Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation (COMCEC)

Islamic Fund Management

COMCEC COORDINATION OFFICE
October 2018

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AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ACAPS	Autorité de Contrôle des Assurances et de la Prévoyance Sociale (Insurance and Social Security Authority)
AMA	ASAAN mobile account
AMC	Asset management company
AMMC	Autorité Marocaine du Marché des Capitaux (Moroccan Capital Market Authority)
AuM	Assets under management
BAM	Bank Al-Maghrib
BNM	Bank Negara Malaysia
CAGR	Compounded annual growth rate
CDC	Central Depository Company of Pakistan Limited
CDS	Central Depository System
CFC	Casablanca Finance City
CFS	Continuous funding system
CGSMF	Credit guarantee scheme for small and marginalised farmers
CGT	Capital gains tax
CIS	Collective investment schemes
CISCA	Collective Investment Schemes Control Act
CKO	Centralised KYC Organisation
CLS	Continuous linked settlement
CMDP	Capital Market Development Plan
CMP	Capital Market Masterplan
COD	Certificates of deposit
COM	Certificates of musharakah
CPEC	China-Pakistan Economic Corridor
CSO	Conseil Supérieur des Oulémas (Council of Scholars)
DFIs	Development financial institutions
DTA	Digital transaction accounts
DNS	Directorate of National Savings
ECs	Exchange companies
EOBI	Employees Old Age Benefits Institution
EPF	Employees Provident Fund (Malaysia)
ESG	Environmental, Social and Governance
ETFs	Exchange Traded Funds
EU	European Union
FBR	Federal Bureau of Revenue (Pakistan)
FCIS	Foreign collective investment scheme
FDI	Foreign direct investment
Fintech	Financial technology
FIs	Financial institutions
FMI	Financial market infrastructure
FNB	First National Bank
FSB	Financial Services Board
FSCA	Financial Sector Conduct Authority
FSR	Financial sector regulation
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GEPF	Government Employees Pension Fund
GFCI	Global Financial Centre Index

GOM	Government of Malaysia
GoP	Government of Pakistan
HNWIs	High-Net-Worth Individuals
ICIS	Islamic collective investment scheme
ICM	Islamic capital market
ICP	Investment Corporation of Pakistan
IDB	Islamic Development Bank
IFAAS	Islamic Finance Advisory and Assurance Services
IFCI	Islamic Finance Country Index
IFD	Islamic Finance Department of the SECP
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IPO	Initial public offering
KYC	Know your customer
LTIA	Long-Term Insurance Act
MFIs	Microfinance institutions
MIFC	Malaysia International Islamic Financial Centre
MRA	Mutual-recognition agreement
MUFAP	Mutual Funds Association of Pakistan
NAV	Net asset value
NBFCs	Non-bank finance companies
NBFIs	Non-bank financial institutions
NCCPL	National Clearing Company of Pakistan Limited
NFIS	National financial inclusion strategy
NIT	National Investment (Unit) Trust
OPCI	Organismes de placement collectif en immobilier (Collective undertaking for real estate investment)
PA	Prudential authority
PDS	Private debt securities
PE	Private equity
PIB	Pakistan Investment Bonds
PMEX	Pakistan Mercantile Exchange Limited
PNB	Permodalan Nasional Berhad
PRS	Private retirement scheme
PSX	Pakistan Stock Exchange
PSX-KMI	Pakistan Stock Exchange-Karachi Meezan Index
REIT	Real estate investment trust
RMC	REIT management company
SAC	Shariah Advisory Council
SADC	Southern African Development Community
SAIA	South African Insurance Association
SAMOS	South African Multiple Option Settlement
SARB	South African Reserve Bank
SBP	State Bank of Pakistan
SC	Securities Commission (Malaysia)
SDG	Sustainable development goal
SECP	Securities and Exchange Commission of Pakistan
SGFG	Société Marocaine de Gestion des Fonds de Garantie des Dépôts Bancaires (the Moroccan Bank Deposits Guarantee Funds Management Company)
SIRESS	SADC Integrated Regional Electronic Settlement System
SME	Small and medium-sized enterprise

SRO	Self-regulatory organisations
STIA	Short-term Insurance Act
TFC	Term finance certificates
UAE	United Arab Emirates
UCIT	Undertakings for collective investment in transferable securities
VC	Venture capital
VPS	Voluntary pension scheme

EXECUTIVE SUMMARY

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

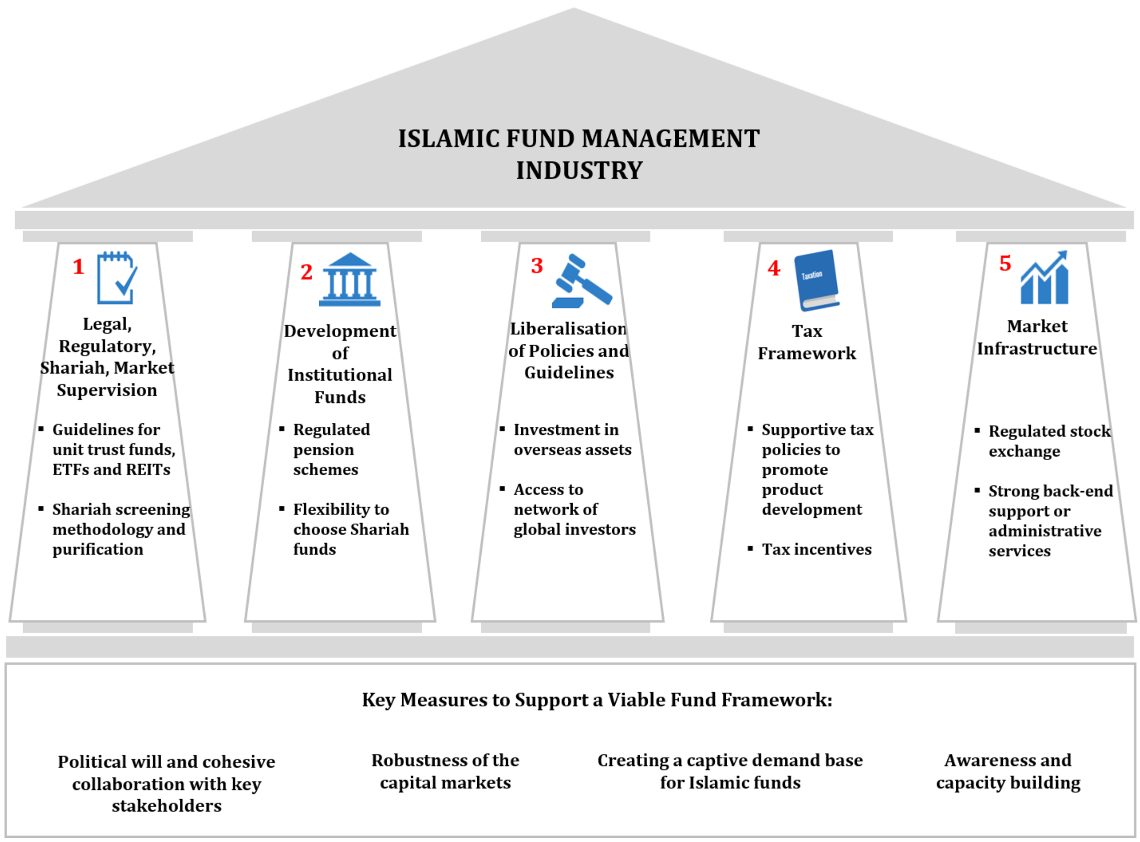
This report, *Islamic Fund Management*, reviews the development of the Islamic fund management industry and analyses the factors required to support its sustainable growth. In determining these factors, comparisons have been made between countries experiencing different stages of market progress—Malaysia as a matured market, Pakistan as a developing market (but in an advanced stage), South Africa also as a developing market (albeit in an intermediate stage), and Morocco as a market still in its infancy.

Overall, the Islamic fund management industry is still a niche sector representing a minor segment (i.e. USD56.1 billion as at end-2016) of the global fund management industry (USD84.9 trillion in 2016). As at end-2017, 88% of the industry's asset under management (AuM) was concentrated in the top five jurisdictions, i.e. Saudi Arabia (37.10%), Malaysia (31.66%), Ireland (8.62%), the United States (5.25%) and Luxembourg (4.76%), while the remaining 12% was distributed across 29 other jurisdictions including offshore domiciles.

The report also provides a detailed description of the various types of Islamic funds available in the market including Islamic equity funds, fixed-income funds, money market funds, exchange-traded funds (ETFs) and real estate investment trusts (REITs), along with their comparative advantages and disadvantages.

Following analysis of the case-study countries, it is acknowledged that the establishment of the necessary pillars to kick start or support the development of the Islamic fund management industry is key towards ensuring sustainable organic growth. **Figure 1** illustrates these core pillars.

Figure 1: Building Blocks to Sustain the Long-Term Growth of Islamic Fund Management



Source: RAM

Pillar 1 – Legal, Regulatory, Supervision and Shariah Frameworks

The establishment of a robust regulatory framework and ongoing market supervision engender trust in the markets, allowing greater transparency in product development, approval processes and governance while ensuring the protection of investors' interests. The governing rules and regulations that are issued by a regulatory body set the tone on the conduct of asset management companies (AMCs) or fund managers and facilitate the orderly development of the Islamic fund management industry. Since licences are issued by the authorities, misconduct or the provision of false information to the public will result in the revocation/suspension of licences and/or imposition of fines.

Equally important is the development of a trusted Shariah framework to govern the operations of the Islamic fund management industry within accepted Shariah parameters. The issuance of guidelines on Shariah screening and purification processes provides greater clarity to investors and other market participants as regards their business conduct.

Pillar 2 - Development of Institutional Funds

The development of a captive market for Shariah-compliant assets is key to building an investor base for Islamic funds. Wealth preservation and capital appreciation start with market awareness on the importance of investing and saving. Governments of developed and non-developed countries have instituted government-linked bodies to manage retirement funds. Furthermore, the level of financial inclusion differs from one country to another. As such, the institutionalisation of public savings goes a long way towards facilitating the development of a local fund management industry. An example in this regard is the making of retirement allocations compulsory for both employers and employees. Institutions that have been established to manage these funds provide funding to AMCs. Therefore, if Muslim members or those with certain ethical preferences or institutional investors choose to invest in Shariah-compliant funds, this will provide a catalyst for the development of the Islamic fund management industry.

Pillar 3 - Liberalisation of Policies and Guidelines

The liberalisation of policies and guidelines promote investment in a broader spectrum of assets and corporate bond markets while enabling fund managers and investors to diversify their investment portfolios. The entry of foreign-based fund managers into the local market also provides access to a global network of investors, hence opportunities for foreign investment in local funds. A diverse investor base plays an important role in deepening the liquidity of the domestic ICM. The liberalisation of capital controls is equally important to facilitate the free flow of capital funds.

Pillar 4 - Tax Framework

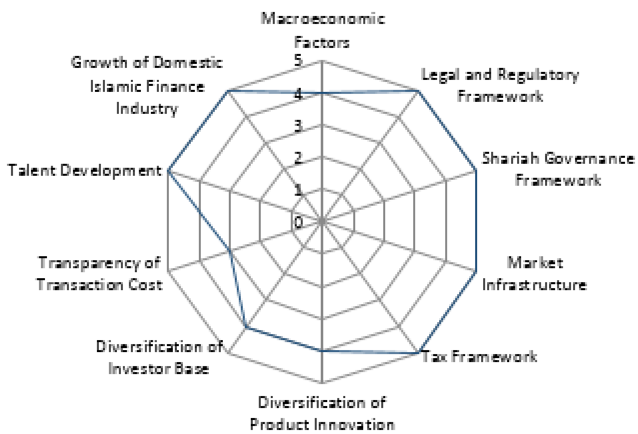
The establishment of tax neutrality facilitates the costing of Islamic finance products, so as to be competitive with conventional offerings. Additional tax incentives to encourage investors to choose Shariah investments provide another venue for the growth of the Islamic finance market. Some countries also provide tax rebates to individuals vis-à-vis investment in retirement schemes and children's education, all of which help strengthen demand for fund management.

Pillar 5 - Market Infrastructure

The development of a strong stock exchange facilitates investment in the equity of listed companies, and also for sukuk and funds to list on its platform. A fully integrated exchange that offers a complete range of exchange-related services—including trading, clearing, settlement and depository services—will help build robust equity and sukuk markets. The advent of a comprehensive value chain of intermediation, advisory and back-office services is equally important in supporting ICM activities. These include fund accounting as well as trustee, legal and audit services, which all play a significant role in the overall development of Islamic fund management.

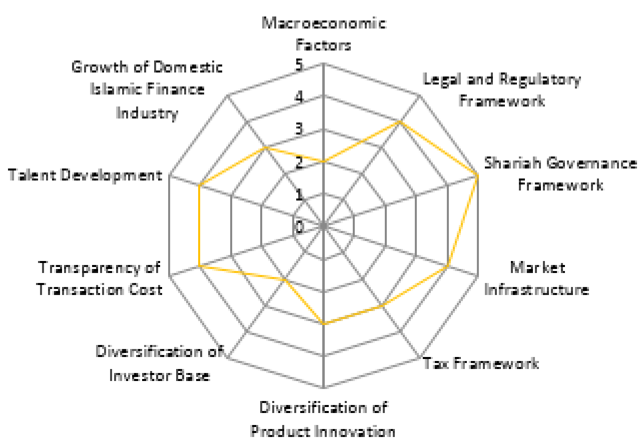
The lessons gleaned from the case studies have been summarised in a Development-Stage Matrix. Upon understanding the factors that had exerted the greatest impact, we have been able to create an ecosystem for the Islamic fund management industry. Accordingly, recommendations have been proposed to address the issues faced by the respective markets, depending on their level of progress.

The following spider charts encapsulate the current state of each case country's Islamic fund management industry and the areas, which need to be further enhanced to facilitate the industry's progression:



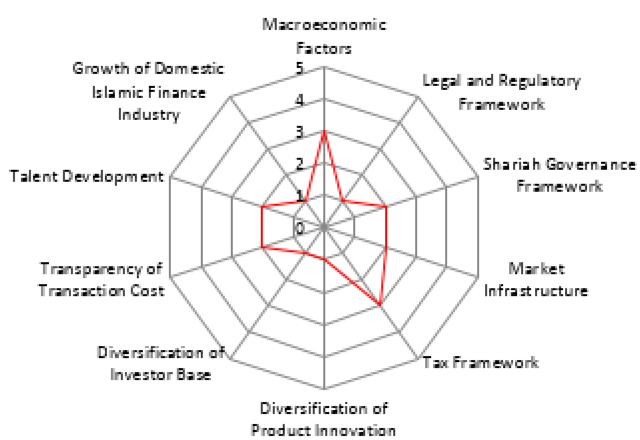
Malaysia

- Categorised as 'matured' due to its level of market maturity.
- Each factor was ranked favourably denoting the strong eco-system that the government and regulators have developed to support a thriving Islamic fund management industry.
- Nevertheless, there is room for further improvements which are discussed in detail in the respective case country section.



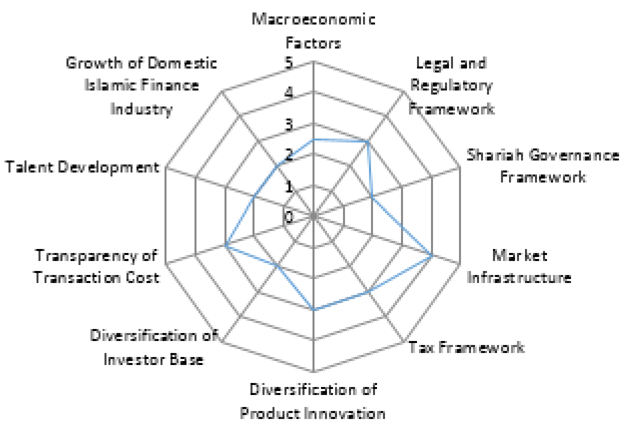
Pakistan

- Categorised as 'developing' (advanced stage) in view of a growing equity and sukuk market.
- The government and regulators have made concerted efforts to improve the policies and guidelines supporting the country's Islamic finance industry.
- As market activities improve, so will the level of progression for the variables denoted in the spider chart.



Morocco

- Morocco's Islamic finance industry is still in a nascent stage hence its categorisation as 'infancy'.
- The country's Islamic capital market has yet to be established. Only Islamic banking has been made available, having commenced operations in 2017.
- Its spider chart depicts the above conditions and the pillars which need to be developed.

	**South Africa** ▪ As a non-Muslim country, South Africa has fared well to be categorised as 'developing' (intermediate stage). ▪ Its robust banking system and healthy capital markets depict its budding potential to inculcate Islamic finance into its financial landscape. ▪ Sustainability of its Islamic fund management industry will be dependent on market practitioners' efforts to portray a valuable proposition in driving future growth.

Sources: RAM, ISRA

In conclusion, a key measure of success for any Islamic fund market is the extent to which it unlocks and promotes opportunities for wealth creation as well as capital formation. As such, the pillars supporting the overarching stability of an Islamic fund management industry and its collective development and progress will have a bearing on the pace of future growth. To further boost growth, the preservation of trust and confidence among market participants, especially retail investors, holds the key to success. Financial inclusion and the cohesive collaboration of key market stakeholders will thus determine whether domestic wealth can be created and leveraged to support a country's economic expansion.

1. INTRODUCTION

The capital markets, both Islamic and conventional, represent an important component of the overall financial system. Similar to conventional finance, the ICMs play a crucial intermediary role between the supply and demand of funds, by meeting the requisite investment and financing needs. ICMs must conform to certain rules and principles, as set out in the Shariah (Islamic law), such as the prohibition of interest (*riba*), uncertainty (*gharar*), gambling and speculation (*maysir*), investment in prohibited elements such as alcohol, pork, tobacco, pornography, illegal drugs and other non-permissible activities. An ICM thus provides a platform for the issuance of Shariah-compliant securities such as shares and sukuk (Islamic investment certificates, also known as Islamic bonds) in the primary market, thereby enabling the public and private sectors to raise funds to be channelled into productive investment areas. Market participants such as governments, Islamic banks, Islamic insurance (*takaful*) operators, AMCs and other institutions as well as households invest their excess liquidity in these Shariah-compliant securities—to earn capital gains, dividends and profits. Concurrently, an ICM enables the establishment of a well-functioning secondary market where market players can trade these securities, initially issued in the primary market, to manage their liquidity. By making available various financial services and fulfilling the needs of investors and fund seekers, ICMs contribute significantly to the overall development and growth of economies.

The ICM was initially developed in the 1990s through the equity market, with the Islamic screening of shares and the launch of Shariah-compliant funds. At the same time, the Islamic debt market had started evolving through the issuance of sukuk. Over the years, the equity market has expanded to include various types of funds such as Islamic unit trusts, Islamic exchange-traded funds (ETFs), commodity funds, Islamic real estate investment trusts (REITs), Islamic private equity (PE) and venture capital (VC) funds, money market funds, other structured funds and various types of Islamic indices and index products. The development of sukuk as an alternative to conventional debt securities has been an important step towards accelerating the development of ICMs. So far, sukuk has been the backbone of ICM development in many jurisdictions. It is expected to continue playing a major role in further expanding the frontiers of the ICM beyond Muslim countries.

