UNDERSTANDING ISLAMIC INSURANCE AND INVESTMENTS (IFB103x)

Islamic Financial System

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Introduction

The Islamic *Takaful* System-Part 1.
Insurance is a risk-sharing arrangement between an individual and an insurance company. The insurance company, or the insurer, agrees to indemnify the individual, or the policyholder, against certain losses specified by a contract, or the policy. Insurance is a monetary medium through which individuals and organizations transfer risk, or ambiguity about monetary loss, to others.

Several misconceptions exist against the benefits of insurance. One of them is that Muslims should live in a state of *Tawakkul* or total dependence on *Allah* (***Subhanahu wa ta'ala***) and therefore, seeking insurance or protection from risk is considered unsuitable for a Muslim. This is a false impression because an insured person does not seek to change the Will of *Allah* (***Subhanahu wa ta'ala***). According to Islamic law, every individual should take precaution and then fully depend upon the *Almighty Allah* (***Subhanahu wa ta'ala***), thus, Islamic law permits individuals to seek ways of reducing risk. Therefore, Islam is not against insurance but only against conventional insurance.

On completing this chapter, you will be able to:

- Explain the three objections of Islamic scholars against conventional insurance,
- Explain why a *Sharī'ah*-compliant model for insurance evolved,
- Explain the concept of *Takaful*, a form of cooperative insurance, developed in Islamic finance,
- Explain the *Sharī'ah* basis for the *Takaful* system and
- Distinguish between *Takaful* and conventional insurance.

Islamic Appraisal of Conventional Insurance

Sharī'ah scholars have several objections against conventional insurance. Conventional insurance involves *Maisir, Gharar* and *Ribâ*. The *Sharī'ah* strongly prohibits these three elements. Let us discuss these elements in conventional insurance.

Maisir

Maisir means wealth obtained by chance and wishing for something valuable without working for it; this resembles gambling. Insuring for profit is considered to be in the nature of betting, which is equivalent to gambling. The *Sharī'ah* forbids *Maisir* or gambling.

However, conventional insurance is different from gambling due to the "insurable interest" aspect. Here the policyholder must possess an insurable interest in his subject matter or at least expect to acquire insurable interest. This helps in preventing the use of the insurance as a tool for gambling.

One of the reasons why the *Sharī'ah* forbids *Maisir* is because it involves one party's unjust enrichment at the cost of the other. Conventional insurance involves the same kind of unjust enrichment for the insurers because companies make huge profits if the insured event does not happen and policyholders are not the same as the shareholders. Therefore, the *Sharī'ah* forbids conventional insurance.

Unjust enrichment is less in a mutual insurance company. Here, the policyholder themselves own the organization. This kind of mutual insurance company is permitted only because the model minimises the possibility of unjust enrichment.

Gharar

Gharar means risk, uncertainty, and hazard. The Islamic framework permits some degree of *Gharar*, but excessive *Gharar* is prohibited. *Gharar* occurs due to insufficient knowledge or lack of adequate and accurate information regarding the contract. Let's see how.

Conventional insurance involves *Gharar* because there is often a fair chance that the contingent event may not occur, leading to the policyholders losing their premium amount.

Gharar also exists because:

- The insurer does not know how much the policyholder will claim in future.
- The policyholder does not know whether he will actually receive any benefits indicated in policies from the insurer.

It may be said that the policyholder purchases "peace of mind" through insurance, so the *Gharar i*ssue is not relevant. The insurer is not only paying claims against the insured subject matter, but also covering the assured entity when the policy period begins or when risk becomes applicable.

Conventional insurance is prohibited, because it involves uncertainty and is viewed as a pair of buy and sell contracts between policyholders and insurers. However, mutual insurance is permissible, because the policyholders are the owners of the organisation, thereby avoiding some objections applicable to conventional insurance.

Ribâ

Ribâ means interest. Prohibition of *Ribâ* is fundamental to Islamic financial ethics and law. In conventional insurance, the policyholders expect a pre-determined amount, which is excess than the invested. This excess amount is considered as *Ribâ*; the *Sharī'ah* prohibits this indirect involvement of *Ribâ* in insurance.

Insurance is permissible if:

- The insurer provides profit shares rather than fixed profit and
- The insurance companies change the nature of investment to be *Sharī'ah*-compliant.

The Need for *Sharī'ah*-Compliant Insurance

In the First International Conference on Islamic Economics held at Makkah in 1976, it was decided that the insurance for profit is contrary to *Sharī'ah*. However, nowadays it is necessary to insure the life or property of individuals, organisations and societies against losses. The only restriction is that the insurance schemes should exclude elements prohibited by the *Sharī'ah*.

The chief objection against conventional insurance under the *Sharī'ah* is *Maisir*. The *Fiqh* Council of the Muslim World League therefore introduced a concept of "cooperative insurance".

- People involved in similar businesses contribute their funds for a specific period in the schemes of cooperative insurance.
- If anyone suffers specific losses due to unanticipated events, then that individual can be compensated from those funds.
- After the specified time, the remaining money will be distributed to members in proportion to their contribution.

In this scheme of insurance, the element of profit is absent, making this acceptable under the *Sharī'ah*.

The Concept of *Takaful Ta’awuni*

Islam permits insurance when it is contracted under *Takaful* or mutual guarantee and *Ta’awun* or mutual cooperation. *Takaful Ta’awuni* or Islamic cooperative insurance is an alternative insurance contract for Islamic people, which does not involve the buying and selling of protection.

Under this contract, a group of people with common interests contributes their funds to guarantee or protect against misfortune. Thus, the concept of *Takaful* is based on unity, responsibility and brotherhood among participants. Therefore, the *Fiqh* Council of the OIC approved the use of *Takaful* system for insurance in Islamic finance.

In practice, however, most *Takaful* covers are provided not through cooperatives or through mutual insurance but by companies.

Takaful functions as follows:

Participants contribute their funds as donation or *Tabarru* in *Takaful*. Financial assistance is given to the participant who suffers any mishap. After the *Takaful* benefits are paid, the surplus money is returned to the participants.

The *Sharī‘ah* permits this form of insurance based on the following reasons.

- In this contract, *Maisir* and unjust enrichment is absent.
- The donated fund belongs to the participants and no one can enjoy the funds at the cost of the other participants.
- The transaction is transparent and there is no element of *Gharar*.
- In this contract, there is no possibility of *Ribâ*.

The *Sharī‘ah* Basis for *Takaful*

Takaful is an ancient concept in Islamic commercial law. Islam accepts the right of individuals to protect their religion, life, dignity, honour, property and talent.

The following practices were present in early Islamic Arab society.

- *Aqilah* - Meaning kinsmen; according to this contract, people shared their responsibilities. Ancient Arab tribes practised this contract and the holy Prophet (peace be upon him) approved it.
- *Qasamah* - A contract in which an oath is taken from the kin of the person murdered.

- *Mawalaht* - A contract in which a person donates his property to another in return for paying any debts after the former's death.

Aqilah was established during the early second century of the Islamic era when the Arabs were expanding their trade into Asia. During that time, the Arabs and Asians contributed funds to help anyone in the group affected by any mishap or attacked by pirates.

