CHAPTER 6

Innovations in Shari'a-Compliant Wealth Management

6.1 Global demand-led opportunities

6.1.1 The obvious Muslim market: Growing, increasingly significant but fragmented

According to the Pew Research Center in 2011,[1] the global Muslim population is expected to increase by 35% in the next 20 years, thereby increasing the current total population from 1.6 billion to 2.2 billion by 2030. The research also indicates that the largest future growth (up to 2020) will be happening in the Americas. Thus, wealth/asset management companies should take note of these trends, as it potentially offers opportunities for Shari'a-compliant products to be an alternative to conventional products that are already established in these regions.

On the MENA region, the International Finance Corporation states that two-thirds of the population is below the age of 30, and approximately 27% are below the age of 15.[2] This means that at least 7 out of 10 people in the region are just starting out their careers, or are still in school. Potentially, wealth management can play a significant role in ensuring that the aging population is able to provide for their young (through investments and inheritance), together with providing the means for the employed (who are in their 20s) to start saving their money for the future.
The trend on aging populations is similar elsewhere in the world; the Pew Research Center states that Muslim birth-rates are declining for some regions with significant Muslim populations, such as the Asia-Pacific and the Middle East. Thus, based on this trend, there is a potential to develop relevant Shari'a-compliant financial products for this market, and assist the aging population to secure themselves for their retirement. Private pension would be a good example.

It would also be logical to assume that there should be a general demand for Shari'a-compliant products in the Muslim global market, based on the religious obligation of the Muslim community to obtain halal products whenever available, including financial products. For example, conventional insurance penetration rates in Muslim-majority countries have been low compared to developed countries, yet efforts to introduce takaful to some countries (such as Malaysia) have been successful as a Shari'a-compliant alternative to conventional insurance.

6.1.2 The less obvious non-Muslim market

The value proposition of Shari'a-compliant investments from the risk-return perspective, not just in bull, but also in bear cycles, have also attracted the attention of the non-Muslim market segment. The rising risks in the global financial system in the midst of unprecedented challenges of the current economic environment have only added further impetus in the quest for alternative solutions. As a case in point: the largest Shari'a-compliant equities mutual fund in the world is domiciled in the United States with mostly non-Muslim investors.

6.2 Shari'a-compliant wealth management industry landscape

Wealth management is the strategy of financial sustainability to ensure a steady accumulation of wealth over a long-term period for the purpose of providing for future financial security in one's lifetime and for one's forbears. The process usually begins with a more aggressive wealth accumulation phase that is coupled with insurance protection in the early stages of one's career, followed by a more conservative wealth preservation phase, and finally an income-generating phase upon retirement. This process goes together with estate planning.

Thus, the role of wealth managers is to provide investment solutions or products that fulfill the needs of the client

[1] Pew Research Center (2011) [Online], Available: http://pewresearch.org/pubs/1872/muslim-population-projections-worldwide-fast-growth [22 Jul 2011].

[2] International Finance Corporation (2009) Sustainable Investing in the Middle East and North Africa Region Report, Washington, D.C., USA: The World Bank.

in terms of risk-return, liquidity and income during the different phases of life. Although conventional wealth management has a vast array of building blocks in the form of investment instruments and funds, there are still significant gaps in the menu that makes it challenging for wealth managers to construct Shari'a-compliant optimum solutions for their clients.

For example, the landscape has been largely dominated by illiquid longer term investments in property, private equity or in infrastructure at one end, and low-yielding commodity murabaha investments at the other. This gap offers potential for product development to match the choices available in the conventional space for diversification purposes.

Sukuk funds are also being challenged by the lack of supply and liquidity of the underlying instruments. The quest for yield has thus resulted in Shari'a-compliant financial instruments and structures utilising a wide range of underlying assets such as commodities, properties, leasing, trade finance, utilities, and infrastructure.