For an efficient, well-functioning and well-regulated ICM, the key requisites include a facilitative legal and regulatory framework, a robust Shariah governance framework, attractive taxation policies, proper accounting and audit mechanisms, adequate risk-management strategies, product innovation, standardisation and documentation, as well as a diversified pool of investors and market players. In particular, the Shariah governance function requires important organisational measures to be in place to ensure the independent oversight of Shariah compliance over all processes in the industry, from product structuring and implementation to issuance and further development.

1.1 Aim, Objectives and Scope of the Study

The focus of this study is on the Islamic fund management industry, which represents a key segment of the overall Islamic finance industry, and the ICM in particular. The aim is to examine the working mechanisms, development, challenges and prospects of the Islamic fund management globally as well as in country-specific case studies. The key objectives are as follows:

1. Analyse the historical development, theoretical nature, legal and regulatory aspects of Islamic funds, along with the debates on and interpretation of various schools and jurisdictions. We also discuss the differences and similarities between Islamic fund management and its conventional counterpart.
2. Examine the structures and working mechanisms of various types of Islamic funds as well as the specific issues and challenges encountered in the further development of this sector.
3. Undertake country-specific case studies to present the current status of the Islamic fund management industry in various countries, alongside the issues faced by each jurisdiction and the best practices to be adopted to enhance the development prospects of Islamic fund management.

This study provides policy recommendations to promote Islamic finance in the sub-sector of establishing, structuring, managing and implementing Islamic funds at both the global and national levels. It is prepared for the relevant policy makers of OIC member countries to provide guidelines on the building of a cohesive roadmap for Islamic fund development. The study can also be beneficial to other audiences such as non-OIC member countries, international organisations and the overall international finance community. Its coverage includes mostly OIC member countries; where specifically stated, some non-OIC member countries have also been examined.

1.2 Methodology

The study employs the following research methodologies:

1. **Literature Review**: It involves a review of secondary sources of literature, both written and visual, and investigation of information, documents, publications and the experience of the relevant countries (OIC member nations as well as countries from the rest of the world), and national and international institutions. Specifically, the policies and practices on fund management, both national and global, have been reviewed by accessing specific countries' reports and analyses, industry and economic reports, and other research publications.

2. **Desk-Based Research**: This comprises accessing primary data on the type of funds, size, market share, asset class, investor type, domicile, and other information from data providers such as Bloomberg and Eikon-Thomson Reuters, besides national regulators such as securities commissions and central banks. Data published by international institutions such as the World Bank, the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB) and others have been referred too.

3. **Field-Visit Case Studies**: This comprises the analysis of OIC and non-OIC member countries, as case studies, based on field visits. The cases specifically focus on analysing national and international institutions in their capacity to promote Islamic fund management. The field visits mainly involve the compilation of data and information that are otherwise not accessible, and the appraisal of issues regarding Islamic fund management policies and practices such as administrative and political challenges, perception and awareness, market dynamics and other aspects. The method adopted comprises face-to-face interviews and discussions with key informants (e.g. regulators, policy makers, fund managers, investors, consultancy firms and others).

4. **Country Groupings/Categories:** To facilitate analysis and recommendations, the study has organised the country-specific case studies into country groupings/categories by focusing on the geographical groups of the OIC (Arabian, Asian and African) and the development level of their respective conventional and Islamic fund management industry.

The study showcases four countries, i.e. Malaysia, Pakistan, Morocco (representing OIC member countries) and South Africa (representing non-OIC member). The countries have been selected based on their regional location, as reflected in **Table 1.1**.

Table 1.1: Case-Study Countries by Regional Location

	Arab	Asia	Africa
OIC Member	Morocco	Malaysia Pakistan	
Non-OIC Member			South Africa

The development levels of the Islamic fund management industry in the respective countries are categorised based on the analysis in **Table 1.2.**

Table 1.2: Case-Study Countries by Growth and Competitiveness Level

	Slow market growth	Rapid market growth
Strong competitive position	Category B	Category A
Weak competitive position	Category D	Category C

Countries in **Category A – Rapid market growth and strong competitive position of Islamic fund management industry**. They face challenges in their efforts to continue building on their success while ensuring Islamic finance remains central to the development of their capital markets as they evolve (e.g. Malaysia).

Countries in **Category B – Slow market growth and strong competitive position of Islamic fund management industry**. They face challenges in trying to bring their Islamic fund management industry on to a level playing field vis-à-vis the conventional segment. The existing infrastructure may, however, be helpful in making the industry competitive relative to its conventional counterpart. The improvement of macroeconomic conditions is crucial towards driving the growth (e.g. Pakistan).

Countries in **Category C – Rapid market growth and weak competitive position of Islamic fund management industry.** This is applicable to countries with an expanding Islamic fund management industry, but which is still relatively small compared to the overall industry.

Countries in **Category D – Slow market growth and weak competitive position of Islamic fund management industry.** This requires the fundamental enhancement of the infrastructure of the Islamic fund management industry infrastructure (e.g. Morocco).

1.3 Overview of the Study

The study is organised as follows:

Executive Summary: It summarises the key discussions, findings and recommendations of the study.

Chapter 1 – Introduction: This chapter introduces the study, stipulates its aim and objectives, delineates the research methodology adopted, and provides a brief overview of the study content.

Chapter 2 – Review of the Global Islamic Fund Management Industry: This chapter provides an overview of the development of the global fund management industry, including Islamic funds. In particular, it explains the workings of a fund, examines its role in the capital markets and overall economy, differentiates between conventional and Islamic funds, and provides an overview of current trends, sizes, types, asset classes, investors, vehicles and other aspects. The chapter also focuses on Islamic fund management, examining the Shariah requirements in setting up an Islamic fund, the contractual obligations in an Islamic fund structure and the roles of the various parties involved in Islamic fund management. In addition, the chapter discusses the evolution of the fund management industry against the backdrop of new trends such as sustainable and responsible investment (SRI) and financial technology (fintech).

Chapter 3 – Comprehensive Analysis of Islamic Fund Management: Infrastructure Development, Investment and Commercial Considerations: This chapter provides a comprehensive and detailed analysis of the various types of Islamic funds by focusing on the establishment, the structure, Shariah guidelines, as well as legal and regulatory requirements. It also analyses the investment and commercial considerations of fund set-up, including the type of fund, investment strategies, asset allocation, portfolio monitoring and periodic rebalancing, operational costs, target investors and geographical distribution. Lastly, it discusses the critical success factors and challenges when developing the Islamic fund management industry.

Chapter 4 – Country-Specific Case Studies: This chapter first introduces the methodology and selection criteria of the country-specific case studies, the policies and practices in Islamic fund management which have been examined in this study. It then presents an analysis of the Islamic fund management market in four countries, i.e. Malaysia, Pakistan, Morocco and South Africa. The case studies involve the examination of the domestic and global market shares of the different segments of the Islamic finance market in the respective countries, the evolution of Islamic fund management, the infrastructure development of Islamic funds, investment and commercial considerations, the key factors underpinning the overall growth and development of Islamic fund management, the lessons learned and country-level recommendations.

Chapter 5 – General Policy Recommendations for Implementation by OIC Countries: This chapter offers general policy recommendations on the setting up and development of Islamic funds within the context of their working mechanisms, legal and regulatory framework, Shariah governance, market and infrastructure development, commercial issues and other challenges that affect the progression of the Islamic fund management industry. It then stipulates policy recommendations in the form of a roadmap, which OIC member countries can benefit from in their efforts to develop Islamic funds and Islamic finance in general. The policy recommendations are proposed based on the stage of market development, as described in **Table 1.2** above.

Chapter 6 – Conclusion: This chapter summarises the findings of the study and concludes the study.

2. REVIEW OF GLOBAL ISLAMIC FUND MANAGEMENT INDUSTRY

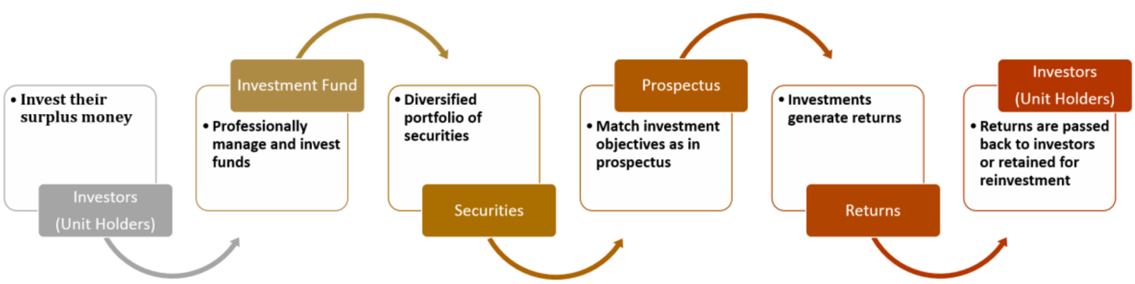
The Islamic equity market has evolved through the years, from the development of Shariah-compliant screening methodologies that have led to the development of Shariah-compliant stocks and Islamic indices, to the development of more innovative structured investment products and different types of funds. Besides products and services, the Islamic equity market has also expanded in terms of market players, geographical coverage, infrastructure development, financial technology, sustainable strategies, and other areas. This chapter sheds light on the development trends in the global fund management industry, particularly Islamic funds. It explains the principles, roles, functions, mechanisms, evolution and future trends in Islamic fund management.

2.1 Development of Global Fund Management Industry

2.1.1 Definition of Fund Management

Fund management involves a group of investors channeling their surplus money to a legal entity known as a 'fund', which pools the collected funds and invests it in a diversified portfolio of securities and other assets to achieve specific financial goals (ISRA, 2015, p. 524). Investors, usually known as shareholders or unit holders, can be individuals or institutions. The legal entity that professionally manages the funds and undertakes the investment on behalf of the investors is known as a fund manager or fund management company. The fund manager handles the clients' investments, establishing a portfolio of assets constituting securities such as stocks, bonds, money market instruments, a combination of these or even other funds. The fund's portfolio of investments is structured and maintained to match its investment objectives, as stated in its prospectus. The flow chart of the fund management process is depicted in **Figure 2.1**.

Figure 2.1: Flow Chart of the Fund Management Process



Source: ISRA

The fund sells shares or units to investors and redeems shares from those who wish to have their money back, at a price determined by the current net asset value (NAV) of the fund (Gerber, 2008, p. 3). The NAV is the price of one share in the fund at the end of the trading day. To get an initial unit value of a share at the time the fund is created, the monetary value of its investments is divided by the number of units issued. The NAV of the fund then fluctuates as the underlying assets trade daily and investors buy and sell the units of the fund.[1]

Each share or unit in the fund represents an investor's proportionate holding of the fund's portfolio, based on his/her share of capital contribution. The unit holder is equally entitled to a proportionate share of the returns generated by the investment fund (net of the manager's cut and any other possible deductions). Returns are usually in the form of income distribution (dividends) and/or capital appreciation, as the fund's value grows with the good performance of its underlying assets.

Most funds charge the following types of fees:

- A commission fee upon the purchase of units, known as a front-end load.
- A redemption fee upon the sale of units, known as a back-end load.
- An annual management fee.

Some funds also charge fees or penalties for early withdrawals.

Box 2.1 provides the definition of an investment fund, as given by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

Box 2.1: Definition of Investment Fund by AAOIFI

Funds are investment vehicles, which are financially independent of the institutions that established them. Funds take the form of equal participating shares/units, which represent the shareholders'/unit holders' share of the assets and entitlement to profits or losses. Because funds are a form of collective investment that continues throughout their terms, the rights and duties of participants are defined and restricted by the common interest since they relate to third parties' rights. As such, in cases where the fund is managed on the basis of agency, the shareholders/unit holders will waive their right to management, redemption or liquidation, except in accordance with the limitations and conditions set out in the statutes and by-laws.

Source: AAOIFI, Financial Accounting Standard No. 14, Investment Funds, Appendix B.

An investment fund usually falls under the umbrella term of collective investment scheme (CIS). Depending on where the funds originated from and are domiciled, they can take the form of unit trusts, investment trusts, mutual funds or other appellations. For instance, investment funds in the United States (US) are generally known as mutual funds. Unit trust, on the other hand, is a more common term in the United Kingdom (UK) but is also used in other countries such as Malaysia, South Africa and Indonesia. A unit trust is a distinct vehicle that applies a trust structure over the fund company's structure. The trustee acts on behalf of its beneficiaries, typically investors, and engages professional fund managers to manage the investments of the beneficiaries. Besides investment in commercial papers, a unit trust can also invest in other assets such as real estate.

Funds originated under the European Union (EU) legal framework are usually known as Undertakings for Collective Investment in Transferable Securities (UCITS). While UCITS have to comply with EU regulations, they are still subject to the regulations of the country where

[1] The fund management process described here applies in general. ETFs, for instance, work differently. NAVs for funds with non-listed assets will also work differently.

they are domiciled. Given that, they have to meet certain levels of regulatory and investor-protection requirements, UCITS are appealing to international investors and increasingly gaining traction in different regions, including Asia, Africa and Latin America (ISRA, 2015, p. 525).

2.1.2 Key Differences Between Islamic and Conventional Funds

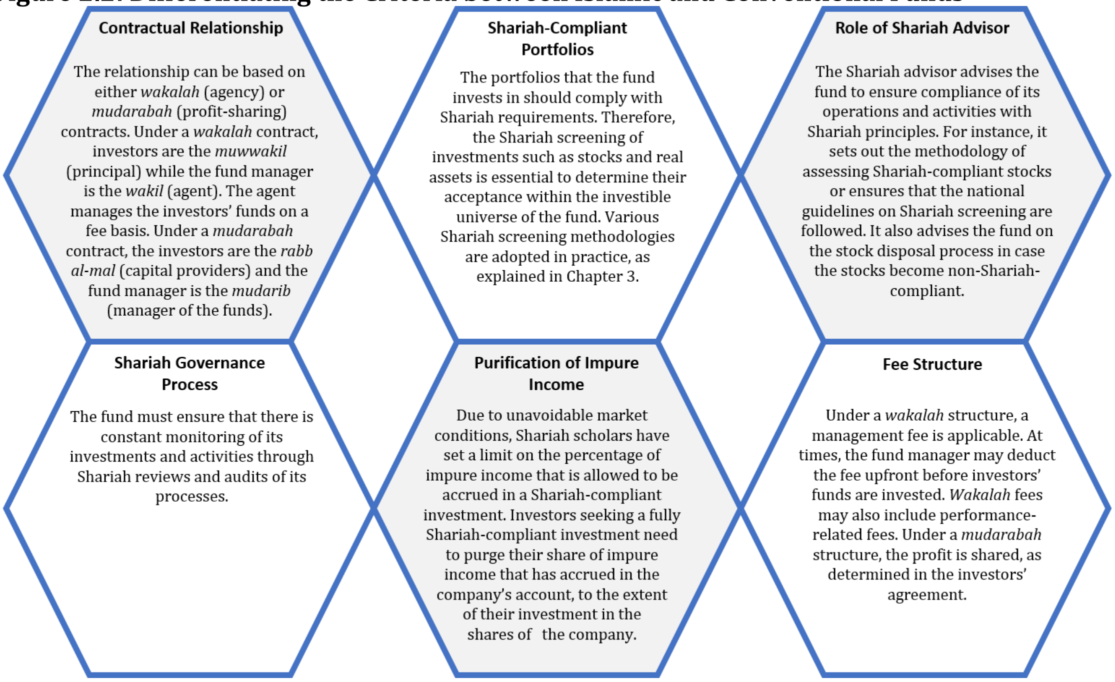
Islamic investment funds are similar to conventional funds in terms of the common objectives that they share, such as pooled investment, capital preservation and returns optimisation (ISRA, 2015, p. 523). The activities of the two sets of funds are also similar, involving the following:

- Determining clients' financial needs and objectives.
- Financial analysis of investments.
- Selection of assets and securities.
- Investment planning and strategies.
- Portfolio monitoring and periodic rebalancing.

The distinguishing feature between the two types of funds is that Islamic funds must always comply with Shariah rules and laws in terms of their operations, activities and investments.

Islamic fund management is therefore about the professional management of investors' money in Shariah-compliant securities and assets, in line with Shariah principles to achieve set financial goals. Elements such as Shariah screening of investments, the role of Shariah boards, Shariah governance mechanisms involving Shariah reviews and audits, purification of impure income and alms-giving (*zakah*) calculation are important in the adherence of Islamic funds' activities to Shariah requirements. The key differentiating criteria that distinguish Islamic from conventional funds are explained in **Figure 2.2**.

Figure 2.2: Differentiating the Criteria between Islamic and Conventional Funds



Source: Adapted from ISRA (2015)

It is also important to highlight that one of the key effects of Islamic asset management is in security selection. **Table 2.1**, for instance, depicts the difference in asset allocation between a conventional and Islamic investor.

Table 2.1: Difference in Asset Allocation between Conventional and Islamic Investor

Conventional Investor

Asset Class	Allocation
Money market funds	5%
Fixed income	40%
Equities	40%
Alternative Investments	15%

Islamic Investor

Asset Class	Allocation
Murabahah and trade finance funds	5%
Sukuk	40%
Shariah-compliant equities	40%
Shariah-compliant alternatives	15%

Source: Sandwick (2016)

2.1.3 Role of Fund Management from Economic and Islamic Viewpoints

In many countries, the development of banking is often prioritised to the detriment of fund management. This has a potentially negative impact on financial stability—as fractional reserve banking is a more fragile model—and efficient capital mobilisation. Banks favour collateralised capital lending to the public/corporate sector and personal (home and car) segment. This leaves small and medium enterprises (SMEs) relatively underserved. Specialised VC and PE funds are generally skilled at deploying capital, raising corporate capabilities and enhancing corporate behaviour. Screening by investors in the public space also influences corporate behaviour (e.g. negative screen from the boycotting of companies practising apartheid in South Africa by investors in the 1970s, to modern-day ESG screens employed by powerful investor networks, such that companies are incentivised to adopt high ESG standards).

The advantages of developing an asset management industry are as follows:

- Low capital inputs, high intellectual property inputs.
- Stable earnings when minimum volumes are achieved.
- Less earnings volatility.
- Broad gross and net margins.
- High return on shareholder capital.
- Much lower risks than investment banking (Sandwick, 2016).

From a macroeconomic perspective, a thriving fund management industry plays an important role in:

- Promoting savings and investment.
- Circulating capital in the real economy.
- Providing the needed liquidity to fund the capital requirements of sovereigns, institutions and individuals.
- Enabling greater authenticity of risk-sharing than typically possible in banking.
- Complementing the Islamic banking and *takaful* sectors.
- Contributing to economic development and growth.