According to contemporary jurists, *Aqilah* is the foundation for *Takaful*. In an *Aqilah* contract, during a natural calamity, everyone in the society should contribute some amount to relieve people from the disaster. The collected money is then distributed to the families in trouble. The same principle is applied in the *Takaful* contract. Islam accepts *Takaful* because this contract involves reciprocal compensation and joint responsibilities.

Takaful vs Conventional Insurance

Though *Takaful* is a form of insurance, it is different from conventional insurance. Let us discuss the differences.

Motive and Ownership

The motive of conventional insurance is based on profit. In conventional insurance, the policyholders expect more return for their investment. The shareholders own the insuring company.

The motive of *Takaful* is based on community welfare and protection. The insurer is called the *Takaful* operator. He will receive compensation, either through shares in return for investment of funds or by means of agency fees. The policyholders are the owner, and the *Takaful* operator acts as an agent manager.

Profit

In conventional insurance, the profit of the insurer comes from the underwriting surplus and investment income. The underwriting surplus is the difference between the total premium received and the benefits paid to policyholders. The management of the insuring company distributes the profit. This causes a conflict between shareholders of the insurer company and the policyholders.

In *Takaful*, the operator has no claims in underwriting surplus. The *Takaful* operator specifies in advance the time and manner of profit distribution. There is little chance for conflict between the interests of the policyholders and the shareholders of the operator company.

Legal Source

The laws and regulations of conventional insurance are made by human beings.

The laws and regulations of *Takaful* are based on divine revelations.

Options for Policyholders

In conventional insurance, the policyholders have a choice to choose the profit motive. The policyholders may choose original cost or replacement cost based on valuation of property and claim.

In *Takaful*, the policyholders cannot expect profit from the insurance company. They can only get compensation for rebuilding, repair or replacement.

Investment Rights

In conventional insurance, the insurer decides the time and manner of investment of the premiums. In the investment; policyholders are not involved at all. Therefore, the investment involves *Ribâ* and *Maisir*, which are prohibited.

In *Takaful*, the contract specifies to policyholders how and where the premiums would be invested. Therefore, the *Takaful* does not involve *Ribâ* and *Maisir*. In addition, the *Takaful* operator has an additional obligation of annual *Zakat*.

Dissolution

In conventional insurance, when dissolving the contract, the reserves and surplus are distributed to the shareholders.

In *Takaful*, when dissolving the contract, the reserves and surplus are returned to the participants or donated to charity.

Chapter 10 - The Islamic Takaful System-Part 2

Introduction

The Islamic *Takaful* System - Part 2.

In a traditional *Takaful* venture, people with common interests form a group and establish a common fund that can be used to help any of the members in times of loss or damage. The money for the fund must come from *Sharī'ah*-compliant ventures.

This concept has gradually morphed into commercial *Takaful* businesses. These *Takaful* operators are owned by shareholders and must balance the traditional concept with the need for profit and return for the shareholders.

Takaful has been restructured into three models based on their view of profit in a commercial venture. The *Tabarru*-based model supports non-profitable commercial ventures, whereas the *Mudarabah*-based model and the *Wakalah*-based model view *Takaful* as profitable commercial ventures.

The concept of the *Mudarabah* contract, types and conditions and treatment of profit and loss are discussed in detail in Chapter 6 of this course.

On completing this chapter, you will be able to:
- Explain the *Tabarru*-based model of *Takaful* insurance.
- Explain the *Mudarabah*-based model of *Takaful* insurance.
- Explain the *Wakalah*-based model of *Takaful* insurance.
- Explain how profits and surpluses are managed, expenses are shared and other issues managed in *Mudarabah*-based and *Wakalah*-based models of the *Takaful* business.
- Describe the types of *Takaful* products designed for individuals and families and for other diverse purposes.

The *Tabarru*-based *Takaful* Model

The *Tabarru*-based *Takaful* model originated from Sudan.

This 100% not-for-profit model does not offer any capital gain to its shareholders and policyholders.

Policyholders manage the fund and have all control.

Promoters offer a donation or *Tabarru* to the *Takaful* fund to begin business or provide a *Qard-ul-Hasan* or benevolent loan during a crisis.

It is practised primarily in social and government undertakings or not-for-profit programs where it is clear that the funds are donations for the less privileged in society, not loans.

The *Mudarabah*-based *Takaful* Model

In the *Mudarabah*-based *Takaful* model, the *Takaful* operator runs the business of insurance without availing financial gains but receives returns only from the business of investment of *Takaful* funds. The policyholders act as *Rabb-al-maal* or fund providers, and the *Takaful* company acts as a *Mudarib* or agent who receives share of the profits.

To know more about the *Mudarabah* contract underlying this model, refer to the following chapters of this course:

- *Mudarabah* as a way of mobilising funds: Chapter 3, **A Framework forthe Islamic Financial System-Part 1**
- The concept of the *Mudarabah* contract, types and conditions and treatment of profit and loss: Chapter 6, **A Framework forthe Islamic Financial System-Part 4**.
- The history of *Mudarabah*, distinct features of the contract and the two-tier *Mudarabah* model of business for banks: Chapter 7, **Islamic Banking System and its Financial Products**.

Let's now take a closer look at this model.

Step 1

In the first step, policyholders pay premium that is credited to a policyholders' fund.

Step 2

Shareholders of the *Takaful* company contribute to the shareholders' fund.

Note: The *Takaful* company is founded with capital from shareholders.

Step 3

Acting as a *Mudarib*, the *Takaful* company invests the policyholders' fund in *Sharī'ah* compatible assets and investments.

Step 4

Profits obtained from investment of the policyholders' fund are disbursed to corresponding parties.

Policyholders and the *Takaful* company share returns on the policyholders' fund in a pre-determined ratio.

The policyholders' fund is also charged for losses incurred in the venture.

Step 5

A charge is levied on the parties for the funds invested and the business operations undertaken.

Operational expenses, such as general and administrative costs of the investment department are levied on the *Takaful* company and the shareholders' fund.

General and administrative expenses incurred due to managing other business operations are levied on the policyholders' fund.

Step 6

The *Takaful* company provides benefits to beneficiaries on submission of valid claims due to losses and damages.

Step 7

At stipulated periods, policyholders are eligible for full refund of the surplus if any, and liable for deficits if any.

Note: Surplus is the difference between the premium received and the claims paid.

The *Wakalah*-based *Takaful* Model

In the *Wakalah*-based *Takaful* model, the *Takaful* company operates as the agent or *Wakil* for policyholders. The *Wakil* incurs all the operational expenses on the principal's behalf but is paid a pre-determined compensation.

To know more about the *Wakalah* contract underlying this model, refer to the following chapters of this course:

- The concept, the types of *Wakalah* contracts, permitted subject matter and general as well as special applications: Chapter 6: **A Framework forthe Islamic Financial System-Part 4**.

- The use of the *Wakalah* contract for a Letter of Credit: Chapter 8, **Controversial Financing & Fee-based Products**.

Let's now take a closer look at this model.

Step 1

In the first step, policyholders pay premium that is credited to a policyholders' fund.