Although Shari'a-compliant mutual funds are growing in number, most of them consist of short-term money market funds based in the Middle East. The number of Shari'a-compliant equity funds that provide growth and liquidity are still small in terms of assets under management (AUM), and are relatively unsophisticated in nature when compared to the variety available to conventional wealth management. By virtue of the liquidity of stock markets relative to sukuk, property and other direct investments, there are ample opportunities for innovation within the equities asset class. Returns can be generated by tapping pockets of growth within regions, sectors, themes or factors. The volatility inherent in the listed equities can be managed through asset allocation or diversification, and income can be generated through dividend-yielding stocks.

Traditionally, professional wealth management is undertaken by banks, private bankers, boutiques, and independent financial advisors. However, over the years the industry has seen the development of Shari'a-compliant innovations, not just in products but across the whole value-chain of wealth management. This includes wealth advisory, investment product structuring, investment management, wealth management platforms, takaful, estate planning, tax advisory, and bank distribution of wealth management solutions.

6.3 Supply and delivery of Shari'a-compliant wealth management solutions: fraught with challenges, but provide fertile grounds for innovation

6.3.1 Shari'a non-uniformity

Non-uniformity in the interpretation of Shari'a compliance for investments, together with the fragmentation of the global Muslim middle-class market segment, have made it challenging to achieve commonalities that are pre-requisites for achieving economies of scale. This results in longer than normal gestation time for new products, thus requiring greater understanding and patience from top management and Boards. It is too easy, and sadly all too frequent, for management to "pull the plug" on innovative products and initiatives just before the tipping point.

6.3.2 Supply and liquidity of instruments and sukuk

Wealth management, whether Shari'a-compliant or otherwise, requires products along the whole risk-return spectrum for diversification purposes that will serve as building blocks to produce customised solutions, tailored according to the risk-return tolerance of the investor. For Shari'a-compliant wealth management, the gaps are glaringly apparent:

- The most obvious would be the lack of supply of financial liquidity instruments, particularly for tenures of less than two weeks, and for sizes of less than USD1 million. This poses quite a challenge for short term open-ended money market funds.
- The supply of sukuk products, particularly those underpinned by an ijara structure (as preferred by AAOIFI), are challenged by the lack of supply and quality of the underlying assets.
- Currently, sukuk products are mainly produced by Malaysia and the Middle East. Although this will not pose a problem for domestic investors in these regions, it will not provide the required diversification for these products to be of a truly global asset class.
- Benchmarking and yield curves also remain challenged by a lack of sovereign sukuk issuance, especially at the long end.

6.3.3 Regulatory framework uneven across markets

The regulatory framework to support Islamic finance and the issuance of sukuk is still a work-in-progress, particularly in developed countries where sovereign sukuk issuances would be the most meaningful for benchmarking, as well as encouraging the deepening of the sukuk market.

6.3.4 Distribution

Wealth management products are normally distributed via the wealth management units of retail banks, private bankers for sophisticated investors, and in some countries, independent platforms of financial advisors. To support this, banks possess well-entrenched processes for the selection of products from their wealth management menu which generally caters to larger funds (usually at least USD100 m) with established medium to long-term track records, and domiciled in certain approved jurisdictions. This would in fact eliminate the majority of Shari'a-compliant funds, as most have only come into existence more recently, and thus would have yet to achieve the critical mass and economies of scale that are necessary to absorb the costs of a global fund administration platform in an approved jurisdiction.

6.3.5 Awareness

To some extent, the value proposition and competitiveness of Shari'a-compliant investment products have gained some traction among industry participants, academics and savvy private bankers and institutional funds. However, they are still not widely obvious to most investors and distributors.

The challenges are indeed numerous and may seem foreboding, but they also provide fertile grounds for innovation.

6.4 Alchemy: The innovation process

Innovation is not the result of merely originating a concept out of thin air but is often incremental in nature, involving the ability to deconstruct the elements of an existing concept and reconfiguring it in a different way. Thus, innovation should not be conducted for its own sake, but with the focus to transform challenges into opportunities.

Successful innovation is one that can be commercialised, adding value to the marketplace and ultimately resulting in monetisation for both client and shareholder. It can thus be likened to alchemy, turning base elements into "gold", inferring the creation of "real value" in the long run.

