THE GROWING TREND FOR SHARIAH COMPLIANT FUNDS – CAN UCITS TAP THIS BURGEONING MARKET?

The Islamic funds industry is growing rapidly with an estimated $59bn in assets as of June 2008, and the number of funds has more than doubled in the last three years[1]. The investment policies of these funds are equity (52%), *sukuk* (fixed income) (6%), private equity and real estate (18%), *murabahah* deposits (money market) (13%), balanced funds (8%) and the remainder in leasing based instruments (4%), with a high concentration of investments in Gulf Cooperation Council («GCC») based assets. In Luxembourg there has been increased interest over recent months in the establishment of investment funds with investment policies that comply with Islamic Shariah laws. This surge in interest in structuring Islamic investment funds emanates from both international asset management groups as well as groups based in Muslim countries, attracted to Luxembourg by the opportunities of the UCITS passport, the sound regulatory and supervisory environment and the multi-product fund administration platform.

This article looks at the existing and potentially new Shariah compliant fund structures that would fit within the UCITS framework, but does not set out to explore the structuring possibilities either under part II of the Luxembourg law of 20th December 2002 or under the law on Specialised Investment Funds of 13th February 2007.

1. NON-EXHAUSTIVE SUMMARY OF SHARIAH PRINCIPLES OF IMPORTANCE WITHIN THE UCITS FRAMEWORK

Shariah outlines all forms of practical actions by a Muslim in practicing his faith and belief[2]. While covering all areas of life a number of guidelines and prohibitions apply specifically in the area of Islamic banking and finance. The main (non-exhaustive) guidelines are as follows:

1. the prohibition of interest for the mere use of money;
2. any contract based on the occurrence or non-occurrence of a future uncertain event is in principle not allowable;
3. speculation is not permitted;
4. Shariah does not allow the financing of a certain number of commodities or activities such as conventional insurance and financial services, pork-related products, gambling, alcohol…, etc. (hereafter «prohibited activities»).

For an investor wishing to invest in accordance with Shariah principles, only certain selected financial products are permissible. It is certainly worth exploring the positioning of the Luxembourg UCITS brand in this market to target the growing demand from investors for Shariah funds in the petrodollar rich GCC countries, in South-East Asia and the Muslin communities in Europe.

A number of such structures have already been set up in Luxembourg and Shariah compliant equity funds clearly dominate the scene. According to the latest statistics available, there are currently 32 funds and sub-funds (including non-UCITS funds) which declare themselves Shariah-compliant and are inscribed on the official list of collective investment undertakings.

2. SPECIFIC CHARACTERISTICS OF SHARIAH COMPLIANT UCITS

Shariah compliant UCITS have, as a matter of principle, to be set up as any other Luxembourg UCITS in compliance with the provisions of the law of 20th December, 2002 and the promoter can choose either the form of a SICAV or an FCP (with or without multiple compartments). In addition, the documentation of Shariah compliant UCITS needs to provide for the removal of any reference to or notion of interest payment, the exclusion of exposure to non-permitted activities from the investment policy and the screening of financial instruments for Shariah compliance. The board of directors of the self-managed SICAV or the management company, the conducting officers and the appointed investment manager are supported in their respective roles by a Shariah advisory committee / Shariah advisory board.

The advisory committee is generally composed of independent Shariah scholars and their role, which should be described in the Prospectus, is to advise on the compliance of the investments and operations of the UCITS with Shariah principles. In general the advisory committee puts in place an approval process to screen the investment universe of the fund (ex-ante) and provides a list of eligible issuers/instruments to the investment manager. The screening process is based on business sector activity as well as an examination of the issuer's financing. The Shariah advisors would usually also continue to screen the portfolio of investments on a periodic basis as the business activities of an issuer may change over time, e.g., arising out of mergers and acquisitions.

It is worth noting that some regional differences in how stock-screening is performed exist and may impact the requirement for the UCITS to have its own Shariah advisory board. In Malaysia, for example, the screening of listed stocks for Shariah compliance is undertaken by a centralised body, the Shariah Advisory Council of the Securities Commission which publishes a list of Shariah compliant stocks twice a year. Another approach to stock screening is reliance on an external Shariah compliant index as a proxy for the fund's own assessment of the compliance of a particular instrument. Some firms including Standard and Poor's, Dow Jones and FTSE have developed Islamic indices that track the performance of securities approved by their own Shariah advisory boards.

Upon set-up of a Shariah compliant UCITS the split of roles and responsibilities between the board and the SICAV / management company and the Shariah advisory board will need to be clearly defined with UCITS eligibility checked by the management company / investment manager and Shariah compliance checked by the Shariah adviser. This is particularly important if the Shariah advisory board is supported by a contractually appointed Shariah adviser who is advising the investment manager on a day-to-day basis.