From a microeconomic perspective, professional management of pooled investments offers significant advantages. It allows individuals and institutions to combine smaller amounts of money into a larger sum, thus participating in a wider range of investments that may not be feasible for an individual investor (Gerber, 2008). This enables investors to attain economies of scale and become part owners of real assets or business activities, something not possible for an individual investing alone. Investors also benefit from lower costs (i.e. smaller brokerage commissions) as the cost for professional management is spread across many investors. Fund management further allows investors to profit from a reduction of risks through diversification. The pooled funds can be invested in different companies, sectors, countries and regions, thus gaining access to a vast array of investment opportunities at minimum risk. Other advantages include:

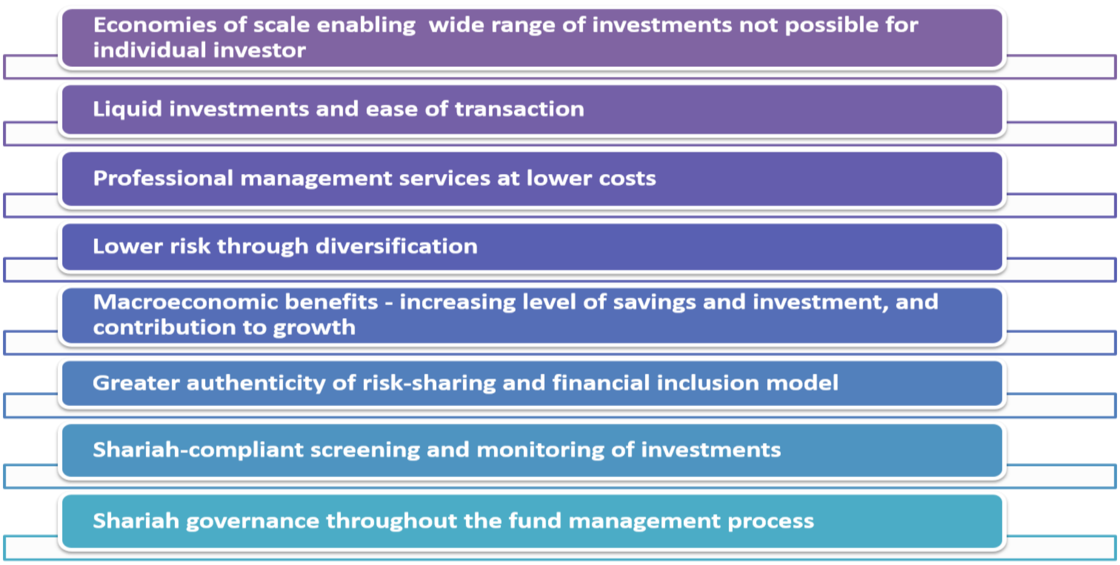
- Convenience in getting in and out of the fund.
- Ease in selling back units and reverting to a liquid position.
- Convenient record keeping and administration.
- Good financial returns over the long term.
- Transparency, access to information and better corporate governance.
- Possible tax benefits.
- Well regulated, hence investors are assured of a certain level of protection.

From an Islamic perspective, fund management addresses the following issues faced by an individual investor seeking Shariah-compliant investment avenues:

- Search cost in selecting Shariah-compliant investments.
- Screening requires a considerable amount of information (e.g. company annual reports, accounts) to be scrutinised, perhaps over a period of several years, to discern trends and know if the investee company has kept to its stated objectives. The fund manager either adopts its own screening methodologies or tracks an Islamic index.
- Skills are required to analyse financial ratios.
- Conflicting advice is often given by Shariah scholars, financial advisers and other consultants. This raises the issue of interpretation and coordination at the level of the individual investor.
- Shariah governance in the form of investment reviews and audits.

Figure 2.3 summarises the roles and advantages offered by Islamic fund management from both the economic and Islamic perspectives.

Figure 2.3: Roles and Advantages of Islamic Fund Management



Source: ISRA

2.1.4 Different Types of Islamic and Conventional Funds

There are three general types of funds: open-ended, close-ended and exchange-traded. Each of these offers investors an easy and low-cost opportunity to invest in a diversified pool of investment with specified investment objectives (Foster, 2014). Specifically, these funds differ in the following aspects:

- An open-ended fund has no limit on the number of units/shares that it can issue. An investor can purchase/sell units directly from the fund or through authorised agents. The fund creates more units to meet demand from investors and the money collected is invested in securities that form the portfolio of the investment fund. The performance of the underlying assets of the fund determines its NAV, which is calculated at the close of every trading day. Investors can buy and sell units from the fund at a price determined by the NAV of the fund. Prices can thus rise and fall based on fluctuations in the NAV.

- A close-ended fund issues a fixed number of shares via an initial public offering (IPO). Once the IPO is over, it is closed to new investments (ISRA, 2015, p. 540). The fund is listed on the stock exchange and its shares are traded on the exchange. Similar to stocks, its share price is determined by market supply and demand; it is often trading at a discount or premium to its NAV (Foster, 2014).

- An ETF invests in securities that track an index such as the S&P 500 or the Dow Jones (ISRA, 2015, p. 543). Its portfolio reflects the constituents of the index and hence replicates the performance of the index. Ownership of the ETF is divided into shares; unlike open-ended funds, its shares are traded like stocks on a stock exchange. Its share price is determined by market supply and demand, similar to a close-ended fund. However, this more closely tracks its NAV compared to close-ended funds as, unlike the latter, ETF shares are continuously issued or redeemed by a financial institution (Foster, 2014).

Investment funds can also be categorised based on their investment portfolios, which in turn reflect the asset class they invest in. **Table 2.2** provides a list of different types of funds based on their investment portfolios and assets.

Table 2.2: Type of Funds by Investment Portfolio and Asset Class

Type of Fund by Investment Portfolio	Description	Assets Invested In
Equity Fund	Principally invests in the stocks of listed companies. Can be actively or passively managed (tracks an index). Can be further sub-categorised into: ▪ **Growth fund,** which invests in a diversified portfolio of stocks that aims for capital appreciation and pays little or no dividend. Growth stocks are from companies that are expected to grow more rapidly than the overall stock market. They can be from small- or large-cap companies. ▪ **Equity income fund,** which invests in stocks that provide income to unit holders in the form of dividends.	Company stocks.
Commodity Fund	Invests in commodities such as precious metals (e.g. gold), energy resources (e.g. oil and gas), agricultural goods (e.g. wheat), livestock (e.g. animals). Besides direct holdings of commodities, they can also invest in stocks of companies involved in the commodity markets (e.g. gold-mining companies) and commodity options and futures. Generally, the more a commodity is in demand, the higher the price and profit for the investor.	Commodities, commodities options and futures. Shariah-compliant commodities for Islamic commodity funds.

Type of Fund by Investment Portfolio	Description	Assets Invested In
Money Market Fund	Invests in short-term money market securities (one year or less) and aims mainly to preserve its principal capital and generate a modest income for the unit holders. Commonly deemed as safe as bank deposits, but with a higher yield. Extremely liquid; investors can withdraw their money at any time, with almost no risk of loss of principal. Islamic money market funds invest in short-term sukuk and other investment instruments.	Short-term treasury bills, debentures, commercial papers. Short-term sukuk for Islamic money market funds.
Fixed-Income Fund	Its main objective is to generate a flow of fixed income.	The government, municipal and corporate debt obligations, preferred stocks, money market instruments, and dividend-paying stocks. Sukuk and dividend-paying stocks for Islamic fixed-income funds.
Balanced or Mixed Fund	Its investment objective is to attain a mix of safety, income and capital appreciation/growth while avoiding excessive risk. Investment in each asset class usually must remain within the minimum and maximum ratios.	Mix of stocks (for growth), bonds, money market instruments or other fixed-income instruments (for income). Shariah-compliant stocks and sukuk for Islamic balanced funds.
Index Fund	The investment portfolio is constructed to match or track the components of a market index. It, therefore, aims to replicate the performance of a benchmark index, regardless of market conditions. This type of fund falls within the category of passive investing.	Invest in all the constituents of the market index or representative securities of the market index.
Fund of Funds	Invests in units/shares of other investment funds instead of investing directly in stocks, bonds or other securities. This investment strategy is also known as a multi-manager investment, where investments in a variety of funds are all bundled into a single fund. Diversification can be achieved by investing in	Units of other funds.

Type of Fund by Investment Portfolio	Description	Assets Invested In
	funds from other countries or in different sectors and asset classes, with various risk exposures.	
REIT	Invests in a diversified pool of properties, e.g. commercial buildings, student accommodations, retirement homes, shopping malls, housing complexes, land and plantations. Returns take the form of rental payments. REITs usually have to distribute most of their gains as dividends to their unit holders.	Real estate. For Islamic REITs, tenants must be involved in Shariah-compliant activities.

Sources: ISRA (2015), PWC (2016), ISRA

While the abovementioned funds can have their Islamic equivalents, there are also some—such as PE and VC funds, hedge funds and other specialist funds—that are commonly classified as alternative funds. PE and VC funds, for instance, do not actively invest in the capital markets. Others such as pension funds and sovereign wealth funds are often loosely referred to as funds, even though they are institutions with multiple 'funds'. These are classified in **Table 2.3** below as alternative types of funds. Within this category, certain types of Islamic funds, such as *ijarah*, *murabahah*, *hajj* and *waqf* funds, are described in more detail.

Table 2.3: Alternative Funds and Some Specific Types of Islamic Funds

Alternative and Islamic Funds	Description	Assets Invested In
PE and VC Funds	These refer to investments in PE and VC firms, with the aim of improving the performance of the companies and disposing of these investments at a higher rate of return. PE involves investment in more mature businesses while VC refers to investment in riskier start-up businesses. Investors of these funds are mostly institutional and high-net-worth clients, which typically hold them for more than 10 years plus a number of extensions. PE/VC funds are high-risk investments; they are expected to provide higher returns, outperforming traditional asset classes.	Riskier start-up companies (VC) and mature businesses (PE).
Pension Fund	Collects the pension contributions of employers and employees, and invests in a diversified portfolio of assets. Generally has large amounts of money to invest and stand among the major stakeholders of listed and private companies.	Invests the pension contributions of employees and employers.
Hedge Fund	Distinct from mutual fund/unit trust as it pools funds from sophisticated and institutional investors and invests in a variety of assets, with complex portfolio construction and risk-management strategies. Islamic hedge funds have attracted much controversy while others allow Shariah-compliant hedge funds.	Equities, fixed-income securities, options, futures, swaps.
Sovereign Wealth Fund	Refers to an investment fund owned and managed directly or indirectly by a government to achieve	Infrastructure, real estate, commodities

Alternative and Islamic Funds	Description	Assets Invested In
	national objectives such as economic development, capital maximisation and stabilisation (PWC, Sovereign Investors 2020).	such as oil and gas, private equities.
***Ijarah* Fund**	Invests in real assets, which are then leased and generate rental payments to the unit holders. A REIT is an example of an *ijarah* fund.	Leased assets.
***Murabahah* Fund**	Involves the purchase and sale of commodities or real assets on deferred payment terms. An example is a commodity *murabahah* fund.	Commodities, real assets.
***Hajj* Fund**	Entails collecting, managing and investing the savings of those wishing to go for their *hajj* (pilgrimage). An example is Lembaga Tabung Haji—popularly known as Tabung Haji (Pilgrimage Fund) in Malaysia.	Shariah-compliant investments, e.g. Islamic securities, commodities, assets.
***Waqf* Fund**	Involves the management of *waqf* properties, and investing the returns in Shariah-compliant assets.	Properties, investments with social objectives (e.g. healthcare, education, poverty reduction).

Sources: ISRA (2015), ISRA

2.1.5 General Principles of Fund Set-Up, Historical Evolution, Key Global Trends

The basic principles of fund set-up, as briefly noted in **Figure 2.4**, are applicable to both conventional and Islamic funds. Setting up a fund involves considering key aspects such as determining the domicile country that offers the right level of a regulatory framework to establish the fund, accounting for the target investors and their needs, determining the investment objectives and strategies of the fund, and selection of securities. These are considered during the different stages of the fund's setting up.

Figure 2.4: Process Flow of Fund Development

Stage 1: Conceptualisation	Stage 2: Planning	Stage 3: Regulatory Approval	Stage 4: Implementation	Stage 5: Monitoring
Investment Analysis	**Financial Analysis**	**Submission**	**Portfolio Development**	**Performance Analysis and Portfolio Review**
▪ Target investors – retail, sophisticated investors or wholesale. ▪ Choice of Shariah assets (e.g. equities, sukuk, money market, combination of assets). ▪ Shariah screening and benchmark selection (e.g. AAOIFI, Dow Jones). ▪ Select investment strategy (e.g. passive, balanced, aggressive).	▪ Selection of asset class. ▪ Investment strategy. ▪ Quantitative measures for risk and return. ▪ Shariah screening methodology. ▪ Shariah compliance procedures. ▪ Define purification process. ▪ Define compliance and audit review processes.	▪ Guidelines and policies. ▪ Checklist and submission for approval. ▪ Proactive engagements with regulators.	▪ Implement investment strategy. ▪ Strategy optimisation – risk and return. ▪ Shariah review and compliance. ▪ Appointment of professional managers (e.g. Shariah advisors, legal, trustee, auditors, tax consultants).	▪ Performance measurement. ▪ Peer benchmarks. ▪ Rebalancing considerations. ▪ Review of Shariah compliance (e.g. Shariah-compliant stocks). ▪ Implement purification processes (if required). ▪ Perform compliance and audit reviews. ▪ Committee reporting and strategy update based on market conditions.

Sources: Saturna Sdn Bhd, Amundi Islamic Malaysia Sdn Bhd, Franklin Templeton Asset Management (Malaysia) Sdn Bhd, RAM

Additionally, Islamic fund managers need to take into account the specific Shariah-related issues discussed earlier in **Figure 2.2**. These include the elements of proscribed investments and activities, the requirements for Shariah screening of investments, the necessity of appointing a Shariah board and carrying out Shariah reviews and audits, the need for purification of income, and the application of the appropriate fee structure.

The idea of setting up a mutual fund is reportedly a relatively recent development. It dates back to the beginning of the 20th century when Boston law firms had initially established trust divisions to manage the assets of wealthy families (Pozen and Hamacher, 2011). The mutual fund had then evolved as the wealth of families were passed down through generations, with the ensuing need to manage multiple family accounts. In 1924, the concept of open-ended funds was mooted as the fund accepted new money and allowed investors to redeem their shares on a daily basis (Pozen & Hamacher, 2011).

The concept of Shariah-compliant funds, on the other hand, arose from Muslims' need for the management of their investments in accordance with their faith. The concept of fund management had been originally been adopted from the Islamic practice of endowment (*waqf*) (ISRA, 2015, p. 534).

The first modern Islamic investment fund in Malaysia appeared in the early 1960s, with the development of the Tabung Haji (Pilgrimage Fund). This fund collects the savings of Muslims who wish to go on the pilgrimage (*hajj*). This idea is being increasingly used in many other countries to kickstart their fund management industries.

Another aspect of the early-stage development of the Islamic equity markets had centred on the need to establish clear guidance on the Shariah legitimacy of investing in company shares, especially when such firms deal with prohibited elements such as *riba* (interest), and in unit trust funds. Although the idea of investing in a partnership (*musharakah*) fund is well recognised in Shariah, there are issues that must be dealt with, such as the legal personality of a company, the limited-liability structure of a company, participation in companies that occasionally deal with prohibited transactions, e.g. usury, and the trading of shares (ISRA, 2015, p. 474-484). These issues were discussed at the OIC Islamic Fiqh Academy in 1992, during its 7th session in Jeddah, Saudi Arabia; in 1993, during its 8th session in Brunei Darussalam; and in 1995, during its 9th session in Abu Dhabi, the United Arab Emirates (UAE). Notably, Resolution 63/1/7 at the 7th session prohibited investment in the shares of companies that dealt with prohibited elements:

> The basic principle is the prohibition of participating in companies that deal at times in prohibited things such as riba etc., even though their main activities are permissible.

However, prohibiting participation in such companies is deemed to inflict harm on the public and cause hardship. That is why a 'tolerant' view has been adopted by many Shariah authorities on the basis of necessity, which acknowledges the widespread use of interest in commercial markets and the principle of removal of hardship and harm from Muslim investors. This means that the impermissible businesses and operations of such companies are restricted to a certain tolerable limit (the SAC of the SC, 2006; AAOIFI, 2015).

The review and identification of Shariah-compliant stocks had led to further developments in Islamic equity markets, as elucidated in **Figure 2.5**.

Figure 2.5: Further Developments in Islamic Equity Markets

1983	Initial efforts by Bank Islam Malaysia Berhad to provide a list of Shariah-compliant stocks.
June 1986	Amana Income Fund, the first Islamic equity fund to be established in the United States by members of the North American Islamic Trust (NAIT).
1987	Dallah AlBaraka Group established two companies—Al-Tawfeek and Al-Amin—specifically dedicated to the development of Islamic equity funds.
May 1996	First Islamic equity index introduced in Malaysia by RHB Unit Trust Management Berhad.
June 1997	Securities Commission Malaysia introduced a list of Shariah-compliant stocks.
1999	Launch of the Dow Jones Islamic Market Index (DJIM) by Dow Jones & Company in February, the Kuala Lumpur Shariah Index (KLSI) by Bursa Malaysia in April, and the FTSE Global Islamic Index Series by the FTSE Group in October.

Source: IOSCO (2004)

Further to the abovementioned developments, the Islamic equity markets, including the Islamic fund management market, have been charting significant progress. Key global trends include the following:

- Increasing range and style of funds in various geographical regions, underpinned by greater demand from conventional, Islamic and SRI.
- Expansion of asset classes, with sustainable sectors, e.g. renewable energy and green finance, attracting the interest of fund managers.
- Growing role of *takaful* and pension funds in supporting the development of the Islamic fund management market.
- More concerted efforts in the standardisation of Shariah screening criteria, to determine the Shariah-compliance of stocks.
- Greater synergies between Islamic fund's investment strategies and SRI finance with increasing recognition of environmental, social and governance (ESG) principles and sustainable development goals (SDGs) by asset managers, investors and regulators.
- Role of fintech in facilitating access to finance, thereby improving the efficiency of the financial sector.
- Enhanced market infrastructure, e.g. in terms of a Shariah governance framework, with a push towards the establishment of a higher Shariah authority in several jurisdictions—to ensure strict Shariah compliance, promote standardisation and boost credibility.
- Market infrastructure has also been developing through MRAs between jurisdictions for cross-border marketing and the distribution of Islamic funds.
- Fund passporting is another developing area which can create a level playing field for market participants while expanding the investor base. The promotion of UCITS in various jurisdictions is an example. Another one is the introduction of ASEAN's CIS framework in August 2014, which enables Malaysian, Singaporean and Thai investors to trade mutual funds if they meet certain standards (Thomson Reuters, 2015).
- International financial centres such as Luxembourg, the Cayman Islands, Jersey, and the Labuan International Business and Financial Centre (Labuan IBFC) are playing increasingly bigger roles vis-à-vis offering tax benefits to domicile Islamic funds.

2.1.6 Current Size and Market Share of Global Fund Management Industry

Global asset management is a multi-trillion dollar industry. Based on a PWC report (2017), the industry is anticipated to expand further to the centre stage of finance in the coming years compared to the banking and insurance sectors. Contributing factors include increased capital regulations on banking institutions, increasing contributions to pension plans, urbanisation and the growth of sovereign wealth funds (SWFs).