The keywords "Shari'a-compliant," "wealth management," and "innovation" all involve different elements that are not naturally congruent. This is where the future of Shari'a-compliant wealth management lies: connecting the dots among religious principles, law, business, strategy/planning, and human capital in the delivery of competitive and comprehensive wealth management solutions that serve as viable alternatives for both Muslim and non-Muslim clients.

In order to achieve this result, a synthesis mindset will be required (as opposed to being merely analytical). Analysis and synthesis are conceptual dichotomies, and synthesis offers the ability to innovate from various constituent parts. Thus, there is great potential in the building blocks of Shari'a principles that can be synthesized with the various permutations offered by capital market instruments.

While there has been much discussion on sukuk in Islamic finance, there is still potential for innovation in equities (where liquidity is much less of an issue), and also for multi-asset hybrid products with managed volatility in the Shari'a-compliant space.

However, as part of the overall strategy, Shari'a-compliant products should not be mere shadows of conventional banking and investment products, but they should have their own uniqueness (in terms of structure and risk-return profile) that will offer better value to the customer. Thus, the aim of Shari'a-compliant wealth management should ideally be to offer Shari'a-compliant products across the various risk-return spectrum and correlation, and this will provide the desired diversification and risk-optimised Shari'a-compliant portfolio.

The modern Islamic financial system being far younger than conventional finance makes it implicit that innovation is the driving force that is part and parcel of its growth, rather than an exception. And it is from this very perspective that one can expect innovation to grow and bear fruit.

6.5 Building blocks for Shari'a-compliant wealth management solutions

The following Shari'a concepts (which are not exhaustive but provided as examples) are common Shari'a building blocks for the construction of Islamic financial instruments:

1. Mudharaba (Profit-sharing)
2. Murabaha (Cost Plus)
3. Wadia (Safekeeping)
4. Musharaka (Joint Venture)
5. Bai' Bithaman Ajil (Deferred Payment Sale)
6. Wakala (Agency)
7. Qard Hasan (Benevolent Loan)
8. Ijara thumma bai (Hire Purchase)
9. Bai inah (Sell and Buy Back Agreement)
10. Hiba (Gift)

Two good examples of the solutions that can be derived from these building blocks are sukuk and takaful.

6.5.1 Sukuk

With sukuk, various types can be created and issued for different purposes, based on the above Shari'a concepts. For example, salam securities can be used for supplying specific commodities at a future date; ijara for property rental/leasing arrangements; istisna for project financing, and mudaraba/musharaka for investments. Each type will also have its own strengths and advantages. Rodney Wilson states that "clearly there is much scope for product development in this area, with the rights and privileges of musharaka certificate holders better defined in relation to those of equity investors and mudaraba certificate holders." [3] The type developed would depend on the demands of the debt securities market.

6.5.2 Takaful

Takaful (which basically means mutual/joint guarantee) is a good example of a Shari'a-compliant insurance product that fulfills one's responsibility to society, in which part of the participant's contribution amount is stored in a special account as a donation (tabarru) that will be used to help other participants in times of difficulties. Any investments from the takaful fund will be made in only Shari'a-compliant instruments, thus avoiding interest, uncertainty, and gambling. The Shari'a concepts used in constructing takaful include mudaraba and wakala, and there are also general (non-life) and family (life) options available.

[3] Wilson, R. (2004) 'Overview of the Sukuk Market', in Adam, N.J. and Thomas, A. (ed.) Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk, London, UK: Euromoney Books, pp. 3 – 17.

The above two products are considered to be the most innovative Shari'a-compliant wealth/asset management financial instruments to date and have been successful in Malaysia and the GCC.

6.6 Innovation: Beyond sukuk and takaful

Shari'a-compliant wealth management- and as is the case for Islamic finance in general- have always been a result of continuous innovation. Creation of alternative financial structures and solutions, together with the development of required regulatory/governance frameworks based on Shari'a principles, are often done without any precedence. Going forward, innovation will continue to be the driving force in the development of Shari'a-compliant wealth management, particularly in the following areas where it would be most required.