Step 2

Shareholders of the *Takaful* company contribute to the shareholders' fund, which is maintained separately from the policyholders' fund.

Step 3

As a *Wakil,* the *Takaful* company invests the policyholders fund in *Sharī'ah* compatible assets and investments.

Profits generated from investment are added to the policyholders' fund.

Step 4

As a *Wakil*, the *Takaful* company incurs all the operational expenses and thus levies a charge on policyholders.

Step 5

The *Takaful* company is paid a lump sum or fair share of the premium received.

Step 6

The *Takaful* company provides benefits to beneficiaries on submission of valid claims due to losses and damages.

Step 7

At stipulated periods, policyholders are eligible for full refund of the surplus if any, and liable for deficits if any.

Note: Surplus is the difference between premium received and claims paid.

Profit vs. Surplus for *Takaful* Products

Takaful differs from conventional insurance in terms of:

- Source of Returns and
- Pricing.

Let's see how.

Source of Returns

The first source of returns is the insurance premium paid by policyholders, which is common to both conventional insurance and *Takaful* companies.

In conventional insurance, the underwriting surplus is the second source of returns, which is the difference between the premiums received and insurance claims paid or the benefits and compensations received.

Surplus depends on the price and premium attributed to an insurance product.

Takaful companies have no rights or obligations related to surplus or deficits.

Pricing

The second factor that distinguishes conventional insurance from *Takaful* is pricing. All insurance companies incur operational expenses and thus benefit from over-pricing of insurance products.

In conventional insurance, pricing is primarily dependent on industry standards that need to be followed by all companies, whereas in *Takaful* companies, pricing is handled differently. *Takaful* companies return the surplus obtained from over-pricing to policyholders and charge them for shortfalls due to under-pricing.

Deviations in *Mudarabah* and *Wakalah* Takaful

It is important to note that the *Mudarabah* and *Wakalah*-based *Takaful* models deviate from the original *Takaful* principle.

Let's now look at the reasons for deviation in each model.

***Mudarabah*-based Model**

As the original *Mudarabah* model requires *Takaful* companies to levy a huge premium for the expenses covered, making their products unattractive to the public. Therefore, these companies deviate from the outlined principles. Reasons for the deviations include:

- Market-related premiums, the rate of which can be compared with conventional insurance companies
- Profitable returns from underwriting surplus and *Takaful* funds that are shared based on a *Mudarabah* contract

- Profit-seeking commercial venture process that does not conform to the *Takaful* principle and
- Profit obtained from the underwriting surplus and deficits.

Note: This model is commonly used in Malaysian *Takaful* companies as it helps to deal with competition in the market place.

***Wakalah*-based Model**

The *Wakalah*-based model deviates from the outlined principles by the way, in which it levies the agency fee. The two components of the agency fee are a percentage of the contribution, which goes towards the operating cost and a performance commission, which is a percentage of the underwriting surplus.

This model is favoured to reduce the moral hazards associated with *Wakalah* or agency. The performance fee acts as an incentive for the *Takaful* operator to carry out all *Takaful*- related responsibilities efficiently and price its product competitively.

Note: This model has been adopted by a leading bank in the Kingdom of Saudi Arabia.

Sharing Expenses in *Takaful* Products

Expenses incurred on *Takaful* products are handled differently in *Mudarabah* and *Wakalah*-based models.

Let’s see how.

***Mudarabah*-based Model**

The principles of the conventional *Mudarabah* model deem it necessary to levy the shareholders’ fund for all expenses. These include direct and indirect, investment-related and administrative expenses.

The *Mudarib* or the *Takaful* operator is expected to bear all expenses after distributing the profit or surplus on a pre-determined ratio. Also, conventional insurance companies pay appropriate commission to marketing agents for their service.

However, in the modified *Mudarabah* model used primarily by Malaysian companies, it is noticed that expenses are levied both on the shareholders’ fund and on the policyholders’ fund prior to distribution of profit. Here, the *Takaful* operator levies the policyholders' fund for the commission disbursed to marketing agents. These are considered as contrary to the rules of classical *Mudarabah*.

Malaysian family *Takaful* programs adopt the modified *Mudarabah* model, but there are differences in the way each one charges the investment-related expenses.

Sharing of Expenses in *Wakalah*-based Model

In a *Wakalah*-based model, the problem of sharing expenses does not exist. This is because the *Takaful* operator works as the agent for all policyholders and all expenses incurred on specific *Takaful* programs are levied on the policyholder's fund, whereas the *Takaful* operator's administrative and operational expenses are levied only on the shareholders' fund.

In this model, agents can assign sub-agents and the commission is paid from the *Takaful* fund.

Other Issues in *Takaful* Products

Other issues specific to *Takaful* products relate to sharing of surplus, commingling of funds, policyholders as owners, combination of *Mudarabah* and *Wakalah* and reinsurance.

Let's look at each one of them in detail.

Sharing of Surplus

Surplus is disbursed to policyholders in terms of cash or a waiver or a reduction in premium payable for future terms. To avail the surplus from *Takaful* companies, policyholders should not have made prior claims or obtained *Takaful* benefits. Alternatively, they should not have ceased or surrendered *Takaful* certificates before expiry. In some case, to qualify for share of the surplus, the policyholder's claim should be less than their contribution.

The shareholders should not have received a share of the income generated by policyholders' fund.

Surplus is considered an undistributed profit by:

- Treating contributions as donations and moving it to special reserves,
- Moving it to the policyholders' reserves for future needs and
- Using it for philanthropic purposes.

Surplus can be invested to make profits for the *Takaful* operators and the policy holders under the *Mudarabah* model.

Commingling of Funds

A *Mudarib* is permitted to commingle or merge their personal funds with the policyholders' funds for joint investment purposes. To do this, it is necessary to:

- Maintain distinct identities of the two funds attributable to policyholders and shareholders and
- Levy both funds on a pro rata basis for the expenses and overheads incurred on joint operations.

A *Takaful* operator acting as a *Mudarib* not only manages *Takaful* funds, but also meets financial obligations for:

- Initial and current operating conditions and
- Shortfalls in *Takaful* funds through voluntary *Qard-Hasan* or benevolent loan.

Policyholders as Owners

Policyholders are the owners of the *Takaful* business and should ideally be part of the Board of Directors and permitted by it to examine transactions and accounts. However, in reality, this happens rarely.

Mudarabah and *Wakalah*

The combination of two models may serve as an optimal *Takaful* model. The *Mudarabah* model is ideal for handling investment of policyholders' fund as the *Wakalah* model does not provide remuneration to the agent. On the other hand, the *Wakalah* model is best suited for managing the *Takaful* business due to its transparency from the controversial charging of expenses. Therefore, a model that combines the strengths of each model could prove to be an optimal model for *Takaful* businesses.

Reinsurance

Reinsurance or *Re-Takaful* links small *Takaful* operators with large conventional operators to sustain possible financial losses incurred from the voluminous amounts that are insured. This is temporarily permitted if there is a dearth of *Re-Takaful* companies or in the case of a pressing social need.

The steps involved in the reinsurance process are:

1. The insurance company forwards the premiums from the insured to the reinsurance company.
2. The reinsurance company disburses a commission to the insurance company for management expenses and
3. The insurance company also receives a profit commission for clear underwriting.