PWC (2017) estimates that the industry will augment from USD78.7 trillion of AuM in 2015 to USD112 trillion in 2020, as shown in **Table 2.4**. This is expected to be primarily driven by the personal wealth of mass affluent clients and high net worth individuals (HNWIs), followed by the wealth managed by pension funds and insurance companies. The penetration rate for clients' assets under management is projected to reach 39.4% in 2020, compared to 38.9% in 2015.

PWC (2017) also estimates that the growth will be faster in Latin America, Asia, Africa and the Middle East relative to developed markets such as Europe and the US. Overall, Europe and the

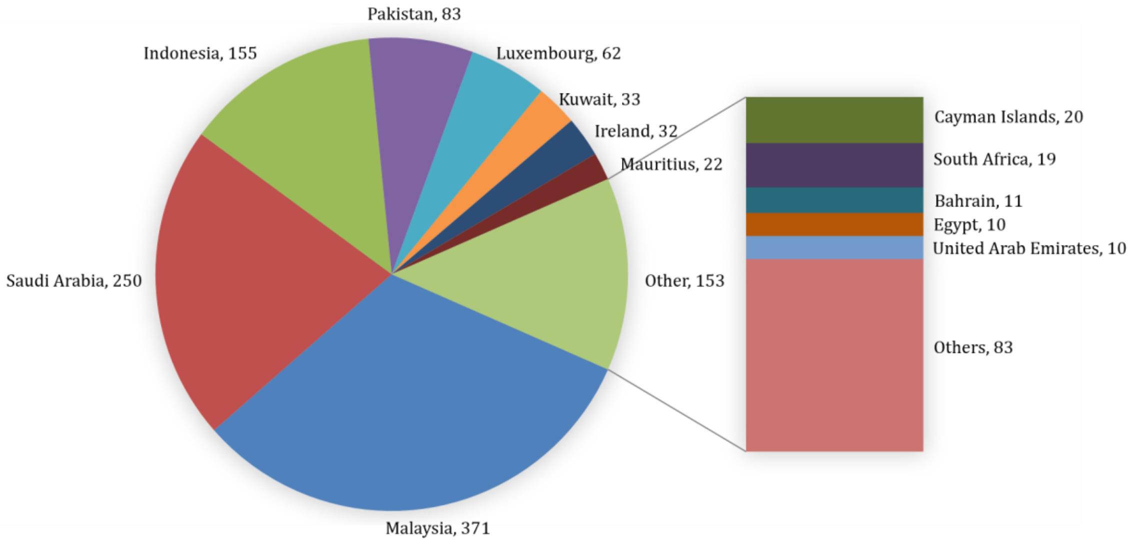
US accounted for a respective 55% and 26% of global AuM in 2016. They are followed by the Asia-Pacific region, with 14% of AuM (PWC, 2017b). **Chart 2.1** indicates the number of Islamic funds by domicile as at end-2017. Meanwhile, **Chart 2.3** shows global AuM by region for the same period.

Table 2.4: Estimated Global AuM 2004-2020 (USD trillion)

Clients	2004	2007	2012	2013	2014	2015	2020
Mass Affluent	42.1	55.8	59.5	64.2	67.2	62.5	96.3
HNWIs	37.9	50.1	52.4	59.2	69.6	67.8	83.5
Pension Funds	21.3	29.4	33.9	35.8	38.7	38.2	55.8
Insurance Companies	17.7	21.2	24.1	26.1	26.2	27.1	38.8
SWFs	1.9	3.3	5.3	6.1	6.3	6.7	10.0
Total Clients' Assets	**120.9**	**159.8**	**175.2**	**191.4**	**208.0**	**202.3**	**284.4**
Global AuM	**37.3**	**59.4**	**63.9**	**71.9**	**78.0**	**78.7**	**112.0**
Penetration Rate	**30.9%**	**37.2%**	**36.5%**	**37.6%**	**37.5%**	**38.9%**	**39.4%**

Source: PWC (2017, p. 5)

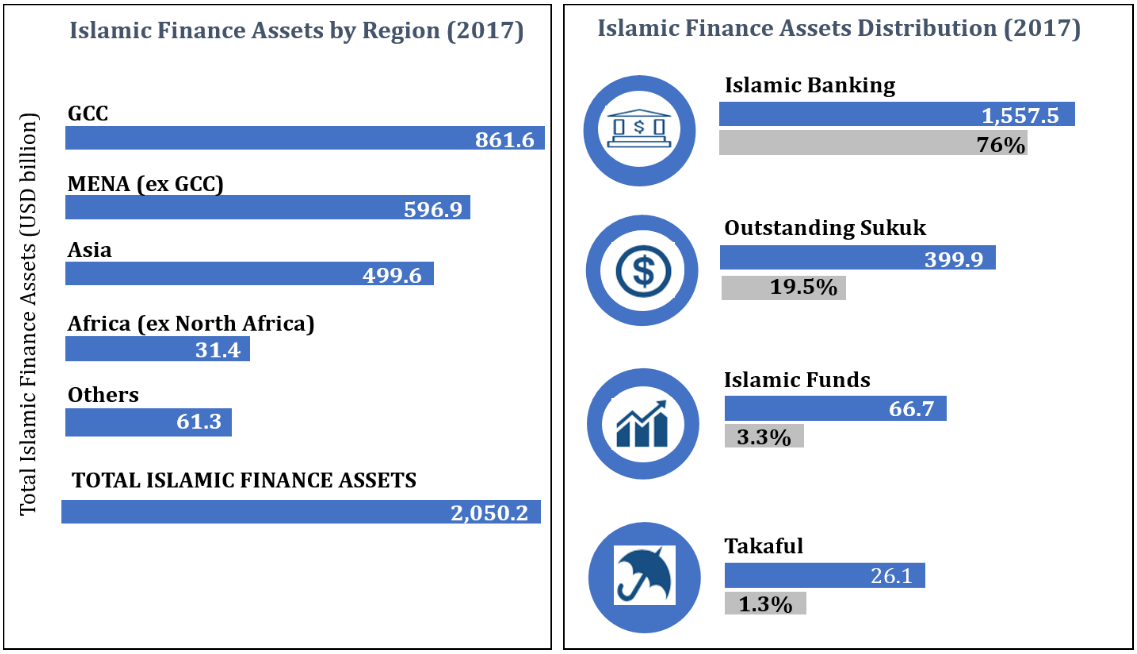
Chart 2.1: Number of Islamic Funds by Domicile (2017)



Sources: IFSB (2018), Bloomberg

The Islamic asset management industry has been posting significant growth since the late 1980s, both in terms of the number of funds and AuM. Reports indicate that the industry expanded from about 800 Islamic funds in 2008 (IFSB, 2017) to 1,161 as at end-2017, accounting for some USD66.7 billion of AuM as at end-2017 (IFSB, 2018). Nonetheless, this sector represents only a small percentage (about 3%) of the total Islamic finance assets of USD2.05 trillion as at the same date—with the Islamic finance industry being mostly dominated by the Islamic banking sector (representing 76% or USD1.6 trillion of total assets) and sukuk (19.5% or USD399.9 billion of total assets). **Chart 2.2** illustrates the breakdown of Islamic finance assets by region and sector as at end-2017. The ICD-TR (2017) expected the Islamic finance industry to post an average annual growth of 9.5%, with total assets hitting USD3.8 trillion by 2022.

Chart 2.2: Breakdown of Islamic Finance Assets (2017)

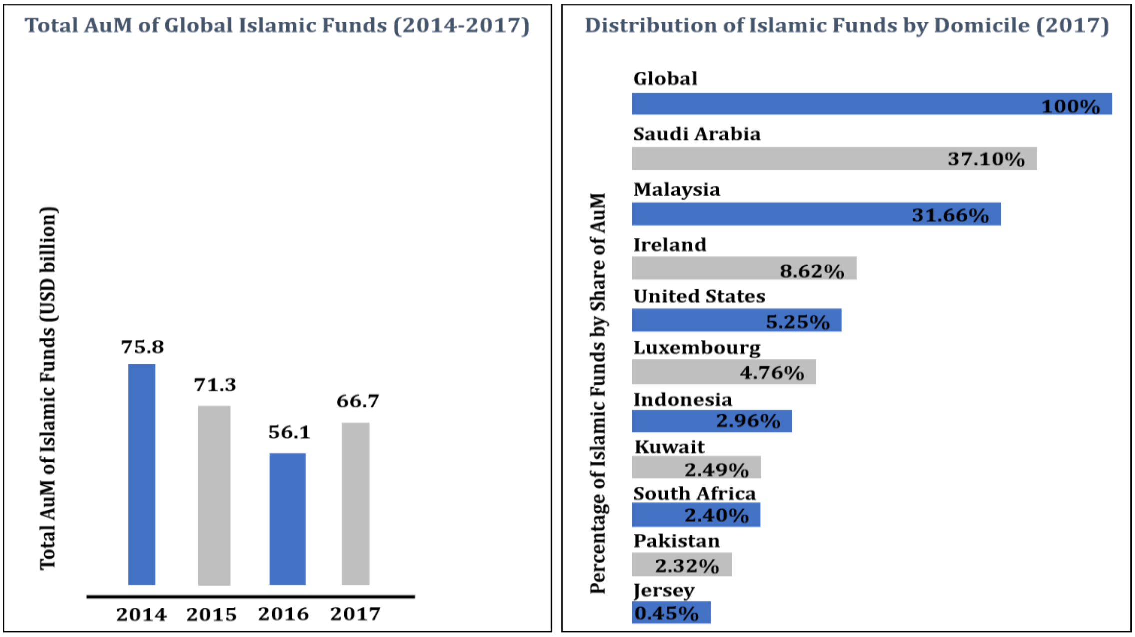


Source: IFSB (2018)

The Islamic fund management industry (USD56.1 billion as at end-2016) represents only a minor segment of the overall fund management industry (USD84.9 trillion as at end-2016), reflecting substantial scope for further growth and expansion. Based on ICD-TR projections (2017), the Islamic asset management sector has tremendous growth potential, reaching USD403 billion by 2022. This corroborates the projection of Thomson Reuters (2015), which indicates that demand for Islamic funds will far exceed supply by 2019, underlining the strong growth potential of Islamic funds. This is expected to originate from the largest markets, including OIC countries such as Malaysia, Saudi Arabia and Iran (ICD-TR, 2017).

At present, the Islamic fund management industry is still a niche sector. The top five jurisdictions accounted for 88% of the industry's AuM as at end-2017, i.e. Saudi Arabia (37.10%), Malaysia (31.66%), Ireland (8.62%), the US (5.25%) and Luxembourg (4.76%), as depicted in **Chart 2.3**. This indicates that the operations of Islamic funds are still limited as key Islamic finance jurisdictions have deep-rooted Islamic banking sectors (e.g. the UAE, Pakistan, Indonesia, Kuwait and Qatar). The remaining 12%, with AuM valued at USD8.4 billion, is distributed across 29 other jurisdictions (including offshore domiciles) (IFSB, 2018).

Chart 2.3: Growth of Global Islamic Funds



Source: IFSB (2018)

The following summarises the key points on the Islamic fund management industry:

- Total number of jurisdictions where Islamic funds are domiciled is 34 in 2017, compared to 37 in 2016. Overall AuM has however increased from USD56.1 billion in 2016 to USD66.7 billion in 2017, as depicted in **Chart 2.3**.

- The USD66.7 billion of AuM in 2017 is held by a total of 1,161 Islamic funds. Out of this total, 821 funds are classified as active, holding about USD 61.6 billion AuM. This compares to 826 active funds in 2016, representing USD 51.2 billion AuM. Although the number of active funds has declined, according to IFSB (2018), there has been an increase in the average size of Islamic funds in 2017, showing a positive development of Islamic funds building up mass and economies of scale.

- Of the 34 jurisdictions that were domiciles for Islamic funds as at end-2017, 20 comprised non-OIC members, with the largest domiciles in this category being Ireland, the US and Luxemburg. Meanwhile, 14 OIC-member countries have initiated Islamic funds with Saudi Arabia and Malaysia representing the top domiciles holding the largest market share across the global Islamic fund management industry.

- The background of OIC-member countries that have established Islamic funds differs from one to another, with varying degree of legal, institutional and technical infrastructure development for the Islamic fund management industry. Leading countries in Islamic fund management such as Saudi Arabia and Malaysia remain the key domiciles for Islamic funds. These countries, according to IFSB (2018), also feature among the top categories for the geographical focus of investments of Islamic funds.

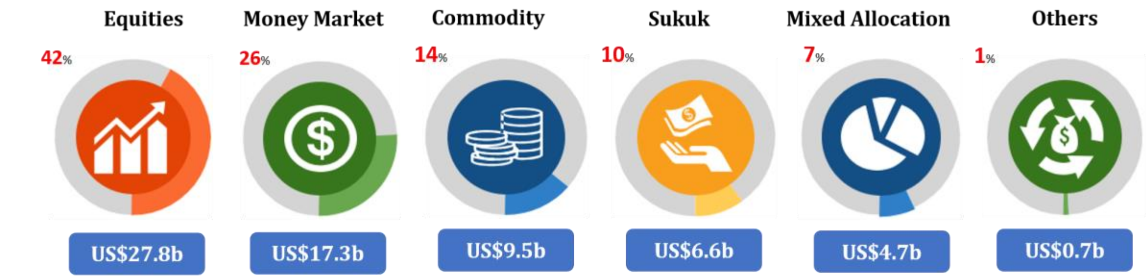
Malaysia, for instance, continues to map out strategies to strengthen the country's competitive edge in the industry. It provides tax incentives and has eased licensing requirements for dealing with fund management and giving investment advice. Malaysia's move into private pension funds is particularly seen as a positive development to lift up the industry to a higher level (MIFC, 2017). Further developments in Malaysia as a case study for Islamic fund management is discussed Chapter 4 of the report.

- On the other hand, OIC-member countries also constitute examples like Morocco where the Islamic fund management industry is yet to emerge. Another OIC country, which would situate itself within the infancy category of Islamic finance /Islamic fund management development, would be Ivory Coast. These countries are still establishing the base infrastructure for Islamic finance development and slowly expanding to develop the other sectors of the industry such as Islamic capital markets (ICM). This report will provide further explanation of the state of the Islamic fund management industry in the case of Morocco in later chapters.

- Other OIC-member countries which can be classified as having a developing Islamic fund management industry would include examples like Indonesia (with 2.96% of global Islamic fund assets), Kuwait (with 2.49% of global Islamic fund assets), and Pakistan (with 2.32% of global Islamic fund assets) (see **Chart 2.3** above). This report also covers the case of Pakistan as an OIC-country emanating significant progress in Islamic fund management.

The IFSB (2018) notes that in terms of asset class, global Islamic funds were dominated by equity-based funds (42%) as at end-2017, followed by money market funds (26%) and commodity-based funds (14%). The other significant asset classes include fixed-income or sukuk funds (10%) and mixed-allocation funds (7%), as depicted in **Chart 2.4**.

Chart 2.4: Islamic Funds by Asset Class (2017)



Sources: Bloomberg, IFSB (2018)
Note: There may be some overlap between the asset classes. For example, if a fund focuses on commodities by investing in the equities of companies operating in that sector, it could in principle be treated as a commodity fund or an equity fund. For the purposes of this report, the funds are categorised by asset class based on classifications provided by Bloomberg.

To further develop the Islamic fund management industry, there are lessons to be learnt from the development of the global fund management industry. In particular, the key pillars of the industry in Europe and the US are pension funds and insurance companies (Quorum Centre, 2018). They provide trillions of dollars of new money coming into investment funds each year.

In the Islamic finance market, *takaful* and Islamic pension funds are still too small to make a meaningful contribution to the current asset management industry. For the asset management industry to grow, there is a need to first build up assets on the *takaful* side, which will provide natural growth to Islamic funds. A report by the Quorum Centre (2018) proposes building a sustainable *takaful* industry by developing a global *hajj* savings scheme under a *takaful* umbrella. If only 1% of the world's nearly two billion Muslims contributed USD10 per month, an equivalent of USD200 million per month or USD2.4 billion per year will be invested as new money in the *takaful* and Islamic asset management industries.

The IFSB (2018) also notes that active Islamic funds, with an average AuM of USD80 million per fund, remain small in contrast to their conventional counterparts. This shows that Islamic funds need to explore potential mergers and different forms of collaboration to achieve critical mass volume and economies of scale that will enable them to become more competitive in the global fund management industry. The practice of merging to gain scale is a relatively recent phenomenon, even in the conventional market. In Europe, for instance, there have been mergers among several international fund managers to reduce overlapping costs, leverage distribution and spread fixed costs (PWC, 2017).

2.2 Islamic Fund Management and Its Role in Islamic Capital Markets

Islamic fund management plays a significant role in intermediating foreign capital inflows and mobilising domestic savings to promote a country's economic expansion. The industry complements the entire financial and capital markets ecosystem. Prior to examining this, the section delineates the basic requirements vis-à-vis setting up a Shariah-compliant fund and the parties involved in Islamic fund management as well as their roles.

2.2.1 Structuring a Shariah-Compliant Fund

Basic Shariah Requirements to Establish an Islamic Fund

The establishment of an Islamic fund is not as straightforward as setting up a conventional fund. The former needs to fulfil specific Shariah requirements, as delineated below. Fulfilling these requirements is pertinent to gaining investors' confidence on the compliance of a fund structure.