6.6.1 Investment strategies

Listed Shari'a-compliant equities face none of the supply and liquidity constraints of sukuk. This is because the equities asset class provides sufficient depth and breadth that makes it possible to structure various investment solutions. The different approaches range from being region/sector/factor/macro-centric to being thematic. Some equities even display risk characteristics that are similar to sukuk, and thus are potentially useful "proxies" for the management of volatility within the design of an investment solution. These strategies are not new to conventional investment managers, but when combined with Shari'a screening, they can result in the creation of competitive products that offer certain competitive advantages, compared to their conventional counterparts.

6.6.2 Shari'a Compliance as an alpha source

The lower leverage of a Shari'a-compliant portfolio translates into a portfolio with lower risk and volatility. As a result of the qualitative screening that excludes non-halal sectors, Shari'a-compliant portfolios would by default skew towards resources, consumer staples, pharmaceuticals and technology (sectors which would also do well in market uptrends). The Shari'a rules on cash holdings -to minimize interest income- predispose the portfolio towards a higher return to equity, and a more efficient capital allocation through reinvestment in growth generating assets or higher dividends.

6.6.3 Product structures

Exchange traded funds (ETFs) are commonly used by wealth managers to access certain asset classes quickly and cheaply. There are a small but growing number of Islamic ETFs, which are equity-based, as well as being commodity-based. Innovation has also been driven by the desire for absolute returns and aversion to volatility, resulting in the creation of Shari'a-compliant structured products and capital guaranteed funds.
Whereas traditional option payout structures are impermissible under Shari'a rules (due to the interest prohibition, prohibition of uncertainty at contract conclusion, and prohibition of speculation or gambling), Constant Proportion Portfolio Insurances (CPPIs) and coupon-paying structures can be structured to conform to Shari'a compliance requirements.

Typical Shari'a-compliant structured products are based on the Shari'a principles of urbun, murabaha, and wa'ad. Based on these building blocks, a large number of different payout profiles can be offered to investors.

6.6.4 Product risk

In order to manage the risk of their product menu, wealth management units of large banks limit their product offering to funds with a minimum size (usually USD100m) with an investment track record of at least three to five years, domiciled in certain jurisdictions. In view of the relative infancy of Shari'a-compliant funds in the marketplace, such criteria would make it challenging to provide a menu of Shari'a-compliant investment products across different asset classes (of varying risk profiles and correlations) to provide the appropriate diversification needed by the client.

Thus, in order to tap the underserved demand of their Muslim wealth market, some private bankers have explored alternative criteria. The results have been impressively competitive, showing superior performance at lower risk, through a disciplined methodology of portfolio construction of Shari'a-compliant funds which may not meet the size, long term track record and jurisdiction requirements of the larger banks. It would indeed auger well for the Shari'a-compliant wealth management industry if banks review their fund selection in order to have a broader menu, which would lead to more effective wealth management solutions. Concerns for reputational risks, and a non-level playing field with other conventional banking products could perhaps be mitigated with appropriate disclosure requirements to these niche investors.

6.6.5 Volatility risk

Hedging and hedge funds are the common means in which investors address market volatility. In the Islamic marketplace, there have been major strides in this area in terms of innovation.
Based on a common Shari'a view that Islamic hedging is allowed for protecting real business activities (but not for speculation purposes/undertaking), various hedging solutions have evolved, for example:

- Forward currency or currency swap to protect real import and export activities involving two different currencies.
- Profit rate swap to manage real asset and liability potential mismatch of a financial institution.
- Islamic hedging products, based on the following Shari'a principles:
  - Earnest money or urbun
  - Salam sale
  - Unilateral binding promise (wa'ad)
  - Istijrar – purchasing an asset the price of which is to be determined later.
  - Murabaha / tawarruq contract.

6.6.6 Underlying assets

Innovation is continuing in the hunt for annuity assets which can be structured as Shari'a-compliant yield instruments, ranging from property, utilities, trade finance, containers, student accommodation, mortgages, leasing, plantations, to commodities. Another area which has yet to be meaningfully exploited is the growing halal economy. Shari'a-compliant funding requirements for expansion across the whole value-chain, involving suppliers, manufacturers, packaging logistics, distributors, service providers and platforms would provide opportunities for the provision of sukuk and other funding instruments of various tenures, credit risks and regional exposures.