Note: Islamic banking permits the insurer and reinsurer to enter only into a profit-sharing or a net premium arrangement. *Takaful* companies cannot get commission from the reinsurer, as it implies a principal-agent relationship.

Applications of *Takaful* in Family Insurance

Family *Takaful* plans are categorised as individual plans, group plans, mortgage plans and credit plans.

Let's look at each plan in detail.

Individual Plans

Individual plans help individuals to invest personal funds on a long-term basis. This plan:

- Functions as a family endowment if the policyholder dies before the maturity period,
- Assists policyholders during financial crises, medical emergencies and unexpected disabilities,
- Funds hospitalisation bills,
- Provides funeral expenses for policyholders and nominees,
- Funds higher education expenses for children,
- Helps fund holidays or the *Umrah,*
- Assures consistent finance gain after retirement and
- Helps compile funds that may be left as donation under the *Waqf* system.

Group Plans

Customers of group *Takaful* plans are mosques, Islamic centres, employers, clubs, etc. Group plans cover natural and accidental death, permanent total disability due to accidental or natural causes, and funeral and hospitalisation expenses.

Mortgage Plans

A mortgage plan helps to redeem the policyholder's mortgaged property in case of premature death or permanent disablement. This plan covers the outstanding balance of the policyholder's home loan or personal loan offered by financial institutions, employer or co-operative society.

Credit Plans

Credit plans offer smaller sum coverage and short-term financing options. Returns from the plan are used to redeem the policyholder's outstanding balance in case of premature death. They also cover the balance incurred on the loan availed by the policyholder from other financial institutions, employer or co-operative society.

Applications of *Takaful* in General Insurance

General *Takaful* plans are:

- Motor *Takaful*
- Fire *Takaful*
- Fire Consequential Loss *Takaful*
- Burglary *Takaful*
- Workmen' Compensation *Takaful*
- Personal Accident *Takaful*
- Fidelity Guarantee *Takaful*
- Money *Takaful*
- Plate Glass *Takaful* and
- Public Liability *Takaful*.

Let's look at each plan in detail.

- Motor *Takaful* is the insurance that covers private car, private motorcycle and commercial vehicles available in the market.
- Fire *Takaful* covers loss or damage by fire or lightning.
- Fire Consequential Loss *Takaful* covers material damage to the property covered as a result of fire.
- Burglary *Takaful* covers loss, destruction or damage by burglary or housebreaking or an attempted threat.
- Workmen' Compensation *Takaful* covers the financial obligations of an employer to an employee in case of personal injury caused by accident or disease to the employee during the course of his employment.
- Personal Accident *Takaful* covers bodily injury resulting from violent, accidental, external and visible means, which may result in death, permanent disablement, temporary disablement or medical expenses.

- Fidelity Guarantee *Takaful* covers loss of resources or goods belonging to the policyholder or for which he is responsible caused by any act of fraud or dishonesty committed by any employee.
- Money *Takaful* covers loss, destruction or damage of money by any cause while in transit or in the charge of the participant's messenger and/or employee or burglary from locked safe or strong-room or by hold-up while in the premises.
- Plate Glass *Takaful* covers breakage of glass in the premises and
- Public Liability *Takaful* covers accidental bodily injury to any person and / or accidental loss of or damage to property caused in the course of the business within territorial limits.

Chapter 11 - Mutual Funds and Islamic Perspectives

Introduction

Mutual Funds and Islamic Perspectives.

Conventional investment funds involve long-term investment and provide more advantages to the investors. In the last two decades of the 20th century, the conventional investment fund companies grew rapidly and created secondary market investments.

Conventional investment fund companies provide two major economic benefits.

- Pooled investment creates diversification. Therefore, it is of low risk to investors.
- The fund managers help investors to manage their funds and charge only a minimal fee.

Based on the nature of their assets, conventional investment funds invest in equity, bonds, commodities and various hybrid and derivative products. However, some investment companies that are entirely focused on the real estate sector are known as Real Estate Investment Trusts or REITs.

On completing this chapter, you will be able to:

- Explain the basic nature of a mutual fund and its advantages.
- Describe the two mutual fund structures.
- Describe the characteristics and types of debt funds.
- Describe the characteristics and types of equity funds.
- Explain the concept of and concerns related to hedge funds.

- Describe the concept of real estate investment trusts or REITs and the tax-related aspects, decision makers and types of properties in which they invest.
- Identify the four types of REITs.
- Distinguish among the three REIT structures.
- Identify the perspectives of Islamic jurists on debt funds, equity funds, hedge funds and REITs.

Mutual Funds and Their Advantages

A mutual fund is an investment product that is a single portfolio of stocks, bonds and cash managed by an investment company on behalf of many investors. The investment company manages the funds and sells shares of the funds to investors. When an investor invests in a mutual fund, he becomes a part owner along with other shareholders. The fund manager or investment advisor directs the investment of funds based on the objectives of the fund. The objectives include long-term growth, high current income and stability of principal. Over the years, mutual funds have gained popularity because of their many advantages. These include:

- Diversification,
- Professional management,
- Liquidity and
- Convenience.

Let us discuss briefly about these advantages of mutual funds.

Diversification

Each mutual fund contains securities from a large number of issuers leading to a larger number of investment opportunities than what an individual can afford. This diversification helps to reduce the risk of loss from investing in a single company for the investor.

Professional Management

Investment advisors of mutual fund help investors choose an ideal solution for an affordable fee.

With extensive research and market information, advisors decide on securities that bring in maximum profits for the mutual fund.

Liquidity

Investors can trade shares in a mutual fund on any business day. This lets them easily access to their money.

Compare this to a scenario where a large number of individuals trade directly in securities. A lot of these securities are traded widely, whereas others are not. In such situations, it may take several days to build a position in a security.

Convenience

Mutual funds offer a lot of convenience to investors. One can trade shares through mail, telephone or internet. Therefore, the investors can easily move their money from one fund to another fund according to their financial needs. In addition, the investors can set automatic fund transfer between mutual fund and bank account.

Most mutual fund companies allow investors to:

- Track transactions,
- Complete their tax returns and
- Follow funds' performance.

Various Structures in Mutual Funds

Each mutual fund is different from the others based on their organisation, investment strategies, fee charged to investors and methods of trading shares. Broadly, the mutual funds are categorised based on the period for buying and selling and by fees charged to investors. Based on these categories, the mutual funds are of the following types.

- Open-End and Closed-End Funds
- Load and No-Load Funds

Let us briefly discuss these structures.

Open-End and Closed-End Funds

An open-end investment fund is a common form of mutual fund. The features of this type of mutual fund are listed here.

- Anyone can buy or sell the shares of this fund any time at the current market price or pro rata.
- In this fund, when an investor buys shares, the fund fills the purchase order by issuing new shares of stock.
- There is no limit to the number of shares for trading, apart from the market demand for the shares.
- Both buy and sell transactions happen based on the price of current market value of all securities. This price is known as the Net Asset Value or NAV.
- NAV is calculated on daily basis and it represents the current market value of a share of stock in the mutual fund.