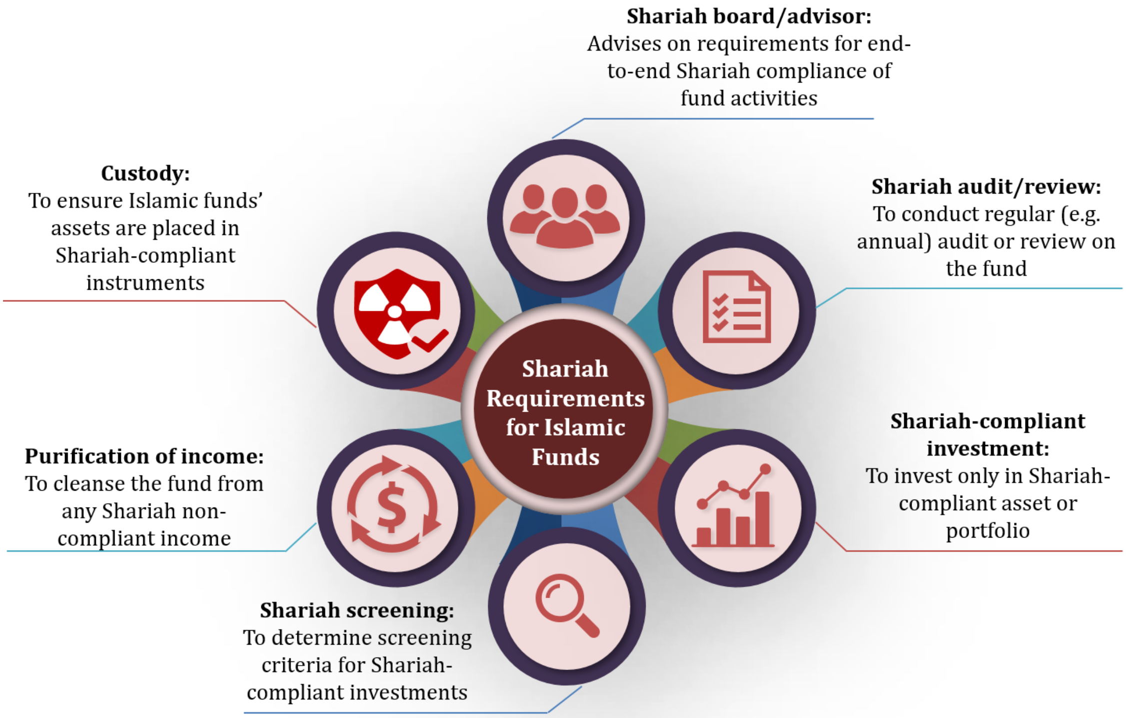
1. **Shariah board/advisor:** To appoint a Shariah board or advisor that monitors, evaluates and ensures that the fund's activities comply with Shariah principles, particularly on the investment aspects. The Shariah board/advisor also provides guidance to the board of directors and the managers of the fund. Rulings issued by the Shariah board are binding on the fund and its manager.
2. **Shariah audit/review:** To conduct an annual audit or review on the fund to ensure its compliance with Shariah principles. This exercise can be undertaken by either the Shariah board/advisor or a recognised and qualified third party.
3. **Shariah-compliant investment:** To only invest in Shariah-compliant assets or portfolios, which are determined through a screening process.
4. **Shariah screening:** To identify whether the companies that Islamic funds invest in partake in Shariah non-compliant activities (i.e. business screening) or if the financial management of the companies involves interest-based borrowings or have excessive

cash or receivables in their statements of financial position (i.e. financial screening).

5. **Purification of income:** To cleanse the fund of any non-compliant income generated from investments in companies that have exceeded the tolerable benchmark of the Shariah screening process. The non-compliant amounts should be donated to charitable organisations approved by the Shariah board/advisor.
6. **Custody:** To ensure Islamic funds' assets are placed Shariah-compliant instruments, either in a non-interest-bearing account or in Shariah-compliant repo.

Figure 2.6 summarises these basic Shariah requirements of an Islamic fund. A more detailed analysis is provided in Chapter 3.

Figure 2.6: Basic Shariah Requirements of an Islamic Fund



Sources: Adapted from PWC (nd), ISRA

The IFSB, in its IFSB-6 on *Guiding Principles on Governance for Islamic Collective Investment Schemes (ICIS),* outlines five guiding principles for Islamic funds, as follows:

Principle 1: General governance approach to Islamic funds – The ICIS's highest governing body will establish a comprehensive governance policy framework, which protects the independence and integrity of each organ of governance and sets out mechanisms for proper control and management of conflicts of interest and duty.

Principle 2: Transparency and disclosure – ICIS insiders [i.e. managers] must ensure that disclosure of material information is not only done with appropriate accuracy and timeliness but also presented in an investor-friendly manner.

Principle 3: Compliance with Shariah rules and principles – The ICIS's governing body must ensure that appropriate systems and mechanisms for monitoring *ex-ante* and *ex-post* Shariah compliance are in place, and are effective.

Principle 4: Additional protection for ICIS investors – The ICIS's governing body must ensure that any movement of the ICIS's funds or assets, to the extent that such is lawful, will be carried out in conformity with the ICIS's investors' objectives and their best interests, and always supported by appropriate and objective valuations.

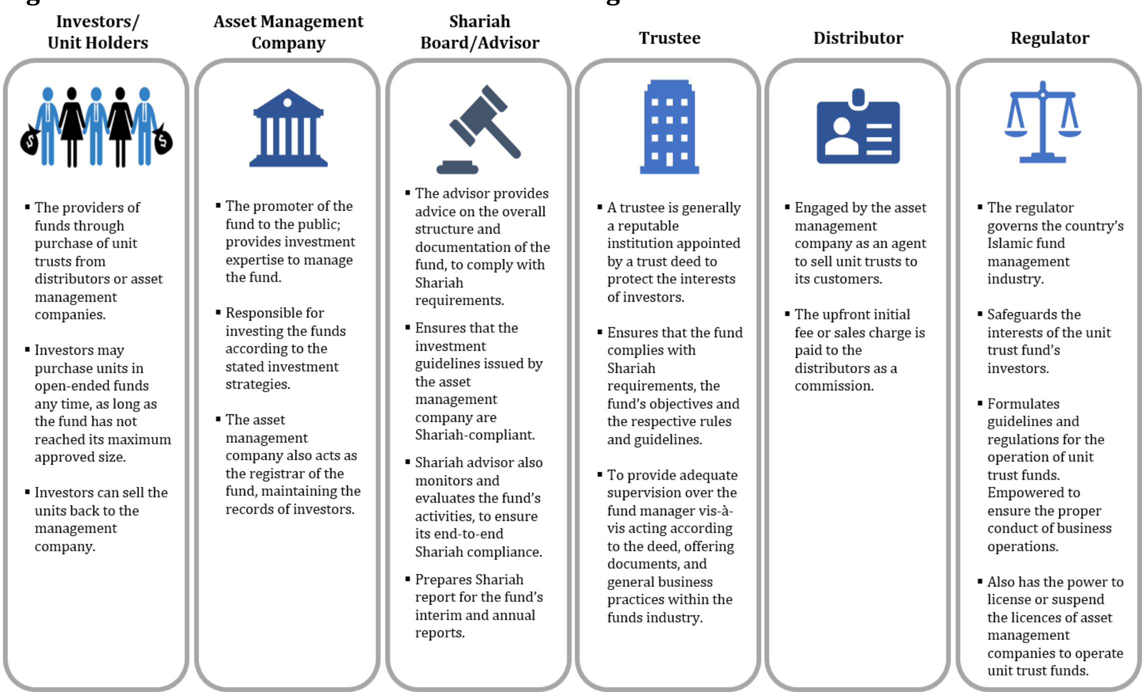
Principle 5: Additional protection for ICIS investors – ICIS insiders must be transparent in the imposition of any fees, the creation of any reserves and the smoothing of any dividend payments.

These guiding principles aim to ensure that Islamic funds are organised and managed efficiently through appropriate oversight, control and review mechanisms, and reduce the risks associated with the conflict of interests between investors and fund managers.

Parties Involved in Islamic Fund Management and Their Roles

The key parties involved in the establishment of an Islamic fund and their key roles are presented in **Figure 2.7**.

Figure 2.7: Parties Involved in Islamic Fund Management and Their Roles



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

Contractual Obligations Relating to Shariah Contracts in Islamic Fund Management

Various Shariah contracts bind the different parties involved in Islamic fund management (ISRA, 2015, p 532-533), namely:

1. **Partnership (*musharakah*) contract:** This exists between the unit holders (i.e. investors) who invest their money in a fund, with the view that the profit derived will be shared according to their capital contributions or agreed profit-sharing ratios.

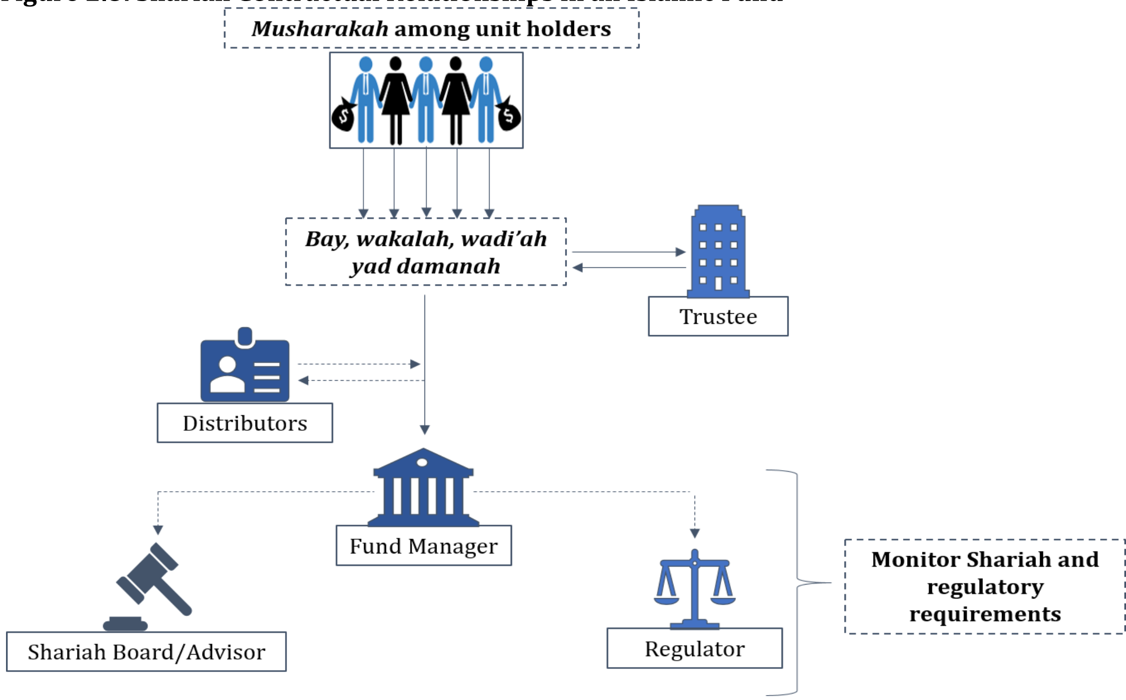
2. **Sale (*bay'*) contract:** This is executed between the unit holders and the fund manager (via sellers or distributors), usually on a cash payment basis. The unit in a unit trust fund is normally priced based on the manager's forward selling or buying price on the next valuation point, upon the receipt of a request for purchase or redemption. The valuation is done at the close of the business day.

3. **Agency (*wakalah*) contract:** This takes place when the unit holders appoint the manager to execute the purchase or redemption order on their behalf. Under a *wakalah* contract, the principal is the unit holder, the agent is the manager and the objective of appointing an agent is for the purchase or redemption of units. A *wakalah* contract also takes place when the unit holders appoint the trustee to act as a custodian to the fund and hold in trust all the assets of the fund on their behalf.

4. **Safekeeping with guarantee (*wadi'ah yad damanah*) contract:** This takes place when the unit holders deposit their investments with the trustee. The owners of the units are the unit holders, the custodian is the trustee and the property comprises all the assets of the fund in the form of money and other investments.

Figure 2.8 illustrates the Shariah contractual relationships among the key parties involved in Islamic fund management.

Figure 2.8: Shariah Contractual Relationships in an Islamic Fund



Sources: Adapted from ISRA (2015), ISRA

Profit- and Loss-Sharing Mechanism of Islamic Funds

The profit- and loss-sharing mechanism features prominently in all Islamic fund management products; the underlying concept is purely based on risk and reward. The risks taken should commensurate with the returns gained and the losses suffered; the higher the risk, the higher the return and loss and *vice versa*. As risks and rewards are interdependent, it is important to be prudent when determining the investment strategies and asset allocations of Islamic funds. The IMF's study (2015, p. 97) on various types of conventional mutual funds shows that plain-vanilla and ETF structures are less risky than hedge funds (which can incur high leverage costs and adopt complex strategies with less disclosure requirements), as depicted in **Table 2.5**.

Table 2.5: Characteristics and Risk Profiles of Major Categories of Investment Funds

Vehicle	Publicly Offered	Redemption & Trading Practice	Settlement Method	Solvency Risk	Leverage via Borrowings	Portfolio Leverage (Derivatives)	Investor Base
Open-Ended Mutual Fund	Yes	End of day	Cash	Low	Possible, with cap	Yes, with cap	Retail, institutional
Close-Ended Mutual Fund	Yes	Not applicable (primary) Intraday (secondary)	Cash	Low	Some yes, with cap	Yes, with cap	Retail, institutional
Money Market Fund	Yes	End of day	Cash	Low	Possible, with cap	Yes, with cap	Retail, institutional

Vehicle	Publicly Offered	Redemption & Trading Practice	Settlement Method	Solvency Risk	Leverage via Borrowings	Portfolio Leverage (Derivatives)	Investor Base
ETF	Yes	Infrequent (primary) Intraday (secondary)	In kind (primary) Cash (secondary)	Low	Possible, with cap	Yes, with cap	Retail, institutional
Private Equity Fund	No	Not applicable (close-ended, with long-term finite life)	Cash	High	Some yes, no cap	No information	Institutional
Hedge Fund	No	Quarterly + lock-up + 90 days advance notice	Cash	High	High, no cap	High, no cap	Institutional

Source: IMF (2015, April, p 98)

In a *wakalah*-based (i.e. *wakalah* between investors and fund manager) Islamic fund, the investors/unit holders are the principal (*muwakkil*) who act like partners (*musharik*) among each other, and the fund manager is the agent (*wakil*) entrusted with the management of the funds. In this case, the investors will share among themselves the profits in proportion to their capital contributions or based on an agreed profit-sharing ratio that is determined upfront. Meanwhile, the fund manager may charge an upfront fee before the funds are invested, or charge performance-related fees. The fund manager is not liable for any loss of investment value except in the case of negligence, misconduct or breach of terms. However, it is the duty of the fund manager to employ appropriate risk-management tools and techniques that comply with Shariah principles. In addition, the fund manager must ensure that investments in Islamic funds do not entail any Shariah prohibitions such as speculation and gambling. As such, highly leveraged investments should be strictly avoided.

2.2.2 The Importance of Fund Management in Islamic Capital Markets

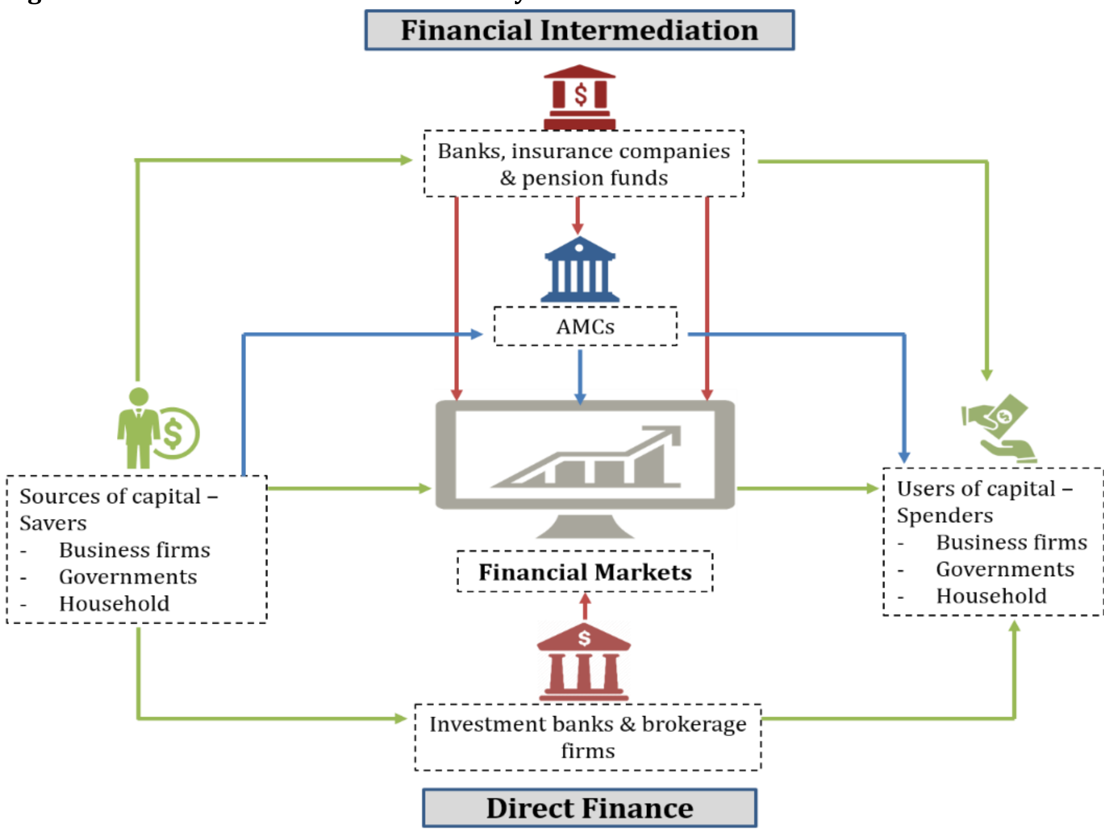
Efficient financial intermediation is key to channelling capital from domestic and foreign sources to fund the needs of users of capital. Different financial intermediaries, including AMCs, as illustrated in **Figure 2.9**, play their unique roles in mobilising the entire financial system, thereby creating an effective transfer of risks and management of liquidity, regardless whether they are Islamic or conventional entities.

In this context, AMCs receive funds from various sources, including commercial banks, insurance companies, pension funds, mutual funds, business entities, government institutions and retail investors. They then channel those funds for investment in the financial markets.

Financial intermediation via AMCs helps investors to easily diversify their assets and provide funding to the real economy, even when banks face financial distress. Banks, due to their fractional reserve capital structure and regulatory issues, are prevented from funding capital users in the same way as AMCs. The latter can invest funds in many more ways than banks (which tend to provide debt funding to other banks, governments, larger companies and retail clients, with retail financing typically on a secured basis). Banks are not designed to fund anything other than safe counterparts when lending. As a consequence, AMCs need to specialise and develop their expertise in maximising returns and mitigating risks in their respective niche areas of investment, be they high-risk hedge funds, VC/PE funds, speciality lenders (mortgages, equipment lease-fund or SMEs), commodity funds, real-estate funds or low-risk money market funds.

In addition, the fund management industry has various advantages over banks in terms of deepening the financial markets and ensuring financial stability. According to the IMF (2015, April), the asset management industry has played a significant role in the financial systems of advanced economies, particularly via bond funds. For the emerging market, portfolio flows, which are channelled via funds, have been recording consistent growth.

Figure 2.9: Intermediaries in a Financial System



Source: Sandwick (2016, p. 6)

The Role of Fund Management in Islamic Capital Markets

The key roles that Islamic fund management plays in the Islamic capital market include the following:

1. To provide retail investors with access to capital markets via standardised asset management, such as investment funds and savings plans. Through this intermediation, the following benefits can be reaped:

   a. Less wealthy investors such as SMEs can invest in different Islamic capital market instruments such as Islamic equity, sukuk, real estate and Islamic derivatives. In addition, they can have access to a diversified portfolio of securities, which would be costly if purchased directly.
   b. Unsophisticated investors such as retail players have an equal opportunity to access the capital markets (Davydoff, Gabaut & Naacke, 2011, p. 19).
2. To contribute to financial market efficiency by strengthening price discovery, reducing transaction costs (particularly for ETFs), providing market liquidity, moderating market volatility and bringing stability to the overall financial system (Davydoff, Gabaut & Naacke, 2011; World Economic Forum, 2015).
3. To supply an efficient avenue for capital recycling. Fund management, like pension funds, allows savers and retirees to channel their savings into an early-stage capital investment that can support funding businesses and real economic activity. In return, savers will receive good returns if the investment result is favourable, or they will bear the risks if the outcome is unfavourable (Caprosia, 2015).