It is important to note that there is a lack of convergence among Shariah advisors and scholars from different jurisdictions or geographical regions in the interpretation of certain Shariah principles, due in part to the complexity and fast changing nature of the Islamic financial markets. As an illustration, there has been major uncertainty recently in the Sukuk market following a position taken by a prominent scholar that certain types of Sukuks based on *Mudaraba* and *Musharaka* contracts were not Shariah compliant.

Even though a UCITS fund is not allowed to «exercise significant influence» over an issuer, Shariah funds tend to make known their views to the issuers in which they invest and may be considered as a particular type of activist investor.

In fact, Shariah compliant funds are in a way comparable to socially responsible investment funds, implementing a more restrictively defined investment policy within the same investment sector or geographical area as «conventional funds».

Another characteristic (for equity funds) is the existence of a *purification* of the dividends received from the target issuers. Securities of certain issuers would *per se* be eligible following the initial Shariah screening but the issuer could nevertheless be considered, up to a limited percentage, to perform prohibited activities or have part of its income generated by interest payments. The dividend purification procedure would normally result in the Fund being credited with the dividends paid by the issuer, minus the purification ratio (to be determined in view of the level of prohibited activities and interest based income) applied to those dividends. Any identified impure income is not due to the UCITS and would be donated to a charity. In general the Shariah advisors propose the name of a charity but the final choice remains with the board of directors.

3. Shariah compliant equity funds

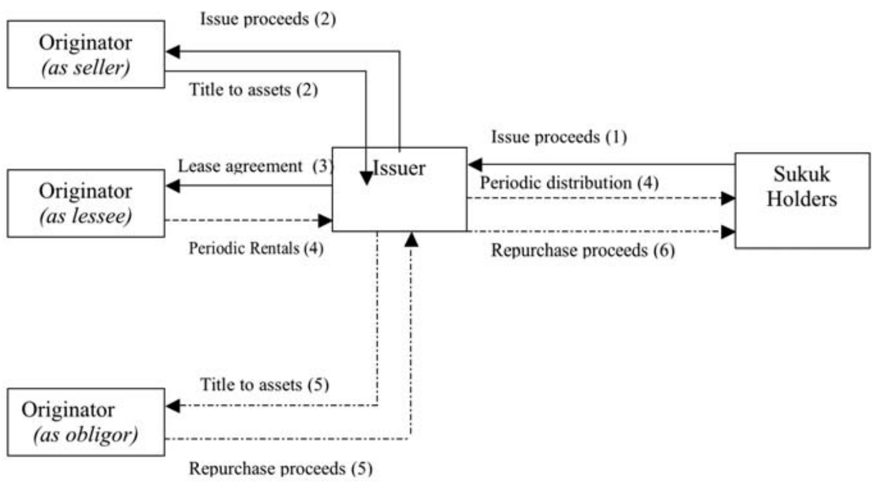
It is predominantly Shariah compliant equity funds which have been approved by the CSSF under the UCITS regulations (although at least one fixed income fund has been approved to date). By and large the current cluster of Shariah compliant UCITS equity funds take advantage of existing Shariah compliant indices provided by the major index providers and only on an ancillary basis would they invest in issuers outside the index universe. This type of organisation clearly smoothes any discussions on Shariah eligibility and also, to an extent, can simplify UCITS III eligibility appraisal for criteria such as liquidity, pricing and valuation.

4. Fixed income Shariah compliant UCITS

Given the ban on charging interest, most conventional fixed income instruments are not eligible investments for a Shariah compliant fund.

The securities/instruments which could be used by managers of Shariah compliant UCITS funds include Sukuks, *Murabahah* deposits and other types of Shariah compliant money market instruments. The Sukuk market is one of the most important growth segments in Islamic finance and is projected to grow by 30-35% per annum[3]. Sukuk, also generally known as "Islamic bond", is a generic term to encompass a broad range of Shariah compliant instruments. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), based in Bahrain, has identified 14 different types of Sukuk although in practice a much smaller number are regularly issued on the market. It is common in naming a Sukuk to refer to the main underlying contract, for example *Ijara* (lease) or *Musharaka* (a partnership structure), but simply naming the contract may not be sufficient to describe all the economic activities and effects involved, given the new generation of innovative and increasingly complicated Sukuk. The majority of Sukuk that have been issued to date have been structured as asset-based rather than asset-backed securities, with the credit risk linked to the originator similar to a conventional bond. However it is important to take into account that there are Shariah limitations on the trading of debt which may impact the tradability of certain Sukuk on the secondary market although there is no unanimity among Shariah scholars about the precise boundaries.