The closed-end fund is different from open-end fund. The features of this fund are listed here.

- It issues a set of shares in an initial public offering and then trades on an exchange like other stocks.
- Its share price is determined by investor demand for the fund, not by NAV.

Load and No-Load Funds

Load funds charge a commission for trading, whereas the no-load funds are commission-free. The load funds have two different structures. They are:

- Front-end load funds charge a commission varying from three and quarter percent to six and quarter percent of the investment. They also charge an annual distribution fee for their service.
- Back-end or redemption load funds charge a commission of three percent of asset value when sold.

Debt Funds

On the basis of the composition of assets and portfolio, the mutual funds are classified as:

- Debt Funds

- Equity Funds and
- Hedge Funds

Debt Funds

The portfolio of debt funds consists of bonds and fixed income securities. The average investors invest in debt funds because they dislike the volatility and uncertainty of stock markets.

Debt funds are classified by duration or maturity and by risks and returns.

By Duration

By duration or maturity, the debt funds are further classified as short-term, intermediate and long-term bond funds.

Short-term bond funds buy a mixture of corporate and government bonds with the period between one and three-and-half years.

Intermediate bond funds have the maturity range between three-and-half and ten years.

Long-term bond funds invest in bonds with the maturity period greater than six years. Due to the longer period, it involves higher reward as well as higher risk.

By Risks and Returns

By risks and returns, the debt funds are further classified as municipal, high-yield and money-market funds.

Municipal bond funds or Muni-bond funds invest in bonds issued by state municipalities. They offer tax breaks to investors. However, the returns are lower. Therefore, the investors who require tax break facility prefer these funds.

High-yield or junk-bond funds but carry a greater risk to investors, because most of these funds invest in low-grade corporate issues.

Money-market funds offer minimum risk to investors but the returns are also very low - in the range of four to six percent. These funds are useful to invest in short-term securities issued by banks, the federal government or big companies with Grade A credit ratings. The returns to the investor come in the form of a dividend.

There are several types of money-market funds based on whether the dividends to the investor are taxable or not.

The main advantages of a money-market fund are stability and full liquidity.

Equity Funds

Most mutual funds investing in stocks are called equity funds. Equity funds are categorised based on the:

- Size of Companies Invested In
- Style of Stock Selection
- Sector or Region and
- Linkage with Stock Exchange

We will describe each category of equity funds briefly.

Size of Companies

Mutual funds invest in stocks of various companies. Based on the size of companies where the funds are invested, they can be classified as small-cap stocks, mid-cap stocks and large-cap stocks. Cap is a short form of capitalisation and it measures the size of a company.

By Style

The funds are classified as value funds, growth funds and blend funds on the basis of the fund manager's style of picking stocks.

Some fund managers prefer to search based on the value of the stock. They will search stocks that are undervalued when compared to either their share prices or to similar companies' stocks. These funds are known as value funds.

Some fund managers prefer to search stocks that are experiencing faster growth than their competitors. These funds are known as growth funds.

Some fund managers buy both the growing and value stocks. These funds are known as blend funds.

By Sector or Region

Some funds restrict investment to a particular segment or sector of the economy. Such funds are known as sector funds. For instance, telecom fund invests only in stocks of telecommunications sector.

Sector funds are always riskier than general funds because of lesser diversification benefits. However, the fund managers approach high potential sectors to achieve higher returns.

Some funds invest in stocks from several national markets to provide overseas exposure. Such funds are called foreign stock funds. These funds provide great diversification benefits because the ups and downs of economies of different regions offset each other.

Similarly, emerging market funds, Asia-Pacific funds, country-specific funds etc, are some other types of funds.

By Linkage With Exchanges

Index fund is a special type of equity fund that mimics a market index and seeks to replicate the performance of the index. In index funds, the fund manager buys all the stocks in a particular index. It differs from "actively managed" mutual funds because the stocks carry similar weights in the funds.

Index funds are also known as tracker funds and generally have lower management fees.

The major benefit of an index fund is that the fund manager need not be worried about which stocks to buy or sell. It is also cost effective because of the absence of a team of highly paid stock analysts and expensive computer equipments.

Hedge Funds

Hedge funds are investment pools managed by a portfolio manager. Hedge funds can trade frequently and are enormously flexible in how they allocate assets. They invest in almost anything, sell short, use options and futures and take positions in illiquid securities like real estate and collectables.

Hedge funds are suitable for high net worth and sophisticated investors because these investors only aim to surpass the traditional mutual funds by using short-selling, derivative investing and arbitrage.

Throughout the world, the hedge funds are quite unstructured. Therefore, they are kept out of reach of average investors for whom short sell and options may be too complex. For example, to protect the investors, the Securities and Exchange Commission of the USA decided that the investment in hedge funds should be a minimum of one million US dollars. Further, hedge funds were not allowed to advertise.

Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts or REITs are companies that own and sometimes, operate income-creating real estate such as apartments, shopping centres, offices, hotels and warehouses. REITs are resourceful for investors as they help them invest in commercial and residential real estate businesses. In the investment sector, REITs combine the best features of real estate and stocks. Some REITs even offer financing for real estate. Let's look at two aspects related to a REIT.

REIT and Tax

A REIT is allowed to deduct its shareholder's dividends from its corporate taxable income. Consequently, most REITs pay no less than 100% of their taxable income to their shareholders and as a result, they save on corporate tax.

To qualify as a REIT, a company has to allocate at least 90% of its taxable income to its shareholders annually but cannot pass on their tax losses.

REIT and Investment

REITs invest in a variety of property types, but some of these focus on only one property type such as shopping malls, self-storage facilities or factory outlet stores.
Health care REITs specifically invest in health care facilities, including acute care, rehabilitation and psychiatric hospitals, medical office buildings, nursing homes and assisted living centres.

A REIT's board of directors or trustees decides its investments. Shareholders elect the directors, who are held accountable to the shareholders. The directors have the responsibility of appointing the personnel at REIT.

A REIT's operation can be specific to regions within one country or have a global reach.

Types of REITs

We can categorise the REITs based on whether they own or lend to real-estate companies and whether they are private or publicly listed.

Let us look at the types of REITs in operation.

Own or Lend

REITs are of three types based on whether they own or lend to real estate companies.

- **Equity REITs** own and operate income-producing real estate and engage in a variety of real estate activities, which include leasing, development of real property and tenant services. They differ from real estate companies as they own and develop properties as part of their own portfolio and not for sale.
- **Mortgage REITs** finance real estate owners and operators or offer credit indirectly by acquiring loans or mortgage backed securities.
- **Hybrid REITs** provide dual services – they own property and provide finances to real estate owners and operators.

Private or Public

While most REITs trade on established securities market, it is not a prerequisite that they be publicly traded companies. "Private" REITs are neither listed on an exchange nor traded over-the-counter.

Private REITs are of three types:

- **REITs that serve institutional investors** who acquire huge financial positions.
- **Syndicated REITs** offer investors a package of services by financial consultants.
- **Incubator REITs** are funded by venture capitalists expecting REITs to develop an adequate track record in order to launch a public offering in the future.

REIT Structures

REIT structures are of three types - Traditional, UpREIT and DownREIT.