2.3 Future Trends of Islamic Fund Management Industry

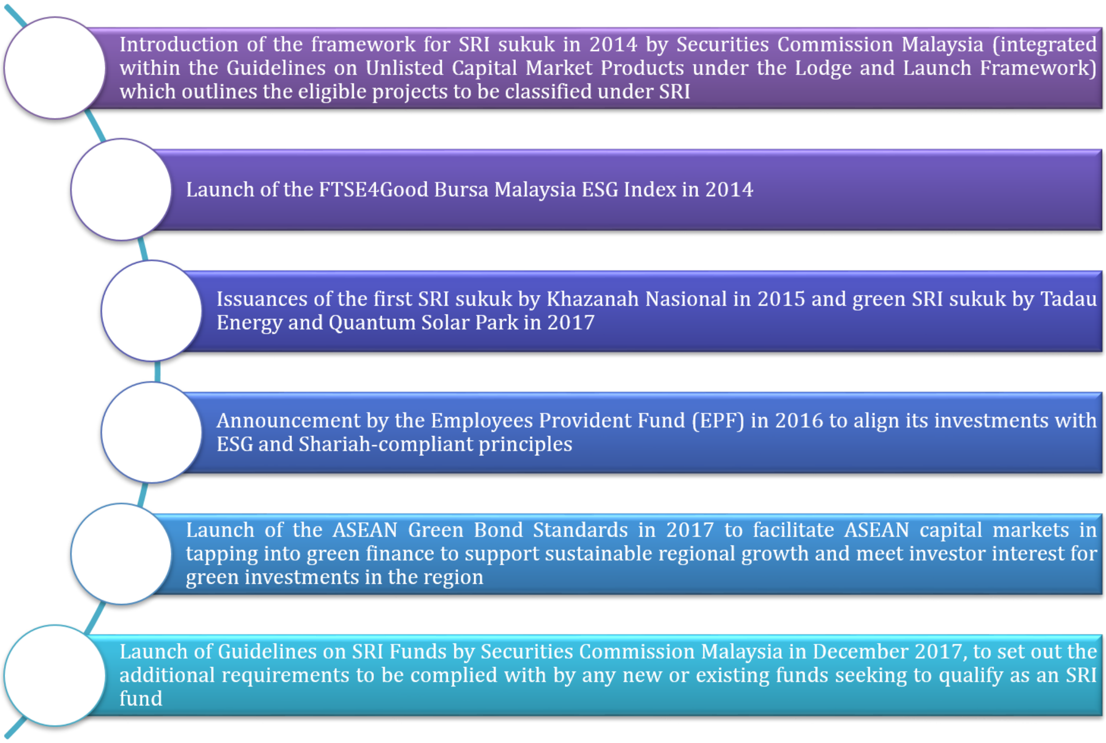
Two trends that have an important effect on the Islamic fund management industry and have the potential to substantially expand this industry concern the role of SRI and the application of fintech in investment management. These are discussed below.

2.3.1 Sustainable and Responsible Investment (SRI)

There is a natural convergence between Islamic finance principles, ESG, SRI, SDGs, green and impact investing. While various labels are used and diverse issues are addressed, the different approaches aim to achieve similar objectives notably that of creating financial systems that are more equitable, sustainable and impactful on society, the environment and the economy. For instance, the issue of climate change—specifically, the commitments of governments to reduce carbon emissions and increase the sustainability of natural resources—presents significant opportunities for green finance to be part of investment or funding initiatives to finance environment-related projects around the world. The shared SRI and Islamic finance values provide a positive outlook on Shariah-compliant SRI funds.

Specifically, a positive environment has been created in Malaysia for the Islamic-SRI sector, with the support of the regulators and the collaborative efforts of industry players. Recent developments are spelt out in **Figure 2.10**.

Figure 2.10: Efforts to Create a Positive Environment for SRI in Malaysia



Sources: Soo (2017), ISRA

Global sustainable investment assets have shown an impressive growth. According to the Global Sustainable Investment Review (2016), the global sustainable investment assets increased about 25% from USD18.28 trillion in 2014 to USD22.89 trillion in 2016, as shown in **Table 2.6.**

Table 2.6: Growth of SRI Assets by Region 2014-2016 (USD billion)

Region	2014	2016
Europe	10,775	12,040
United States	6,572	8,723
Canada	729	1,086
Australia/New Zealand	148	516
Asia ex-Japan	45	52
Japan	7	474
Total	18,276	22,890

Source: GSIA (2016)

The growth of SRI assets relative to their professionally managed assets has been noted in almost all regions, with Australia and New Zealand showing the highest rise as depicted in **Table 2.7**.

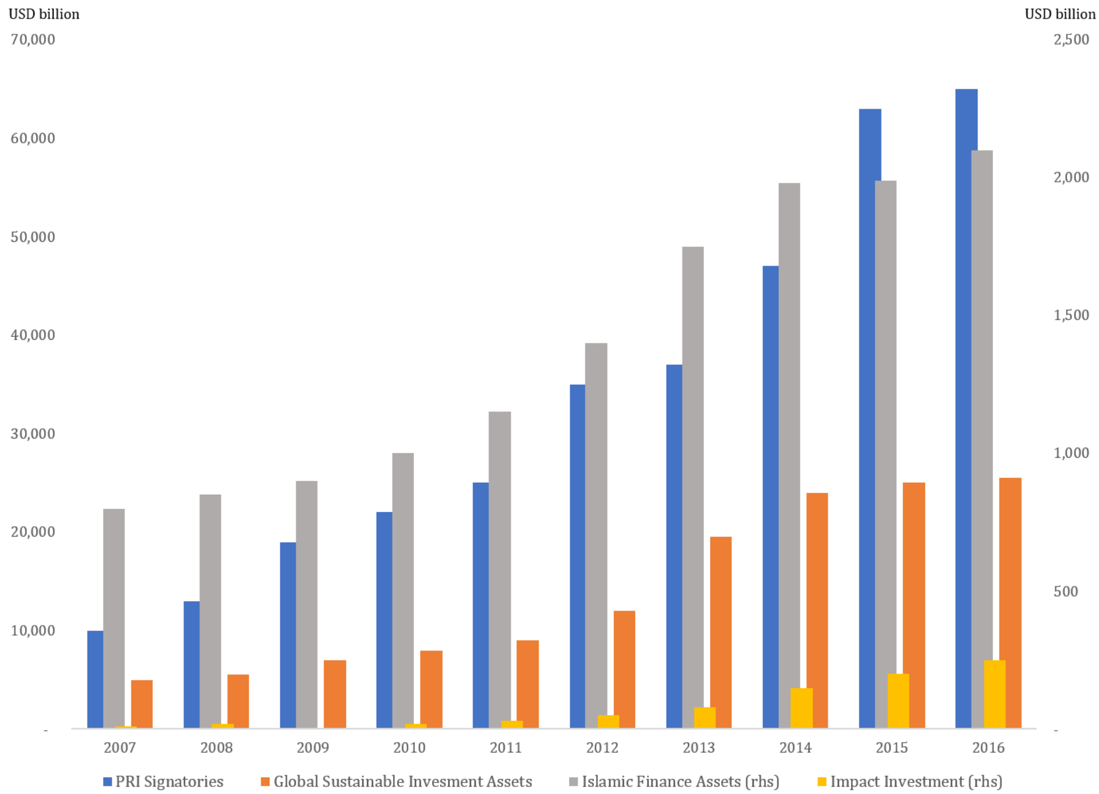
Table 2.7: Proportion of SRI Assets Relative to Total Assets Managed (2014-2016)

Region	2014	2016
Europe	58.8%	52.6%
United States	17.9%	21.6%
Canada	31.3%	37.8%
Australia/New Zealand	16.6%	50.6%
Asia ex Japan	0.8%	0.8%
Japan	-	3.4%
Global	30.2%	26.3%

Source: GSIA (2016)

The RFI Foundation states that 'collectively, responsible finance represents about one-third of all financial assets globally'.[2] Islamic finance assets are described as representing a major source of growth for the responsible finance sector, as presented in **Chart 2.5**.

Chart 2.5: Relative Size of Responsible Finance Assets (2007-2016)



Source: RFI Foundation

Encouraging regulatory developments, multilateral development bank (e.g. World Bank, Islamic Development Bank) initiatives and the growing recognition of Islamic-ESG values by asset managers are giving a boost to responsible finance as a whole (Goud, 2017). The Shariah-compliant SRI fund sector is also expected to expand by virtue of the burgeoning demand from

[2] Source: http://www.rfi-foundation.org/main/background#responsible_finance

value-based investors and given increasing evidence that ESG-screened investments tend to outperform the market.

2.3.2 Financial Technology (Fintech)

The rise of fintech is revolutionising financial services and bringing about changes to the way the finance industry has traditionally operated. New propositions encompass not only improved services but also offer convenience and attend to the needs of technology-savvy customers that demand direct access to their financials as well as immediate response to their needs, without compromising matters such as privacy and security (Kmeid, 2017). Fintech is helping to break down physical barriers in access to financial services; through low-cost mobile and internet technologies, it is promoting greater financial inclusion.

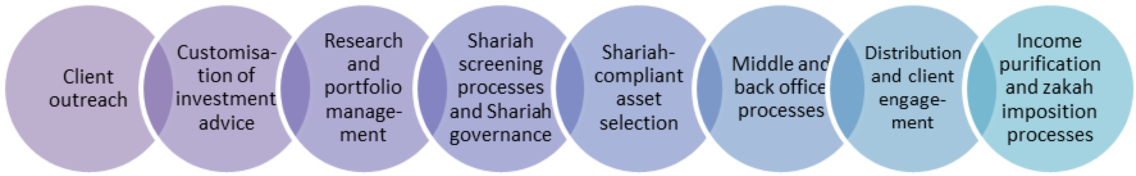
Overall, the fund management industry has been slow to develop even in some developed markets—the result of the small number of players and high costs. Reducing costs should enable a spike in growth and diversity in fund management services, especially in developing markets—for foreign incumbents to enter new developing markets in a cost-effective manner and for home-grown fund management firms to establish. In the near future, fund management may not need significant set-up costs, thus allowing the establishment of specialised firms that serve niche capital users and have extensive outreach to investors.

The Chinese shadow-banking/crowdfunding market is a good example of this, with specialised funds sourced from retail/institutional investors and providing much-needed capital to expanding firms (not properly served by Chinese banks), all enabled through the use of technology.

Just as the banking industry has evolved to offer innovative digitalised financial services to its customers, the fund management industry is expected to leverage fintech to augment its market by reducing costs, expanding online services, and extending customer outreach. Technology is enabling fund managers to provide bank-like services such as payments and easy deposits and withdrawals (e.g. Tabung Haji and other large funds). As fund managers, typically bear lower costs than banks and their returns are generally significantly higher, their technology-driven entrance in the banking arena increases efficiency in financial intermediation by significantly reducing intermediation costs.

The Islamic fund management industry is also expected to keep pace with its conventional counterpart by adopting transformative digitalisation strategies. Studies have shown that there is little difference between Muslims' and non-Muslims' preferences when it comes to digital financial services (Kmeid, 2017). Fintech applications, with some degree of human oversight, are expected to drive a quantum change across the value chain of global fund management, including the Islamic industry, as reflected in **Figure 2.11**.

Figure 2.11: Quantum Change across the Value Chain of Islamic Fund Management



Source: Adapted from PWC (2017b)

For instance, fintech has already started changing investment advisory services by introducing robo-advisers that take over the roles of human financial advisers, planners and fund managers (Investopedia). The first robo-adviser was launched in 2008, known as 'Betterment'. The robo app or web platform allows clients to provide details on their financial situations and investment objectives; the robo-adviser utilises the data to recommend an optimal portfolio to them for a minimal fee. The service is much cheaper compared to the fees charged by traditional advisers; it is an option available to clients who are comfortable with investment products. Besides being low-cost alternatives, automated investment-management advice also offers the advantages of being accessible to everyone, including low-budget investors, being convenient and efficient, and being available 24/7.

The digital platform technology used is said to be similar to the automated portfolio-allocation software used by human wealth managers, to passively manage investors' portfolios since the early 2000s. The difference with the robo-adviser is that the technology is now made accessible to clients directly and can perform more sophisticated tasks such as tax-loss harvesting (i.e. selling a security at a loss to offset a capital gains tax liability), investment selection, retirement planning and overall financial advice.

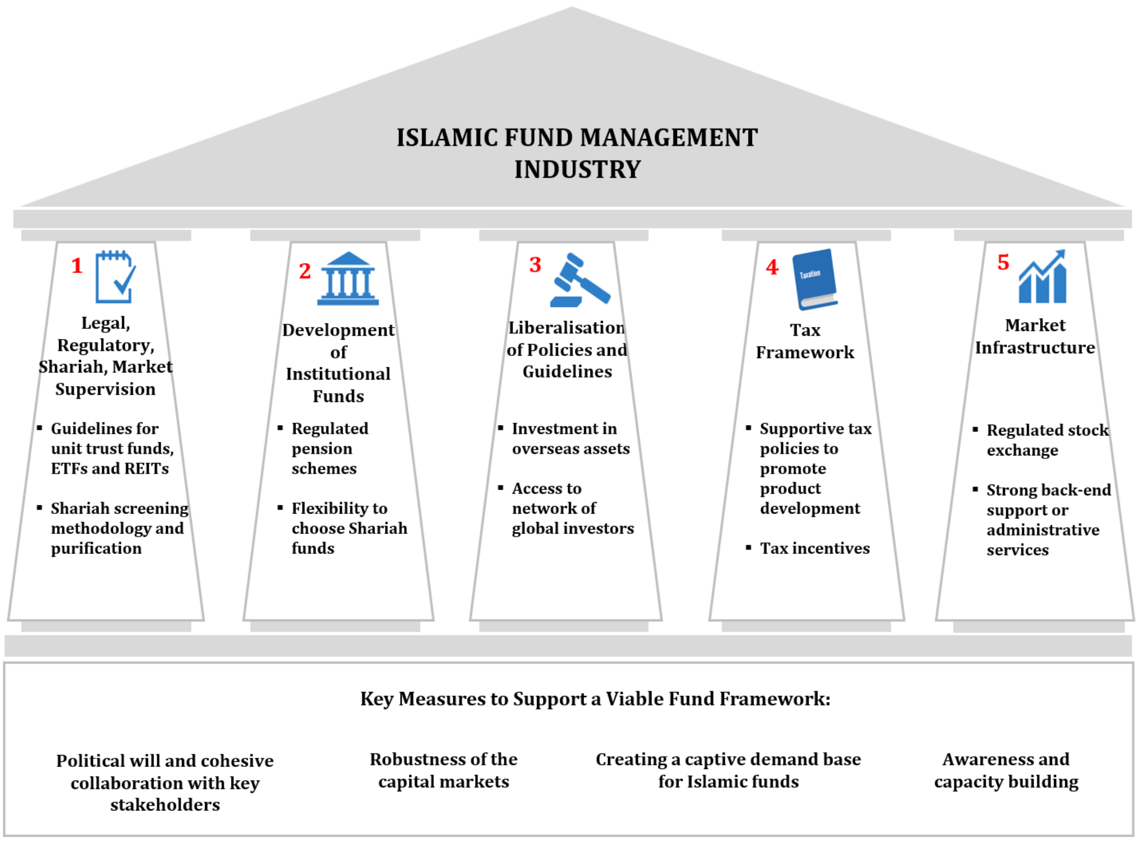
The number of such robo-advisers has grown to about 200 in the US, with more being launched by asset management firms every year (Investopedia). For the Islamic fund management industry, they can be used to assist in the process of Shariah screening of investments, Shariah-compliant asset selection, purification of investments and adding transparency to the Shariah governance framework.

3. COMPREHENSIVE ANALYSIS OF ISLAMIC FUND MANAGEMENT: INFRASTRUCTURE DEVELOPMENT, INVESTMENT AND COMMERCIAL CONSIDERATIONS

3.1 Development of Infrastructure of the Islamic Funds Ecosystem

Building the basic pillars to support the development of the Islamic fund management industry is key to ensuring sustainable organic growth. **Figure 3.1** summarises these key pillars.

Figure 3.1: Building Blocks to Sustain the Long-Term Growth of Islamic Fund Management



Source: RAM

Pillar 1 – Legal, Regulatory, Supervision and Shariah Frameworks

The establishment of a robust regulatory framework and continuous market supervision engender trust in the markets and allow greater transparency in product development, approval processes and governance while ensuring the protection of investors' interests. The governing rules and regulations issued by a country's securities commission set the tone on the conduct of AMCs (or fund managers), and facilitate the orderly development of the Islamic fund management industry. Since licences are issued by the authorities, misconduct or provision of false information to the public will result in the revocation/suspension of licences and/or imposition of fines.

Equally important is the development of a trusted Shariah framework to govern the operations of the Islamic fund management industry within accepted Shariah parameters. The issuance of guidelines on Shariah screening and purification processes provides greater clarity to investors and other market participants in their business conduct.

Pillar 2 - Development of Institutional Funds

The development of a captive market for Shariah-compliant assets is key to building an investor base for Islamic funds. Wealth preservation and capital appreciation start with market awareness on the importance of investing and saving. Governments of developed and non-developed countries have instituted government-linked bodies to manage retirement funds. Furthermore, the level of financial inclusion differs among countries. As such, the institutionalisation of public savings goes a long way towards facilitating the development of a local fund management industry. An example is the making of retirement allocations compulsory for both employers and employees. Institutions that are established to manage these funds provide funding to AMCs. Therefore, if Muslim members or those with ethical preferences or institutional investors choose to invest in Shariah-compliant funds, this will provide a catalyst for the growth of the Islamic fund management industry.

Pillar 3 - Liberalisation of Policies and Guidelines

The liberalisation of policies and guidelines promote investment in a broader spectrum of assets and corporate bond markets while allowing fund managers and investors to diversify their investment portfolios. The entry of foreign-based fund managers into the local market also provide access to a global network of investors and, hence, opportunities for foreign investment in local funds. The diversity of the investor base plays an important role in deepening the liquidity of the local ICM. The liberalisation of capital controls is equally important to facilitating the free inflow of capital funds.

Pillar 4 - Tax Framework

The establishment of tax neutrality facilitates the costing of Islamic finance products, to be competitive with conventional products. Additional tax incentives to encourage investors to choose Shariah-compliant investments provide an added platform for the expansion of the Islamic finance market. Some countries also provide tax rebates for individuals to invest in retirement schemes and children's education—all of which help strengthen demand.

Pillar 5 - Market Infrastructure

The development of a strong stock exchange facilitates investment in the equity of listed companies and for sukuk funds to list on its platform. A fully integrated exchange that offers a complete range of exchange-related services—including trading, clearing, settlement and depository services—will help build a robust equities and sukuk market.

