. New customers are continually coming on stream, structural issues are being resolved and products are evolving rapidly.

The challenges are considerable in Shariah-compliant funds and the pace of change is appreciable. But the ride is likely to be exciting for those participating, and the rewards highly attractive.

How PricewaterhouseCoopers can help

This paper has identified and explained a number of issues for asset management companies to consider when entering or expanding in the Shariah-compliant funds market.

PricewaterhouseCoopers has a diverse team of specialists with wide-ranging experience in helping asset management companies, administrators and custodians establish and develop businesses in the Shariah-compliant funds sector. We can offer the global resources of one of the world's largest networks of Islamic fund experts, with centres of excellence in Malaysia, the Middle East, Europe and the US.

We have significant experience on advising on launches of Islamic fund structures, including equity, sukuk, murabaha, mudharaba, salam/hedge funds, Islamic exchange-traded funds and funds of funds. Our tax specialists can advise on the most appropriate tax structure for each fund type.

For fund promoters we can offer guidance on eligible investments under Islamic principles and the monitoring of investment restrictions. We help companies create Shariah boards and help them monitor Shariah compliance function effectiveness. Advice is also available from our experts on the purification of non-Islamic income, cash management and the custody of Islamic assets. As companies start to develop their fund ranges, we can offer staff training on Shariah principles.

For administrators, we can review the existing administration cycle of funds in order to identify gaps and to implement changes required to be within the scope of Shariah precepts, covering custody, cash management, fund accounting, financial reporting, trustee/fiduciary oversight, transfer agency, ancillary services and Shariah board support.

PricewaterhouseCoopers is committed to bringing the best knowledge to asset management organisations across its global network. We resource projects with specialists from our local offices within the PricewaterhouseCoopers network of firms to match the needs of our clients. This ensures that organisations obtain local expertise and the benefit of our market-leading asset management expertise across the globe.

Glossary

Shariah: Islamic law.

Shariah board: A panel of Shariah scholars that approves proposed new products and also reviews the operations of the company to ensure that its activities have been conducted in a Shariah-compliant manner.

Halal: Anything that is allowed in Islamic law.

Sukuk: The Islamic equivalent of a bond.

Takaful: The Islamic approach to insurance based on mutual principles.

Mudharaba: A partnership between an entrepreneur who contributes labour and one or more capital providers. Profits are shared, while losses are born only by the capital providers.

Musharaka: A form of partnership under Islamic law.

Murabaha: A sale where the seller expressly mentions the cost he has incurred on the asset to be sold and sells it to another person by adding a profit or mark-up which is known to the buyer.

Salam: Advance payment for goods to be delivered at a specified future date.

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