- **Traditional REITs** own their assets directly, not through an operating partnership.
- **In an UpREIT**, a REIT and the partners from an existing REIT come together to form a new one termed as operating partnership or units. For their respective interests, the partners contribute the properties from the 'existing partnership' and the REIT supplies the cash. The REIT becomes the general partner and the majority owner of the operating partnership. After a year, the partners can tender their units for cash or REIT shares at the option of REIT or operating partnership and enjoy the same liquidity of the REIT shareholders.

- **A DownREIT** is similar to an UpREIT. But here, the REIT owns and operates assets, other than its interest in an organised partnership, which possesses and operates separate properties.

Islamic Perspectives on Mutual Funds and REITs

Creating a most favourable portfolio of existing securities is the primary task of a fund manager. However, not all securities comply with the *Sharī'ah* and not all types of funds are permissible in an Islamic market.

Let us discuss which type of mutual funds and REITs are permitted by the *Sharī'ah*.

Debt Funds

Conventional debt funds, whether fixed or floating rate, coupon or zero, with or without options, are not permissible as they amount to *Ribâ*. Islamic fund managers are not allowed to make portfolios of conventional debt securities, which include bond funds, whether short, medium or long- term, money-market funds, municipal-bond funds, junk-bond funds etc.

Equity Funds

Even though common stocks have no equivalent in the *Sharī'ah*, popular view among jurists tilts in favour of modern stock with added restrictions and conditions. These are:

1. The company must engage in actions permitted in Islam because stocks represent pro rata ownership interests in companies.
2. Ownership interest means ownership in real assets and not in debts or cash.
3. The company neither pays nor earns interest.

Since it is very rare for a company to fulfil all these criteria, modern jurists have developed some moderate criteria to identify acceptable stocks.

Hedge Funds

Hedge funds are free-for-all funds. They trade often and take big risks on fiscal derivatives.

Islamic fund managers are not allowed to deal in conventional derivatives or more complex products with these features.

These funds follow different types of investment policies, some acceptable by Islam and aim to outperform traditional mutual funds by short-selling, derivative investing and arbitrage.

REIT

REITs mix the best features of real estate and stocks. In addition, as long as they do not indulge in *Ribâ*-based activities, they are accepted in the Islamic framework. Therefore, only equity REITs qualify, while mortgage and hybrid REITs are prohibited.

Chapter 12 - Islamic Investment Funds

Introduction

Islamic Investment Funds.

In this chapter, you will learn about Islamic investment funds. These funds are created on the basis of a *Mudarabah* contract. Islamic debt funds are created when the capital of the *Mudarabah*-based fund is invested in fixed income yielding operations, such as, *Murabahah* and *Ijarah.*. Islamic equity funds are created when the capital is invested in variable-income yielding operations, such as, *Mudarabah*, *Musharakah* and *Sharī'ah*.

A *Sukuk* represents proportionate beneficial ownership of an asset for a defined period when the risk and return associated with cash flows generated by the underlying assets are passed to the investors. *Sukuk* was first issued in 1978 by Islamic Jordan bank. However, the first successful introduction of *Sukuk* was in 1983 by the Malaysian government. In this chapter, you will also learn about the different types of *Sukuk*, an example of how the Islamic Development Bank (IsDB) developed and marketed a *Sukuk* issue and the challenges of the *Sukuk* market.

On completing this chapter, you will be able to:

- Explain the creation, nature and types of an Islamic debt fund.
- Describe a *Murabaha*-based commodity debt fund.
- Describe an *Ijarah*-based debt fund.
- Describe the creation of Islamic equity funds.
- Identify the conditions governing the selection of stocks for an Islamic equity fund.
- Identify the innovations and concerns related to an Islamic hedge fund.
- Describe Islamic REITs.
- Describe a *Sukuk* briefly.

- Identify types of *Sukuk* recognised by the AAOIFI.
- Describe an *Ijarah Sukuk*.
- Describe a *Salam Sukuk*.
- Describe a BBA *Sukuk*.
- Describe a *Muqaradah Sukuk*.
- Describe a *Musharakah Sukuk*.
- Explain the advantages of developing a market for *Sukuk*.
- Identify key events in the development of an international *Sukuk* market and
- Describe key challenges in the development of an international Sukuk market.

Islamic Debt Funds

An Islamic debt fund is created based on a special-purpose *Mudarabah* or *Musharakah* contract.

Let’s look at the steps in creating such a fund:

1. *Mudarabah* issue and sell certificates or instruments to raise funds.
2. The funds are invested in *Murabaha* and *Ijarah* operations that involve debt and provide fixed income for the intermediary.
3. The net income for the fund can either be predetermined or estimated with reasonable accuracy, after deducting the fee for the *Mudarib* to cover management-related expenses.

Hence, the certificates of investments can promise an assured return to the investor or investors. This is similar to the process for a conventional debt instrument.

However, this income is now free from *Ribâ* because the certificate holder takes a risk and the income comes from a transaction involving physical assets. A variety of debt funds can be created depending on the nature and maturity of the underlying assets.

Murabaha-Based Commodity Debt Fund

In a *Murabaha*-based commodity fund, the subscription amount is used for purchasing commodities for resale. The fund’s income comes from the profits generated by this sale and the income is distributed *pro rated* among the subscribers.

If all the *Sharī'ah* rules governing the transactions are adhered to, then this fund is acceptable.

A fund created to undertake such a sale is a closed-end fund and its units are not for sale in a secondary market. This is because in case of BBA or *Murabaha*, after purchasing the commodities from the original supplier, they are immediately sold to the client. Because payment in *Murabaha* is deferred, it is a debt payable by the client.

Ijarah-Based Debt Fund

In an *Ijarah*-based debt fund, assets such as, real estate and motor vehicles, are purchased using the subscription amount to lease them to their ultimate users. The fund earns income through the rentals charged from the users. The income is distributed pro rata to the subscribers. The fund continues to own the assets.

Each subscriber is given a certificate, called *Sukuk*, to confirm the subscription and to ensure their entitlement to the pro rated share in the income. These *Sukuk* signify the pro rated ownership of their holders in the tangible assets of the fund and not in the liquid amounts or debts. Hence, they are negotiable and can be traded in the secondary market.

The seller is replaced in the pro rated ownership of the relevant assets by the purchaser of the *Sukuk*. All the rights and obligations of the original subscriber are transferred to the new buyer. *Sukuk* are priced based on the market forces and the expected profit. A fixed amount or a proportion of the rentals received goes towards the management fee.

Islamic Equity Fund

An Islamic equity fund is created based on a special-purpose *Mudarabah* contract. Let's look at the steps in creating such a fund:

1. Funds are raised by issuing and selling certificates or instruments.
2. These funds are invested in variable-income yielding operations, such as, *Mudarabah*, *Musharakah* and *Sharī'ah*-approved common stocks.
3. The funds issue units and *Sukuk* that yield variable income for the investor.

Islamic funds equities are the most popular of Islamic funds as these have higher liquidity and there are various equity stocks that can be chosen.