The advent of a comprehensive value chain of intermediation, advisory and back-office services is equally important in supporting Islamic fund management activities. These include fund accounting, trustee services, legal and audit services, which all play a significant role in the overall development of Islamic funds.

Structurally, the main characteristics of an Islamic fund will not differ from a conventional investment fund. For example, the choice of legal structure for the investment vehicle and the choice of jurisdiction will still be driven by the following considerations:

1. A flexible, cost-efficient regulatory framework, particularly with regard to the need to obtain approval from the supervisory authorities and possibly seek a stock exchange listing.
2. A favourable tax regime with tax neutrality and tax incentives for both investors and fund managers.
3. A robust supervisory, audit and monitoring process that provides transparency and emphasises investors' protection.
4. A strong capital market which has a steady supply of Shariah-compliant assets, a build-up of listed Shariah-compliant companies, and captive demand for Shariah-compliant investments.

Notably, capital-market authorities in most jurisdictions, except Malaysia, have not issued specific guidelines on Islamic fund management. Instead, the provisions on Islamic funds are embedded in the general guidelines and regulations on fund management for the conventional space.

3.1.1 Structural Differences in the Development of an Islamic Fund

Additionally, Islamic funds must comply with Shariah requirements to ensure end-to-end compliance in, among others:

- Shariah governance.
- Shariah stock screening.
- Purification of income.
- *Zakah* calculation.
- Management of risk.

Shariah Governance of an Islamic Fund

Based on the summary of the key features of a conventional versus an Islamic fund highlighted in **Table 3.1**, the main differentiating factor is the Shariah governance of the fund. An Islamic AMC will have an independent Shariah advisor or Shariah board comprising three to five Shariah scholars. This board will establish compliance parameters for funds launched, usually prior to the establishment of the fund and before any assets are acquired. The Shariah board will also be responsible for publishing an annual statement, which sets out how the fund has complied with Shariah. The statutory documents of the fund need to clearly set out the roles and responsibilities of both the Shariah board and the fund manager, to avoid any potential conflict of interests, which is an area of concern for international regulators.

Table 3.1: Comparison between Conventional Unit Trust and Islamic Unit Trust

Type	Conventional Unit Trust	Islamic Unit Trust
Feature	A pooled investment plan, where the capital contributions of investors are combined into a legally formed trust fund.	Depending on the type of Shariah contract adopted, e.g. under a *mudarabah* structure, investors are known as *rabb al-mal* and the fund manager as *mudarib*. Investors participate in the equal sharing of a collective investment scheme, and share the profits and losses
Asset Manager	Invested and managed by professional fund managers, acting on behalf of the investors in a portfolio of marketable securities.	
Type of Stocks	All types of equities.	Restricted to Shariah-compliant stocks that are screened based on Shariah screening methodologies, e.g. AAOIFI, Dow Jones, MSCI, SC.

Source: RAM

Furthermore, an Islamic fund must establish a Shariah audit function, either by hiring an external party or internally engaging a Shariah specialist, whose responsibility is to oversee the Shariah compliance of the fund in consonance with the relevant regulations and Shariah resolutions.

Shariah Stock Screening

For an investment fund to be Shariah-compliant, the stock of the company in question must be screened to ensure that the potential investment is suitable under Islam. Under Shariah law, ownership of shares in a company is considered a structured proportionate share of that company's business and assets, with the result that Islamic investors cannot own a company involved in any *haram* activity. Investors will seek guidance from the fund's Shariah board on the permissibility of an investment or business venture.

To enhance Islamic investors' access to the financial markets, a group of leading Shariah scholars has developed a series of screening criteria aimed at identifying the Shariah non-compliant elements of a company; they will devise means to avoid or deal with them in a manner consistent with Shariah principles. Through this screening process, Shariah-compliant investors can, therefore, invest in companies which fulfil such screening criteria. The screening criteria is applied at the time of the investment decision and during the subsequent ongoing monitoring process by the Shariah board, to ensure that the company remains Shariah-compliant during the investment period.

There has been much debate on the interpretation and application of the screening criteria, which will often vary on a case-by-case basis. However, there are two basic screening processes which are applied to companies with the potential of forming part of an Islamic investment portfolio.

Firstly, the **business screen** examines the underlying business of the company and aims to eliminate any *haram* businesses that are contrary to the principles of Shariah. Such businesses include conventional banking, insurance, alcohol, pork-related products, non-compliant food products, gambling, certain tobacco products, pornography and weapons manufacturing. It is not sufficient for the holding company alone to comply with the industry screen, all its subsidiaries must also adhere to the same.

Once this initial screen is passed, the **financial screen** is then used to determine the extent of a company's Shariah non-compliant financial behaviour. This presents a significant challenge, as very few companies are completely Shariah-compliant in the current global market. As a result, many Islamic scholars agree to use certain financial ratios to determine whether a company is financially Shariah-compliant. While these ratios vary based on a specific Shariah board's discretion, a commonly used standard developed by the AAOIFI (2015) can be employed, as follows:

- Total conventional loans (long-term and short-term debts) must be less than 30% of the total market capitalisation of the company.
- Total interest-bearing deposits must be less than 30% of the total market capitalisation of the company.
- Total interest and Shariah non-compliant income must be less than 5% of the total revenue of the company.

By utilising its total market capitalisation, the entire value of the company (including intangible assets) can be considered, thus enabling more companies to be Shariah-compliant. Any of the company's income derived from Shariah non-compliant activities should be purified by the investor, by donating the *haram* portion of the income to charity.

Table 3.2 provides a list of different Shariah screening methodologies adopted by a regulator (i.e. the SAC of the SC) and various index providers. **Figure 3.2** presents an example of the Islamic equity fund screening process in Malaysia.

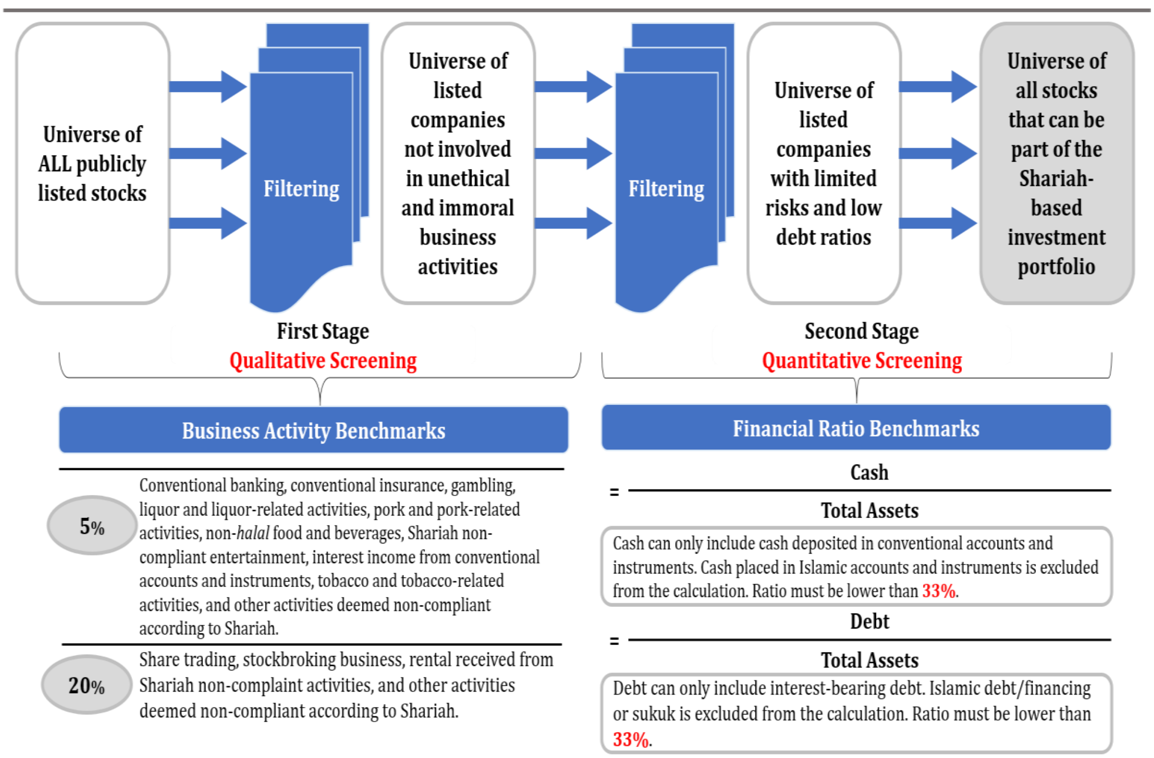
Table 3.2: Comparison of Different Shariah Screening Methodologies

	SAC of SC (Malaysia)	S&P Dow Jones Shariah Indices	MSCI Islamic Index		FTSE Shariah Global Equity Index Series
			Series	M-Series	
Scope	Malaysian stocks	Global stocks	Global stocks		Global stocks
Screener	Regulator	Index provider	Index provider		Index provider
Focus	Business activity and financial ratio benchmarks	Sector-based and accounting-based screens	Business activity and financial screening		Business sector and financial screening
Financial Ratio	▪ Total debts/ Total assets = < 33% ▪ Cash/Total assets = < 33%	▪ Total debts/ Market capitalisation = < 33% ▪ Accounts receivables/ Market capitalisation = < 49% ▪ Cash + Interest-bearing securities/ Market	▪ Total debts/ Total assets = < 33.33% ▪ Cash + Interest-bearing securities/ Total assets = < 33.33% ▪ Accounts receivables + Cash/Total assets = < 33.33%	▪ Total debts/ Average market capitalisation = < 33.33% ▪ Cash + Interest-bearing securities/ Average market capitalisation = < 33.33% ▪ Accounts	▪ Total debts/Total assets = < 33.333% ▪ Accounts receivables + Cash/Total assets = < 50% ▪ Cash + Interest-bearing securities/ Total assets

	SAC of SC (Malaysia)	S&P Dow Jones Shariah Indices	MSCI Islamic Index		FTSE Shariah Global Equity Index Series
			Series	M-Series	
		capitalisation = < 33% ▪ Non-permissible income other than interest income/Total revenue = < 5%		receivables + Cash/Average market capitalisation = < 49.00%	= < 33.333% ▪ Total interest and non-compliant activities/ Total revenue = < 5%
Dividend Purification Ratio	n.a	▪ Dividend x (Non-permissible revenue/Total revenue)	▪ (Total earnings – (Income from prohibited activities + Interest income))/Total earnings		Purification of dividends at 5%

Sources: SC (2013), S&P Dow Jones Shariah Indices Methodology (2017, Dec), MSCI Islamic Index Series Methodology (2017, Sep), FTSE Shariah Global Equity Index Series January (2018)

Figure 3.2: Example of Islamic Equity Fund Screening Process in Malaysia



Sources: CIMB-Principal Islamic Asset Management, SC, RAM

Purification of Income Earned

There are two levels of purification involving Shariah non-compliant investments of Islamic funds, as follows:

1. Excess capital gain from the disposal of Shariah non-compliant securities. This occurs when an Islamic fund invests in Shariah non-compliant or reclassified securities. All excess capital gains are considered impure, hence must be channelled to charitable bodies as approved by the Shariah advisor and trustee.

2. Income generated by the fund via Shariah non-compliant investment activities such as those involving interest, selling pork, alcohol and gambling, where the percentage should not exceed 5%, as indicated earlier. Scholars have different opinions on the calculation of purification income and who should conduct this process (i.e. the fund or the investors), as discussed in **Box 3.1**.

Box 3.1: Scholars' Opinions on Purification of Shariah Non-Compliant Income

Scholars' opinions on the responsible parties to perform purification:

1. The purification should be done at the fund's level, i.e. the fund manager will calculate the Shariah non-compliant income and channel that amount (for example, 2%) to approved charitable bodies before any profit/dividend is distributed to the investors/unit holders.
2. The purification should be conducted by the investors, not the fund. In this case, the fund manager will only report the Shariah non-compliant income on a unit basis. It will be the responsibility of the investors to calculate the purification amount, based on the number of units that the individual holds. This is because the investors can be a mix of Muslims and non-Muslims. It is therefore not obligatory for non-Muslims to adhere to the Shariah requirements for purification.

Method of calculating purification income:

1. **In the case of non-permissible income**, purification must be carried out on the total income, regardless of the source of income or whether the company has gained profits or whether dividends have been distributed. In the case where the actual amount of the non-permissible income cannot be obtained, such amount will be estimated. Purification in this scenario will be carried out by dividing the total non-permissible income by the total shares of the company and then multiplied by the average number of shares owned by the fund during the period. The purification amount will then be pro-rated according to the holding period.

2. **In the case of companies involved in conventional lending,** purification of the profit arising from such loans is based on the following:
   - The total amount of conventional loans of the company is divided by the company's total assets.
   - The result is then multiplied by the total net dividends received by the fund.
   - The result will be the total net dividends received by the fund arising from conventional loans.
   - The amount will then be divided by two as the dividend is derived from capital and labour. The portion arising from capital must be channelled to charity because this had been obtained from a Shariah non-compliant source. The portion derived from labour can be kept because the related business activities are permissible. Purification of profit from conventional loans cannot be carried out when the companies do not pay any dividend. For short-term conventional loans, purification will be undertaken in accordance with the tenure of the loan over the financial period.

Source: ISRA (2015)

Zakah Payment

Following are the two main opinions on *zakah* payment for Islamic funds. The first opinion is more widely accepted in most jurisdictions.

1. *Zakah* is the obligation of the individual unit holder/investor. Upon selling the fund or receiving dividends, the investors must pay *zakah* if they have owned the wealth for one lunar year (*hawl*), and the amount received reaches the 'zakatable' amount (*nisab*).

2. Islamic funds, as legal entities similar to individuals, should pay *zakah*.

Management of Risk

Shariah requires parties to be fair, just and ethical in their dealings with one another, and for the balance of risk (and its accompanying rewards) to be apportioned. The aim is to prevent a party with a stronger bargaining position from exploiting another one that is less able to negotiate fair and equal terms for a transaction.

There is an increasing focus on ensuring that the level of risk commensurates with the risk the client is willing and able to accept. While Islamic principles require the acceptance of risk to justify the earning of a reward, the concept of speculation (*maysir*) forbids risk taking that is akin to gambling.

As a result, one of the primary difficulties for Islamic fund managers is to provide an investment fund that minimises the potential risk to the investor. Unlike mainstream funds that can hedge their risks by diversifying the portfolio of investments, Islamic funds are severely restricted to investments that pass the screening criteria. Traditional derivative instruments, such as futures, are generally not permitted. There is a recent trend of permitted options that can hedge the risks of equity, commodities and currencies. However, the primary method of managing risk is in the form of capital-protected equity structures. These require the investor to use a small portion of the overall portfolio as a downpayment ('*urbun*) for a basket of shares that will be delivered on a date in the future. The disadvantage of this structure is that it reduces the short-term liquidity of the investment and requires the investor to relinquish redemption frequency (Motani & Sah, 2017).

3.1.2 Review and Analysis of Various Funds by Investment Portfolio

Different types of funds—based on their investment portfolios—carry different risk profiles, as delineated in **Figure 3.3**. Equity funds, for instance, entail high risks and represent long-term investments, which are more suitable for aggressive investors.

Figure 3.3: Analysis of the Various Types of Funds by Investment Portfolio

Equity Funds	Fixed Income Funds	Balanced Funds	Money Market Funds	REITs	ETFs	Alternatives
100% invested in stocks	100% invested in fixed-income securities	Mixture of fixed-income and equities	100% in short term fixed-income securities	100% invested in properties	100% invested in stocks	Investments in venture capital, private equity, hedge funds, specialist funds, etc.
Average annual return: 15%-20% medium risk, higher risk compared to other funds	Average annual return: 6%-10%	Average annual return: 6%-10%	Average annual return: 1%-2%	Average annual return: >10%	Average annual return: 1%-10%	Varies depending on the performance of respective funds
For aggressive investors	Medium risk, lower risk compared to other funds	Medium risk, lower risk compared to other funds	Medium risk, even lower risk compared to other funds	Medium risk, lower risk compared to other funds	Medium risk, even lower risk compared to other funds	High risk
Ideal for long term growth (5 years or more)	For conservative investors	For conservative investors	For very conservative investors	For conservative investors	For conservative investors	For high-risk investors

Sources: Compilation from various funds' prospectus, RAM

1. Equity Funds

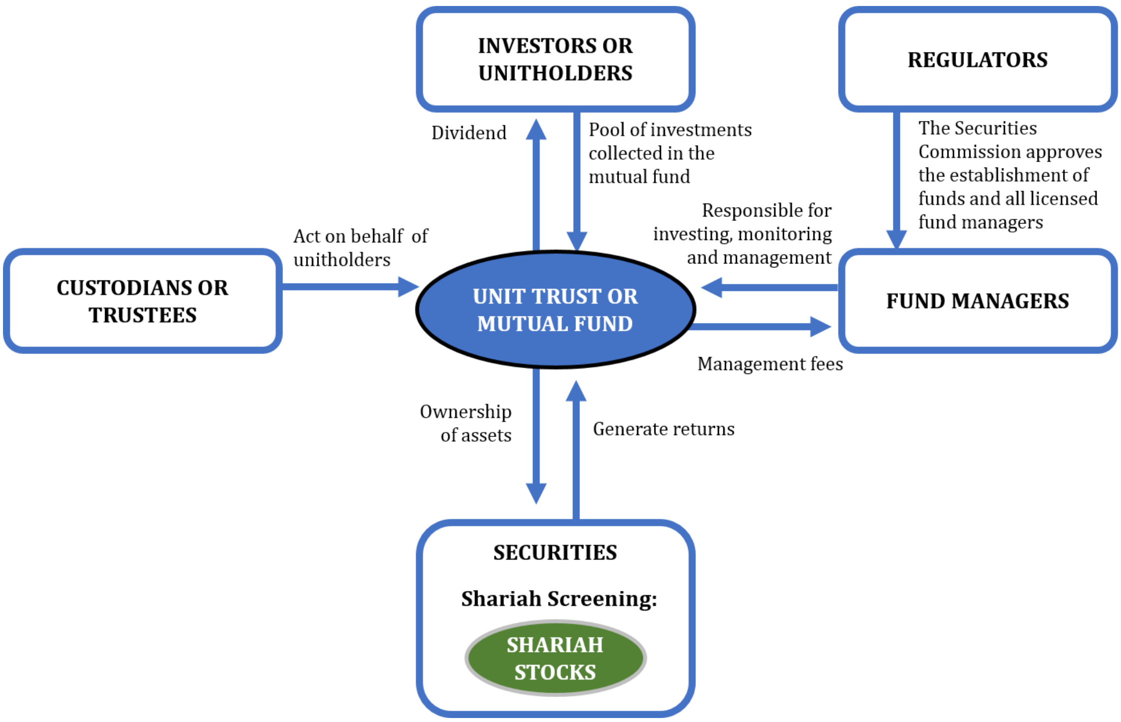
Equity funds invest in a portfolio of stocks and equity-related instruments. Instead of investing directly in a company, the investor shares the risk of the market performance of a portfolio of stocks in various sectors with the fund's other unit holders. The strategies of diversified equity funds are detailed below:

a) **Large-cap equity funds** invest in stocks of large and liquid blue-chip companies with stable performance returns.
b) **Mid-cap funds** invest in mid-cap companies that have the potential for greater growth and returns.
c) **Small-cap funds** invest in companies with small market capitalisations, with the intention of benefitting from greater gains in the form of the stocks' price performance as smaller companies may benefit from newer business opportunities.
d) **Sector funds** invest in companies that belong to a particular sector, e.g. technology or banking. The risks of sector funds are high as they are not diversified. Declines in the stocks of one sector can lead to a significant fall in investment value.
e) **Thematic funds** invest in the stocks of companies which may be defined by a unifying underlying theme. For example, infrastructure funds invest in stocks in the

infrastructure sector, which may have complementing effects to securities in the construction, cement and steel sectors.