6.7 Innovation: Beyond investment products

Continuous innovation that is required for the growth of the Shari'a-compliant wealth management industry should not be limited to investment strategies, product structures, Shari'a structures and underlying assets. Ongoing innovation is also required in the following areas:

6.7.1 Delivery and distribution platforms

The development of systems platforms which integrate investment-linked takaful with asset allocation overlays that enables customisation to retail client needs, have given banks cost-efficient speed-to-market access to new customer segments. Online wealth management solutions would be a natural evolution.

6.7.2 Organisational structures

Innovation is also happening at the organisational level of fund management houses and wealth management businesses in terms of operational processes and policies. As many companies grapple with economies of scale, during this fledgling stage of the industry, organisations have had to actively engage in the innovation of their existing organisational structures and processes in order to leverage on commonalities without compromising on the Shari'a-compliant aspect of their activities. Companies that have achieved economies of scale, based on their existing business would be naturally advantaged. However, this could prove to be a double-edged sword, as some larger global businesses may be challenged by their own traditional organisational processes which hinder the mobilisation of resources to support an emerging business line, albeit with great potential.

The traditional hierarchical organisational structure is less conducive for innovation. As such, organisations that succeed in innovation are more likely to have a flatter structure of talented specialised teams, working together to derive cross-functional synergies. This will include an open culture of idea generation, a robust and active risk management framework which enables innovation, an innovation process which supports the efficient operationalisation of ideas, a model of scalable commercialisation in terms of product structures and distribution partnerships, an achievement of scale through volumisation, and eventual monetisation.

The Shari'a-compliant wealth management industry participants are also likely to be relatively newer (fewer legacy issues) and smaller (therefore more agile), and these factors can be advantageous over other more established participants in this respect. Only sustainable profits and margins of the industry players will ensure the continued viability and growth of the Shari'a-compliant wealth management industry.

6.7.3 Business models

Newer business models are also evolving within the wealth management industry. Large global fund management houses owned by banks or insurance companies usually derive economies of scale through vertical integration, and expansion through acquisition of smaller fund management specialists. Smaller specialist houses are pursuing economies of scale through various ways: joint ventures with bigger houses, mergers or strategic partnerships with complementary businesses, or horizontal economies through smart partnerships with complementary global specialists along the value-chain.

For example, it is possible for a fund management company to focus its operations on only its core competencies in terms of asset classes and investment approach, product design, marketing and client service. Start-up costs for global expansion can thus be minimised and accelerated through outsourcing and partnerships for all other non-core activities such as custody, administration, research in specific areas, and distribution. In this scenario, the competitive advantage would be largely driven by intellectual capital, with both skill and innovation playing leading roles.

6.7.4 Industry structure

Structures within the Shari'a-compliant industry may also be evolving to provide better services, based on the differing needs across the world:

- In less-developed economies where there is generally less savings among the populace, there could be more demand for takaful products. As such, opportunities may present themselves in takaful-linked investment products distributed either through banks or agents.
- Countries with a large middle class may have a more developed industry infrastructure in terms of either bank distribution or independent advisors.
- Some regions with an emerging middle class and a narrow concentration of the highly affluent would probably have private banking assuming the dominant role.
- In some developed countries, the bulk of their savings are contained in specific structures such as retirement schemes with insignificant discretionary wealth assets.

Each of these industry structures provides different opportunities for innovation in market penetration, distribution and product development. The fragmentation of the global market for Shari'a-compliant wealth management makes it challenging for the typical global "one size fits all" business model to provide effective leveraging on all the efficiencies derived from uniform global standards, scale and homogeneity. Perhaps, the very non-uniformity of Shari'a standards, regulatory frameworks, industry structures, levels of economic development, and financial literacy provide ample opportunities for the more agile market participants to be able to innovate and navigate their way through the quagmire. With all these challenges, it might seem extremely challenging to say the least, and whether the effort is truly worth it. However, judging by the demographics and statistics, it would appear so.