Although companies whose stocks are invested in may make questionable decisions, these funds are also acceptable to most Islamic jurists because they believe an individual fund subscriber cannot be held responsible for a collective decision. For example, a shareholder may object to the company borrowing on interest. But if the majority of shareholders vote to do so, the dissenting shareholder cannot be held responsible for the collective decision. However, Islamic jurists have specified some criteria for selecting stocks.

Conditions Governing Islamic Equity Funds

To prevent violation of the *Sharī'ah,* Islamic jurists have imposed several conditions for selecting the stocks in which equity funds can invest.

Let's look at each of them.

Main Business

The main business of a company should not violate the rules of the *Sharī'ah*. Therefore, the equity of companies falls outside the permissible domain if they manufacture and offer liquor, pork, or *Haram* meat, are involved in gambling, night club activities and pornography, or engage in *Ribâ*-based banking and financial services.

Investment and Income

Suppose a company's primary line of business is permissible. However, it is involved in interest based finance through investing, lending, or depositing its surplus funds in interest-bearing assets or borrowing money on interest. In such cases, the Islamic fund manager must express disapproval in the annual general meeting of the company. Even if the company earns a small amount from an interest-bearing account, a part of the income should be donated to charity.

Negotiability of Stocks

The stocks of the company are negotiable if at least 51 percent of its assets are non-liquid. If all the assets are in liquid form that is in the form of money then it cannot be purchased or sold, except on par value. This is because a share represents money and money can only be traded at par.

Islamic Hedge Fund

Hedge funds are permissible in the Islamic framework, if they do not indulge in forbidden activities, such as, dealing in conventional options, futures and other derivatives having these features. They must also not be involved in purely speculative activities, such as, short-selling. Though it is widely believed that Islamic hedge funds are not a possibility due to such restrictions, the development of such a product has been attempted in recent times.

A leading Saudi private wealth management organisation that conducts its business according to Islamic guidelines would use the *bai-salam* contract to synthesise forwards and futures on the basis of stocks. The share price would be paid up-front and the shares would be delivered at an agreed date. The organisation is also examining the possibility of using *bai-al-urbun* as an alternative to the prohibited conventional options.

A division of a leading US-based investment management firm that offers *Sharī'ah* compliant products has developed a risk management tool that replicate options trading, short sales and balance sheet leverage with *Sharī'ah* compliance. They also have designed a software engine that would screen transactions for *Sharī'ah* compliance and allow monitoring using real time, web interface portfolio access.

However, Islamic financiers must avoid the use of creative accounting, structuring and ultra complex contracts to raise margins rather than be more efficient. Any such innovation must only be a response to fulfil customer needs.

Islamic REITs

Islamic equity REITs can own and operate income-producing real estate as long as the REITs do not get involved in financing. The conditions of investment for Equity REITs are same as the conditions of Islamic equity funds.

Equity REITs are preferred to direct investment in real estate companies, as they acquire and develop its properties with the primary aim ofoperating them as part of its own portfolio rather than reselling them once they are developed.

Sukuks

Let's now discuss one of the most important tools of financing in the Islamic system, *Sukuks*.

The validity of a financial asset whose returns are derived from the performance of an underlying asset is acceptable in *Sharī'ah*.

Sukuk are the Islamic equivalent of securitisation. In *Sukuk*, a variety of asset types are securitised. The asset types include mortgages, auto loans, accounts receivables, credit and payoffs and home equity loans. As in conventional securitisation, a pool of assets is built and securities are provided for them. *Sukuk* are essentially participation certificates given to holders against a single asset or a pool of asset.

Sukuk represent partial ownership of an asset for a specific period. Holders share the risk and returns associated with cash flows generated by underlying assets in a pool. Though, conventional bonds and *Sukuk* are both security instruments that provide a predictable level of return, there are two differences between them. A bond represents pure debt of the issuer, but *Sukuk* represents a share in ownership in an existing or well defined asset in addition to the risk on the issuer's credit worthiness. Also, a bond creates a relationship between the lender and the borrower, whereas the nature of the contract underlying the *Sukuk* decides the relationship in *Sukuk*.

Recognised *Sukuks*

The different types of *Sukuk* are *Salam* certificates, *Istisna* certificates, *Murabaha* certificates, *Musharakah* certificates, *Mudarabah* certificates, *Muzaraah* or share cropping certificates, *Musaqah* or irrigation certificates, *Mugharasa* or agricultural-seed planting certificates, certificates of ownership of leased assets or *Ijarah Sukuk* and certificates of ownership of right to use of existing assets, described future assets, services of specified party, or described future services.

All the types of *Sukuk* are permitted for trading in secondary market, except *Salam*, *Istisna* and *Murabaha* certificates. According to *Sharī'ah*, as *Salam* and *Murabaha* create debt, one cannot trade *Sukuk* based on these contracts in secondary market. In specific cases, *Muzaraah* and *Musaqah* are also non-compatible when the *Sukuk* holders do not own the land.

The OIC *Fiqh* council states that *Sukuk* issued against a pool consisting of cash or debt like instruments cannot be traded in secondary market. This control is required to avoid *Ribâ* while trading debt securities in secondary markets.

Ijarah Sukuk

Ijarah Sukuk is based on the *Ijarah* contract. They are subject to certain prerequisites for securitisation.

- The underlying leasing contract must adhere to the *Sharī'ah* principles, which may be different from those of conventional financial leases.
- The users of the leased asset should be able to utilise the asset effectively.
- The nature of the leased assets should be *Sharī'ah* compliant.
- *Sukuk* holders are responsible for the maintenance expenditure of the underlying asset.

Ijarah Sukuk is flexible, has long maturity periods and is transferable and negotiable. Let's look at some of these advantages.

Flexibility

Ijarah provides flexibility of fixed and floating-rate payoffs. It also offers flexibility in inflows and outflows timing as the cash flow to *Sukuk* holders

need not occur at the same time as the rental payments. Also, the underlying asset need not exist at the time of contract.

Extended Maturity

There is no limit to the length of *Ijarah* contract as long as the subject of the *Ijarah* contract exists and the user draws benefit from it. Therefore, *Sukuk* provide an efficient mode of financing for medium to long-term maturity.

Transferability

In an *Ijarah* contract, joint owners of a leased asset through a *Sukuk* can dispose their property by selling it to new owners individually or together. This feature is the basis for a secondary market for *Ijarah*-based *Sukuk*.

Negotiability

It is possible to sell *Sukuk* at market price if most of the underlying assets are physical assets. This makes *Ijarah Sukuk* completely negotiable and tradeable in the secondary markets. This feature improves the liquidity of the *Sukuk* and its attractiveness to investors.

Salam Sukuk

Salam Sukuk is based on *Bay' al-Salam,* or deferred-delivery sale contract, whereby the investor undertakes to supply specific goods, incorporating a mutually agreed contract for resale to the client and a mutually negotiated profit margin.

Salam Sukuk is an innovation of the Bahrain Monetary Agency (BMA). A Special Purpose *Mudarabah* (SPM) is a setup, which buys a commodity on a *Salam* basis; the purchase price is paid entirely in advance with the proceeds from the *Sukuk* certificates. The purchased commodity is delivered at a future date and the beneficiary of the commodity promises to buy the commodity from the SPM on the date when it is due to be delivered. The pre-agreed cost of financing the purchase determines the returns on *Sukuk*.