To follow is an illustration a typical Sukuk-al-ijara[4]:



(1) The Issuer – usually an SPV – issues sukuk to sukuk holders in exchange for proceeds.
(2) The Issuer purchases title to the assets from the Originator.
(3) The Originator enters into a lease agreement with the Issuer to lease the assets.
(4) The Originator makes periodic rental payments on the lease to the Issuer which the Issuer passes on to the sukuk holders.
(5) At maturity (or upon a *dissolution event*) the Issuer sells the assets back to the Originator (*purchase undertaking*).
(6) The Issuer passes the proceeds on to the sukuk holders and the SPV is dissolved.

5. Operational issues

It is generally accepted that the custodian of a Shariah compliant UCITS does not itself need to operate along the lines of an Islamic bank but needs to be in a position to service the Shariah compliant fund without violating any Shariah principles.

The prohibition of interest will prevent a fund lending or borrowing on interest and arrangements will need to be put in place with the Custodian to deal with overdrafts in particular, in a Shariah compliant manner. Some of the concerns applicable to any UCITS are magnified for Shariah compliant funds due to the small market size of eligible instruments, the lack of an active secondary market for the trading of Shariah compliant instruments and the non-standardised documentation and set-up. The secondary market for Islamic products tends to be shallow and illiquid due to the insufficient supply of tradable Islamic products as well as the typical buy-and-hold approach of investors, and this may lead to difficulties in determining the fair value of the investments.

6. Accounting standards and accounting and auditing requirements

Certain Shariah compliant transactions may not have parallels in conventional financing and this may lead to certain accounting difficulties. The AAOIFI develops accounting, auditing, governance and ethical standards relating to the activities of Islamic banks and by mid 2008 the AAOIFI had issued 30 Shariah standards. In addition the Malaysia based Islamic Financial Services Board (IFSB)is a standard-setting board that covers banking, insurance and securities regulation. The work of the AAOIFI and the IFSB has helped to harmonise the application of standards among the different Shariah boards in different jurisdictions although their adoption has been mixed. These accounting standards can act as a useful reference aid in determining the accounting treatment for Islamic products that do not have a clear parallel under Luxembourg GAAP or IFRS.

It is likely that investors in Shariah UCITS will look for assurance that the portfolio is Shariah compliant as there is currently no common view on the Shariah compliance of instruments among Shariah scholars, and this has led to a certain level of uncertainty and concern among investors. As part of their audit the external auditor of a UCITS will tend to look at the Shariah screening process put in place by the UCITS. The auditors will seek to gain an understanding of how the process and procedures actually operate to ensure that the investments comply with Shariah principles.The auditor may request disclosure of material information to investors, which may include details on Shariah compliance. For some UCITS this Shariah related disclosure in the annual report currently takes the form of a certification by the Shariah Advisory Board of the compliance of the portfolio of investments with Shariah principles during the period. A Shariah audit may be requested by the UCITS and in this case the external audit firms, if they do not have the expertise locally, may request Islamic finance specialists in other offices to perform the Shariah audit.

In terms of the accounting of an Islamic UCITS the external auditor may be requested to provide assurance services on some of the Shariah specific aspects of the UCITS. One example is the cleansing mechanism to purify investments that are tainted by prohibited activities, as described earlier, which is generally carried out by an Islamic fund on behalf of its investors. The Board of Directors may request the external auditor to provide assurance on the figures calculated prior to making a donation to a charity.

7. Taxation of Shariah compliant funds

As already mentioned some Shariah financial instruments may not have parallels in conventional financing. For example, the Sukuk is considered an equity based investment under Shariah, but many of the Sukuk issues have very strong similarities in terms of cash-flows and risk to a conventional bond. There is currently no Luxembourg Tax Circular dealing with the classification of Islamic financial instruments and it would be essential to approach the Luxembourg Tax Authorities to clarify if the Sukuk investments that the UCITS intends to hold would fall under the classification of debt instruments and therefore within the scope of the EU Savings Directive. The same may also be necessary for other types of Shariah instruments as there is currently limited tax jurisprudence on Islamic instruments in Luxembourg.

In the same manner as innovative financial instruments and techniques have been successfully structured to qualify for investment by UCITS funds since 2002, the flexible Luxembourg regulatory framework will within the limits of the UCITS directive offer satisfactory solutions for Shariah compliant funds.

The know-how acquired on the smooth operation of existing Shariah compliant structures and the initiatives of the Luxembourg government, ALFI and ABBL to position Luxembourg as a credible location for Islamic Finance in general, and Shariah compliant investment funds in particular, will help to boost the position of Luxembourg as a credible platform for asset management groups seeking a global hub for their Shariah compliant products. ■

Gast Juncker
Partner
Elvinger, Hoss & Prussen

Dee Ruddy
Senior Manager
KPMG

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[1] IOSCO Report on Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products - September 2008.
[2] Islamic Banking and Finance – Bahrain Monetary Agency 2002
[3] Moody's « Special Report on Sukuk » 2008
[4] Introduction to Sukuk Deutsche Bank AG August 2007.