6.8 Innovation: core driver of Shari'a-compliant wealth management

Relative to the conventional wealth management industry, full-fledged Shari'a-compliant wealth management is only just emerging, and it needs continuous innovation to actualise its full potential and value to investors. In the end, one can conclude that true innovation at its very core is all about innovation with purpose, and to continuously produce and distribute products with value by transmutation and synthesis. The aim of promoting better value is also in line with Shari'a compliance regarding transactions based on real assets, thus the synthesis of the two will result in wealth management solutions that are accessible, beneficial to customers in the long-run, and are more secure in nature.

Shari'a Compliant Wealth Management: The growing niche within the halal services industry

The halal industry is the fastest growing segment across the world emerging as a market force that is attracting non-Muslims with its wholesome, hygienic and contamination-free principles in food production. The global value for trade of Halal foods and non-food products is estimated at USD2.1 trillion with food comprising approximately 61% of the total industry.

In countries like Malaysia, the government is pushing hard to make the country a global hub for halal products. Spearheaded by the world's first development corporation specifically dedicated to the halal sector, the Halal Industry Development Corporation (HDC), the country is leading the way in innovation within the halal industry.

At the World Halal Forum held in Kuala Lumpur in 2011, there was a strong emphasis on the convergence of halal goods and services industry and the Islamic finance into an integrated halal economy.In fact the halal brand has also extended to the services industry including travel, and finance.

New rising hubs

Although the GCC and Southeast Asia remain strongholds for Islamic finance, increasing awareness is creating interest among customers in other parts of the world. Among the rising markets that are showing serious progress is South Africa. As an example of Islamic finance activity, the National Treasury is offering Islamic bonds to foreign investors. The country is well-positioned to promote the development of the industry in the rest of the continent that is home to more than 412 million Muslims. South Africa's robust regulatory and legislative structures, strict risk management frameworks as well as governance and compliance procedures could be a key enabler for companies to spread their services into the rest of the continent. South Africa is in the process of enacting legislation to facilitate Islamic banking, such as instituting tax reforms that are Shari'a-compliant and allow investors equal access to Islamic and conventional banks.

Leading financial groups like Absa already has an Islamic window and a takaful subsidiary offering Shari'a compliant insurance offerings. Along with First National Bank (FNB) and Standard Bank, these banks can together play a catalyst role in spreading Islamic finance across South Africa and even beyond.

Wealth management: the growing niche within Shari'a compliant finance

According to Boston Consulting Group's (BCG) annual Global Wealth Report 2011, global wealth is expected to grow at a compound rate of 5.9% from year end 2012 through 2015 to about USD162 trillion, driven by the performance of the capital markets, the growth of GDP, and increased savings in countries around the world. Wealth will grow fastest in emerging markets at above average rates ranging between 14% and 18% in certain regions. This shift in wealth distribution holds new untapped potential for wealth managers who are looking to expand their customer base and diversify their investment geographies; hence the rising interest in Shari'a compliant wealth management as a new alternative to tap into new territories with sizable opportunities.

Managing wealth in accordance with Shari'a has increasingly become a popular option in the Middle East and parts of Asia and Africa, areas that encompass growing wealth markets and some of the highest concentration of millionaires in the World. For instance, Saudi Arabia had the highest proportion of UHNW households according to the BCG report. Globally, an estimated 31% of global Shari'a is held as deposits in banks.

More Shari'a compliant investment options

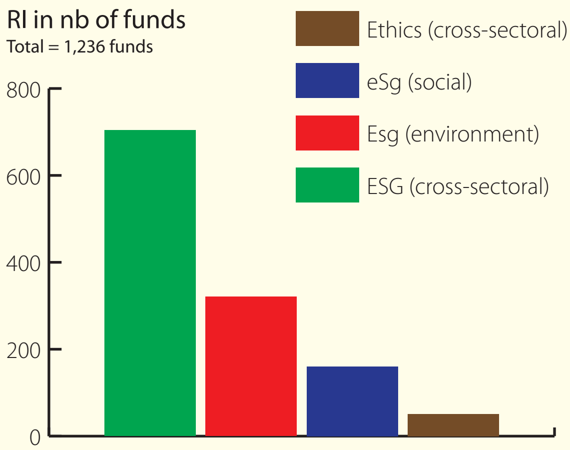
The Shari'a compliant investment universe has grown significantly. The total size of the Islamic funds industry was estimated at about USD58billion in 2010 (a growth of 13% from 2008) according to the Ernst & Young (EY) Islamic Funds & Investments Report 2011. According to the same report, the addressable universe for Islamic fund managers is in excess of USD500 billion, and is growing by at least 10-15% annually.