Salam Sukuk results in a pure financial claim and are de-linked from risk/return of the underlying asset. Due to this, the *Sharī'ah* considers them as pure debt security, which cannot be traded, either at discount or premium, in the secondary market. This is to prevent *Ribâ* in the transaction. Therefore, they should be held by the investors until maturity.

BBA Sukuk

Bai' Bithaman Ajil or BBA *Sukuk* is based on the sale of an asset to the investors with the issuer's promise to buy the asset back in the future at a predetermined price including the profit. Therefore, the issuer gets immediate cash and a pre-agreed profit. The investor's return could be equal to the pre-agreed profit.

BBA *Sukuk* is an innovation of the Malaysian market.

The Middle Eastern investors do not prefer this structure because the *Sharī'ah* does not allow debt trading that occurs through the BBA arrangement. Also, few of the BBA issued in the Malaysian markets are based on financial assets, which are not accepted in the *Sharī'ah*.

Muqaradah Sukuk

Muqaradah Sukuk is based on the *Mudarabah* contract. In *Muqaradah Sukuk*, a pool of investors provides capital against certificates or bonds for a specific project undertaken by an entrepreneur (*Mudarib)* with an agreement to share revenues. These are suitable for infrastructure development projects.

Investors can share the project revenues. They are solely dependent on the revenue generated by the project and have no alternative to the *Mudarib*. When the subscription expires, the investor can transfer the ownership by sale or trade in the secondary market.

However, due to lack of transparency in the public sectors and lack of liquidity, *Muqaradah Sukuk* is not preferred by the investors.

Musharakah Sukuk

Musharakah Sukuk is based on the partnership and profit and loss-sharing contract, that is, a *Musharakah* contract. They are similar to *Muqaradah Sukuk*, except that in a *Musharakah Sukuk*, the intermediary or the entrepreneur is both an agent and a partner.

Musharakah-based contracts have been issued by many Islamic nations.

To finance the Tehran Municipality, the Money and Credit Council of the Islamic Republic of Iran devised and approved the *Musharakah* certificates in Iran.

Sudan is also a pioneer in the development of *Musharakah*-based certificates. Its Ministry of Finance, with the help of International Monetary Fund (IMF), designed *Musharakah Sukuk* based on state ownership of key profitable and large public enterprises, which can be traded in the market. The Bank of Sudan used a similar arrangement for treasury intervention and open market operations for managing monetary policy.

Musharakah Sukuks were also launched in Turkey to finance the construction of a toll bridge in Istanbul.

Though the issuers of *Musharakah Sukuk* are public sector institutions, low transparency in the government's affairs may keep the investors away from this *Sukuk*.

The Advantages of a *Sukuk* Market

Sukuk meet the demands of users of funds, such as small businesses, large companies and sovereign governments. The users gain direct access to cheaper funds by bypassing intermediaries.

Retail investors prefer *Sukuk* as it widens their opportunity with more choices on maturity and portfolio selection.

Sukuk provides liquidity to the institutional investors and financial intermediaries, who become proficient in portfolio and risk management.

Sukuk payoffs are similar to those of the conventional fixed-income debt security, which is preferred by conventional investors. Hence, *Sukuk* also acts as an integrating tool between the Islamic and conventional market.

The International *Sukuk* Market

The current ratio between sovereign and corporate *Sukuk* is 3.5 to 1. Many conventional rating agencies have begun to rate select issues. For example, Standard & Poor's (S&P) has designed a methodology to rate *Ijarah*-based *Sukuk*. Dow Jones has announced plans to constitute a *Sukuk* Index to monitor the performance of

Sukuk market. Also, *Sukuk* is no restricted to specialist Islamic issuers or investors. For example, 48% of a recent sovereign issue was subscribed by conventional investors, including 24% by institutional investors, 11% by fund managers and 13% by central banks and government institutions.

A majority of the top investment banks that managed *Sukuk* issues are based in Malaysia. Similarly, a leading multinational bank with focus on the Asia Pacific region has played a prominent role in the development of this market.

The Islamic Development Bank (IsDB) recently managed a large *Sukuk* issue that was different from the typical *Sukuk*.

Challenges for Developing a *Sukuk* Market

Sukuk market is in its developing phase but possesses a great potential for further growth of the Islamic financial industry. *Sukuk* market faces challenges in investment pools, cost efficiency, pricing, funding cost, liquidity, management and monitoring costs. Let's look at each of them.

Investment Pools

Except the *Sukuks* issued by the Islamic Development Bank (IsDB), all the other *Sukuk* have been linked to a real asset. This causes difficulty for institutions who want to raise capital on a smaller scale. However, it works for sovereign, supranational, or multilateral borrowers who have large-scale assets to securitize.

Sukuk issued against *Salam* or *Murabaha* contracts cannot be traded in the secondary markets. Islamic banks should therefore utilise the securitisation process to take the assets off their balance sheets and make their portfolios more liquid.

The challenge is in developing *Sukuk* based on pools of heterogeneous assets with varying maturities and different credit qualities. The *Sukuk* market will develop with the participation of Islamic banks.

Liquidity

Limited availability of good quality bonds forces the investors to hold *Sukuk* till its maturity. This results in reduced activity in the secondary market, which leads to a reduction in liquidity and an increase in the transaction costs. This problem can be addressed by increasing the supply of *Sukuk* and developing a market for retail investors.

Management

Issuing of *Sukuk* may involve intermediation costs when more than one investment bank is involved.

Conventional banks often co-lead a *Sukuk* issue with the Islamic banks and may obtain a larger share of fees. Also, conventional investment banks may not invest time and effort for developing small scale *Sukuk* in the local market.

Islamic investment banks must get more actively involved to resolve such problems.

Cost Efficiency

Issuers, investors and intermediaries should patiently nurture the market. Each new issue in an Islamic transaction incurs higher levels of legal expense, documentation expenses and distribution costs; and involves the examination of structural robustness and evaluation of the credit quality of the obligor. This problem can be addressed by standardising the contracts.

Pricing

For conventional borrowers, a *Sukuk* issue does not mean cheaper funds. This is because the terms are mostly derived from competitive pricing levels in the more liquid and cheaper conventional bond market. Therefore, the borrowers should devise a comprehensive, long-term and strategic view for reducing the overall funding cost by tapping into Islamic markets, rather than focusing on a single transaction.

Funding Cost

Although *Sukuk*-based funding is based on collateralised cash flows, it is not always cheaper. As the market matures and investors are more comfortable with the instrument, there will be a decrease in costs and an icrease in the efficiency of the market.

Monitoring Cost

Borrowers may be tempted to exaggerate competence, ability, or willingness required by the investors in order to obtain a contract with or without favourable terms. In such cases, to protect the interests, the investor can ask the borrowers to provide evidence proving their competence, ability and willingness to put in the necessary effort. To protect themselves from adverse selection, the investors may enter into contracts with entrepreneurs with the assurance that these agents are competent and trustworthy. Investment banks play a critical role in dealing with this adverse selection problem by conducting due diligence and providing a transparent execution of the deal.