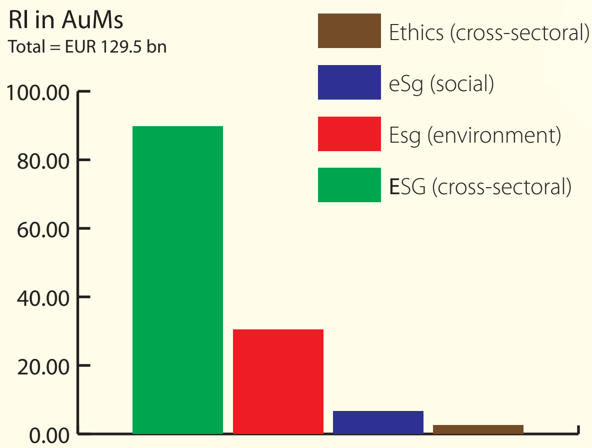
In the GCC, liquid wealth from Shari'a sensitive investors will add more than USD70billion to this pool by 2013. Although still comprising of mainly equities and some sukuk assets, other asset classes are emerging, such as Islamic money market instruments, commodities, real estate, and other alternative investments. A number of structured products and new funds have been introduced in recent years including Shari'a compliant exchange traded funds (ETFs).

There has also been significant growth in Shari'a-compliant undertakings for collective investments in transferable securities (UCITS) funds. Luxembourg and Ireland lead the way in this area, with significant regulatory and administration support. Luxembourg has built its position as the most popular domicile for UCITS. In addition, more flexible structures such as the Specialised Investment Funds (SIF), which allows a wide variety of different investment strategies, can be used for Shari'a-compliant private equity, property or other alternative investment schemes mainly aimed at institutional or high net worth investors. SIFs used either for Shari'a compliant funds or for conventional funds have proven to be highly successful with Middle Eastern investors according to the Association of the Luxembourg Fund Industry (ALFI).

Some cross borders initiatives by regional players from the GCC will certainly boost the development of Shari'a compliant wealth management services globally. Saudi Arabian based SEDCO Capital has pooled its assets and launched a sophisticated Shari'a Compliant Special Investment Funds platform. The AUM is estimated to be USD1.6 billion. Another example is a recent tie up of Commerzbank and Sharjah Bank for private banking services.

By Categories





Source: KPMG European Responsible Investment Fund Survey

According to a study conducted by KPMG (European Responsible Investment Fund Survey), 1,236 Responsible investment funds in Europe alone were identified with EUR129.49 billion AUM.

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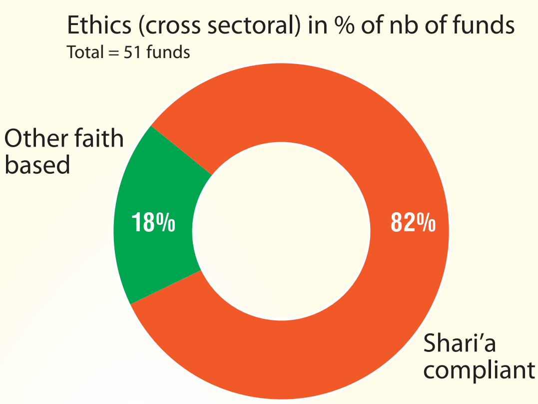

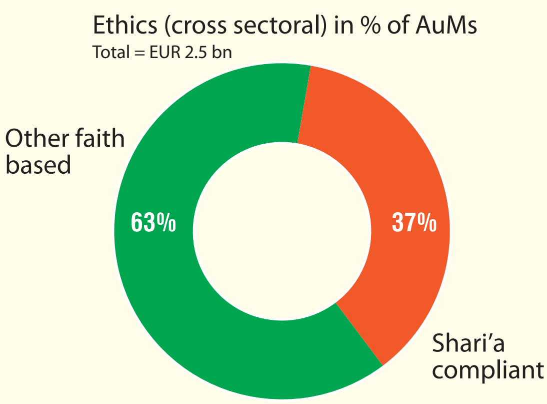

Source: KPMG European Responsible Investment Fund Survey

The same study identified 42 Shari'a compliant funds within the "ethics" category of SRI funds. There were 9 more funds that were not considered within the "ethics" category. Total AUM of the 51 funds was EUR2.5 billion representing 1.9% of the total assets of SRI funds. The growing importance of ethics within the investment industry and its convergence with the principles of Shari'a compliant management is likely to increase the acceptance of the alternative financial segment in secular markets.

Customer focus remains the winning strategy for wealth managers

As markets mature, wealth shifts away from deposits toward investments, driven by increasing need for asset diversification and customer expectation of higher returns. The adverse consequences of the financial crisis gave many customers a new appreciation for risk and transparency around the world. Increasingly, more sophisticated products are being offered - the one-size-fits-all approach to wealth management is out of date, although investment firms are faced with the challenge of providing their customers with customised solutions that are designed around their individual needs.

Customers increasingly expect more from their wealth managers in terms of information, education, guidance, advice, product choice and service levels. In short, wealth management providers will need to combine attractive investment returns, exceptional client service and internal operating efficiencies if they are to differentiate their offering and flourish in this exciting yet competitively challenging environment.

For Shari'a compliant offerings, wealth managers should find out what customers want and create a small set of Sharia compliant products that meet customer needs, but are not too difficult to develop and maintain. For a mutual fund, for example, a bank would screen investments to avoid forbidden activities or industries and would continuously monitor the portfolio to ensure that the product remains Shari'a compliant.

Challenging issues

Despite the promising progress that Shari'a compliant wealth management has witnessed recently, the nascent segment still faces challenges ranging from product scarcity, a shortage of appropriately qualified Shari'a scholars to serve on required review boards, the lack of a global consensus on Shari'a interpretation with regard to financial products, a lack of standardisation for transaction structuring, and developing the necessary talent pool.

Although the outlook for Shari'a compliant wealth management is promising, for the segment to thrive, it will need greater investment in areas such as research and development and Shari'a compliance in order to create product options that can cover demand for wealth protection, asset, investment and risk management. Even on the funds side, the range of Islamic funds is limited. Clearly, more work needs to be done for fixed income products and funds, but creating hedging products is also vital in helping to mitigate risk and creating higher-risk products.

Fund managers, in particular, require volume to remain in business, due to the high cost of building and maintaining the infrastructure required to manage a fund or group of funds, as well as setting up and funding Shari'a boards. Maintaining a Shari'a board is a cost that is unique to the Islamic fund industry and represents a considerable expense. The screening process to ensure products are Shari'a compliant can also be costly.

Another challenge is the concentration of investments within a handful of asset classes, and geographies. The current concentration of products, particularly around equities and real estate, has also highlighted vulnerability. Funds are also likely to be exposed to regulatory, political, legal, economic, and financial risk in cross-border investments.
Efficient management of these risks is vital for keeping costs low and funds profitable. The Islamic fund industry is highly fragmented, and high management fees prevent the achievement of economies of scale. Proper audit controls must be established to ensure that investments have been done in line with Islamic principles and profits are made based on Islamic investing. Moreover, distribution channels must be expanded to reach out globally.

Conclusion

Growing awareness among investors about the benefits of asset diversification and their willingness to consider unconventional investment options are factors helping to boost Islamic fund assets. But if investors are to improve the efficiency with which they maximise those options, it is essential that technical and practical issues which are peculiar to Islamic finance are tackled, for example, risk identification and management. Recent advances in key areas such as liquidity management, the emergence of new international jurisdictions to the Islamic debt space, and innovations which are creating the next generation of Islamic financial products, will provide the framework for the industry to achieve the needed scale and secure its position on the global map while creating sustainable and resilient Islamic financial markets.

As the segment redefines itself over the next few years, investment firms will have to demonstrate that they can provide a compelling value proposition built around exceptional service, strong investment performance, and competitive pricing, if they are to differentiate their offering in this exciting yet challenging environment.

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