In the structuring of Shariah-based investment funds, the asset manager will choose the various screening methodologies available in the market. For example, depending on the geographical location of the investors, the Dow Jones, the MSCI or the FTSE Shariah screening standards can be adopted to meet the requirements of global investors. **Figure 3.4** shows the basic structure of an Islamic equity fund.

Figure 3.4: Basic Structure of an Islamic Equity Fund



Source: RAM

2. Fixed-Income Funds

Debt funds invest in fixed-income securities such as bonds and treasury bills. A debt fund is less volatile and provides a steady but low income relative to an equity fund. The basic structure will be similar to an equity-based fund, except the type of investments will be fixed-income securities or sukuk, as shown in **Figure 3.5**. Types of fixed-income funds include:

a) **Liquid funds**: These funds invest in highly liquid money market instruments and provide easy liquidity. They invest in securities with a residual maturity of not more than 91 days. Investors can park their money in these for a short period of, say, a few days to several months. Compared to other funds, these fluctuate very little.

b) **Ultra short-term funds**: Most ultra short-term funds invest in securities with a residual maturity of not more than one year. These funds are suitable for investors who are ready to assume a marginally higher risk in return for slightly higher returns. Investors can park their short-term surplus funds for a few months to a year in these funds.

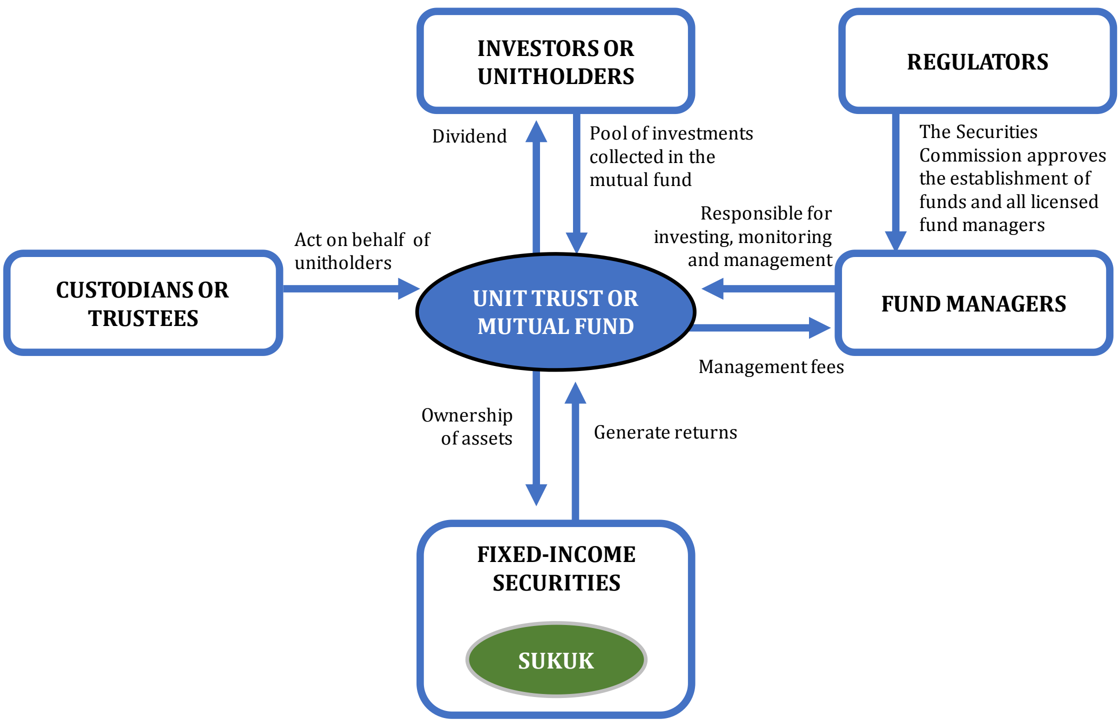
c) **Short-term funds**: These funds invest predominantly in debt securities with an average maturity of one to 4.5 years. They are suitable for conservative investors with a small to moderate risk appetite and an investment horizon of a few years.

d) **Dynamic bond funds**: They invest across all classes of debt and money market instruments, with various maturities. Their actively managed portfolios vary dynamically with the fund managers' views on interest rates. They are ideal for investors who do not wish to make a call on the future direction of interest rates, but still want to benefit from any positive movement.

e) **Income funds**: These funds invest in corporate bonds, government bonds and money market instruments with an average maturity of 4.5 years or more. They are highly vulnerable to changes in interest rates. They are suitable for investors who are ready to assume high risks and have a long-term investment horizon.

f) **Short-term and medium- and long-term gilt funds**: They invest in government securities with short- or medium- to long-term maturities. The average maturity of their holdings can vary greatly as per their declared objectives. These funds do not carry default risk since the bonds are issued by the government. The NAVs of these schemes fluctuate according to changes in interest rates and other economic factors. These funds have a high degree of interest-rate risk, depending on their maturity. The longer the maturity of the instrument, the higher the interest-rate risk.

Figure 3.5: Basic Structure of an Islamic Fixed-Income Fund

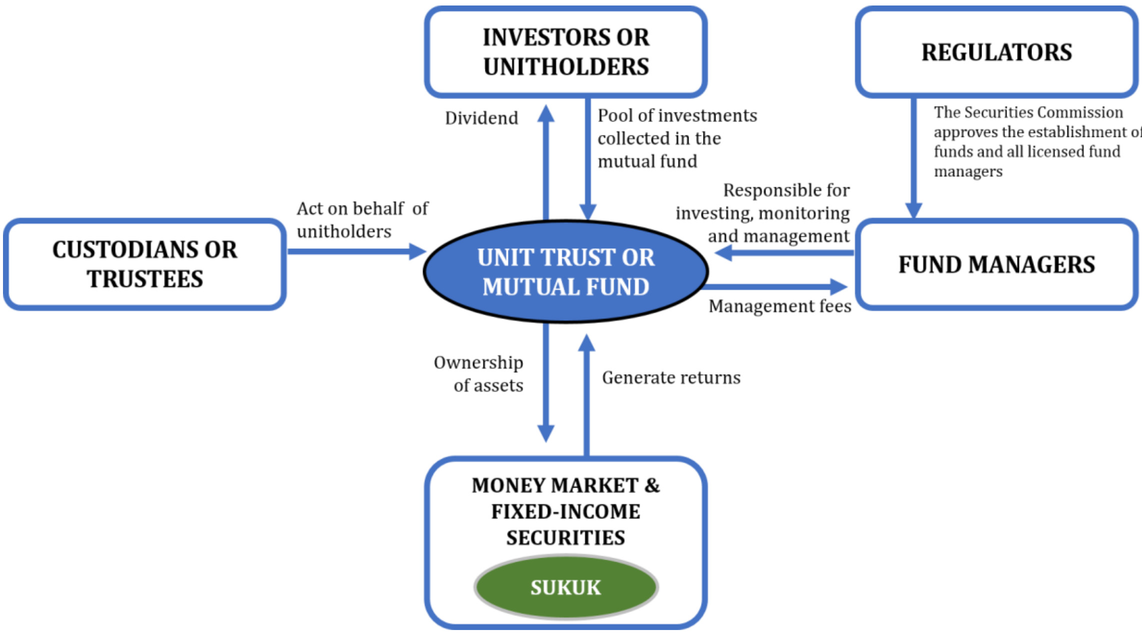


Source: RAM

3. Money Market Funds

A money market fund is a type of fixed-income fund that invests in debt securities, characterised by their short maturities and minimal credit risk (refer to **Figure 3.6**). Money market funds are among the least volatile types of investments. The income generated by a money market fund can be taxable or tax-exempt, depending on the type of securities the fund invests in (SC, 2016).

Figure 3.6: Basic Structure of an Islamic Money Market Fund



Source: RAM

4. REITs

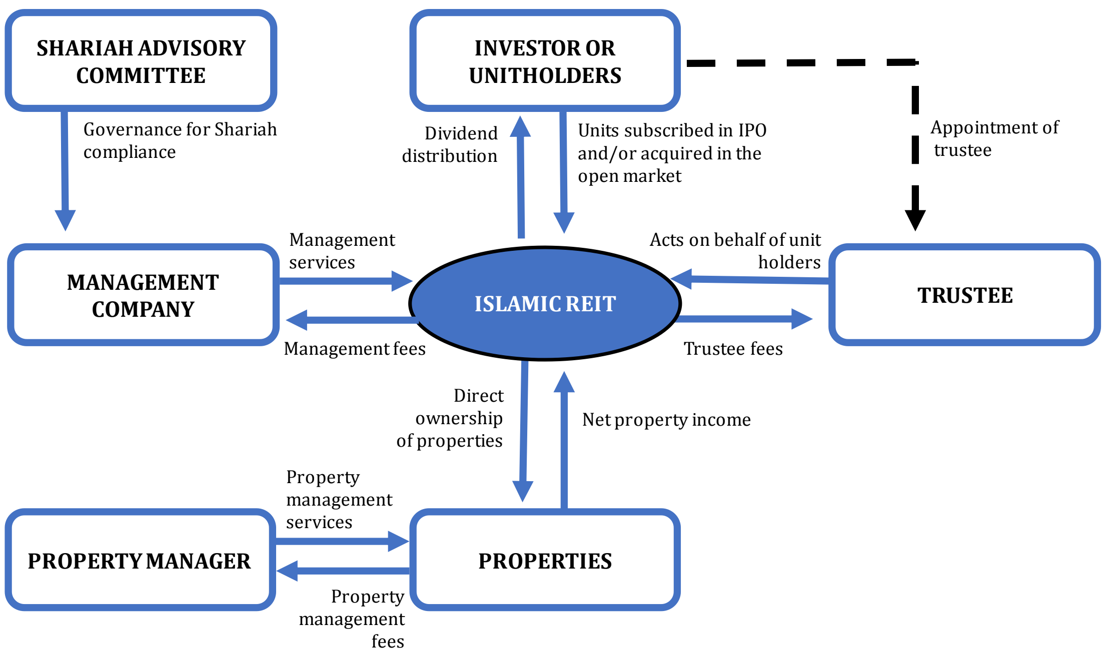
REITs invest in real estate, either in the form of physical property or the securities of companies engaged in the real-estate business. Real-estate mutual funds are an alternative to purchasing investment property, especially if the investor wants to limit his or her investment, level of risk and/or involvement in the management of real estate. The key differentiating factor between Islamic REITs and conventional REITs is the Shariah-compliant assessment to be undertaken by a Shariah advisor appointed to oversee the operations of the Islamic REIT. Such monitoring includes tenants' activities, rental earnings, deposits and financing decisions, acquisition and disposal of properties and investments. These are closed-end funds and some are listed on the stock exchange. Interestingly, even though Islamic REITs have been in several countries (e.g. Malaysia, Pakistan, Kuwait, Bahrain and the UAE), only Malaysia has issued guidelines on Islamic REITs (refer to **Table 3.3** on the salient terms of the guidelines). **Figure 3.7** provides an example of an Islamic REIT.

Table 3.3: Salient Terms of Malaysia's Guidelines on Islamic REITs

	Salient Terms
Tenants	An Islamic REIT may invest in real estate where: 1. All of its tenants carry out fully Shariah-compliant activities; or 2. Some of the tenants carry out Shariah non-compliant activities, provided the percentage of rental received from all such activities (Shariah non-compliant rental) is less than 20% of the total turnover of the Islamic REIT.
Non-Compliant Rental Threshold	Where a tenant's activities comprise both Shariah-compliant and Shariah non-compliant activities, the following requirements will apply to ensure that the Shariah non-compliant rental is below the 20% threshold: 1. The calculation of the Shariah non-compliant rental must be based on the percentage of area occupied for Shariah non-compliant activities to the total area occupied by such tenants. 2. Notwithstanding item (1) above, for activities that do not involve the use of space, such as service-based activities, the Shariah adviser may apply *ijtihad* (intellectual reasoning) when assessing the Shariah non-compliant rental for such tenants.

Source: Securities Commission Malaysia (2018)

Figure 3.7: Basic Structure of an Islamic REIT

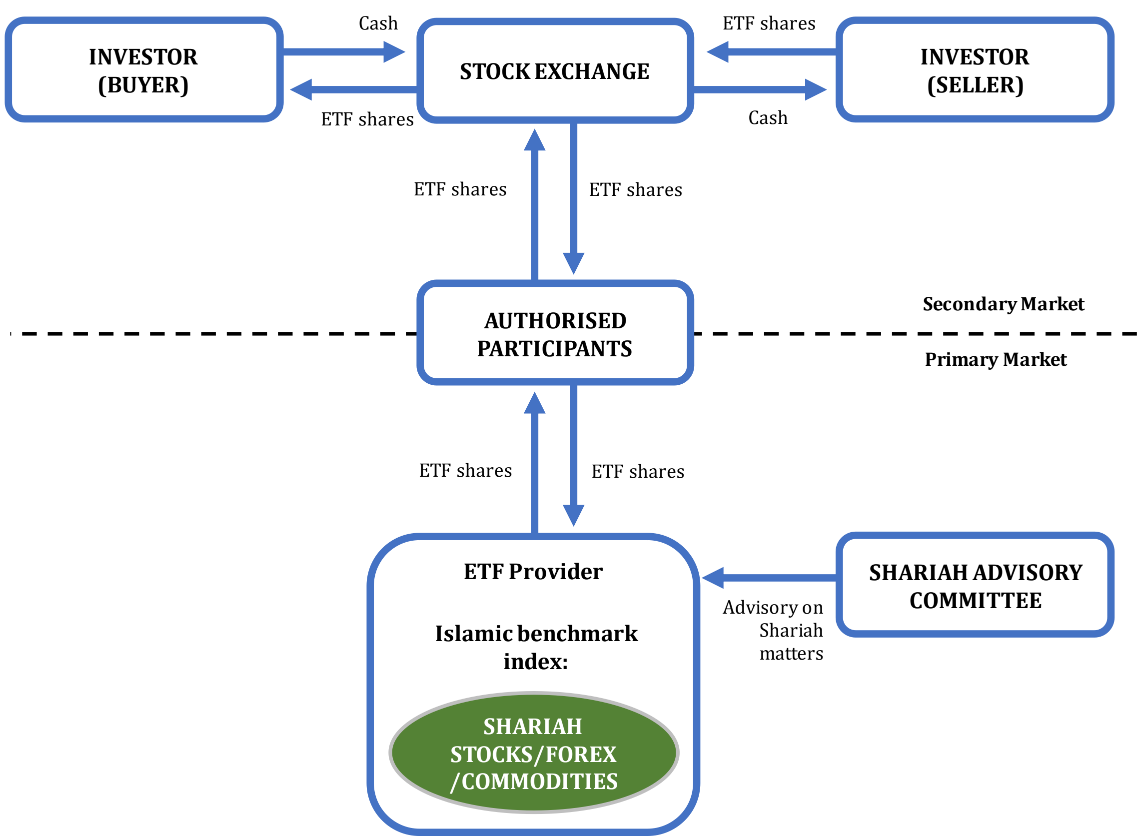


Source: RAM

5. ETFs

ETFs are a type of mutual fund that combines the features of an open-ended fund and a stock. Units are issued directly to investors when the scheme is launched. The units are listed and traded on a stock exchange like a stock. Transactions are done through the exchange's brokers. Investors need a broking account and an account related to buying/selling securities. Units purchased are credited to the demat account of the investor. The prices of the ETF units on the stock exchange will be linked to the NAV of the fund, but prices are available on a real-time basis, depending on the trading volume of the stock exchanges. As such, arbitrage trading ensures that the price of the ETF is typically very close to its NAV at any time. As the ETF requires the ability to add/reduce it's issued share capital according to demand, and as these shares represent the underlying assets, the ETF utilises authorised participants (typically large financial institutions) to create and redeem shares together with their underlying assets. **Figure 3.8** shows the basic structure of an Islamic ETF.

Figure 3.8: Basic Structure of an Islamic ETF



Sources: Nafis Alam (2013), RAM

3.1.3 Advantages and Disadvantages of Various Funds

With any type of investment, investors are exposed to risks and rewards. Having a clear financing objective and awareness of the associated risks will help manage the expectations on investment performance. A summary of the potential advantages and disadvantages of funds by asset class is presented in **Table 3.4**.

Table 3.4: Advantages and Disadvantages of Funds by Asset Class

Asset Class	Advantages	Disadvantages
Equities	▪ Higher returns than fixed deposits and other types of funds. ▪ Steady income. ▪ Capital appreciation. ▪ Portfolio diversification. ▪ Funds are professionally managed, with access to better information compared to average investors. ▪ Minimum entry cost for investment.	▪ Exposed to upfront and recurring transaction costs that will have an impact on returns. ▪ Unpredictability - cyclical market conditions may not suit risk-averse investors. ▪ Medium-to-long-term investment horizon.
Fixed-Income Securities	▪ Portfolio diversification. ▪ Suitable for low-to-medium-risk investors. ▪ Steady income. ▪ Funds are professionally managed. ▪ Minimum entry cost for investment.	▪ Exposed to upfront and recurring transaction costs that will have an impact on returns. ▪ Less exposure to market volatility compared to equity-based funds. However, investors are still exposed to market cycles.
ETFs	▪ Offer investors more diversified exposure than investment in individual stocks/forex/commodities. ▪ Entry cost is lower compared to direct investments, e.g. gold. ▪ Lower annual management fees compared to unit trust funds. ▪ Transparency – investors know exactly which assets are held in the ETF. ▪ Since ETFs are traded like stocks, investors have easy access to liquidity. ▪ Funds are professionally managed.	▪ Limited number of ETFs to choose from in the market compared to unit trust funds. ▪ Intraday price swings may make short-term investors jittery. ▪ Costs could be higher than trading in stocks, which attract no management fees.
REITs	▪ Portfolio diversification. ▪ Potentially higher returns in return for medium-level risk. ▪ Income is secured by long-term leases. ▪ Properties are professionally managed.	▪ Potentially slower growth since only 10% is allowed to be reinvested. ▪ Exposed to potentially high leverage ratios. ▪ Higher tax rate on dividends. ▪ Need to operate in a REIT-compliant manner. ▪ Sensitive to other higher-yielding investments.

Sources: Sharmila (2014), RAM

3.2 Investment and Commercial Considerations

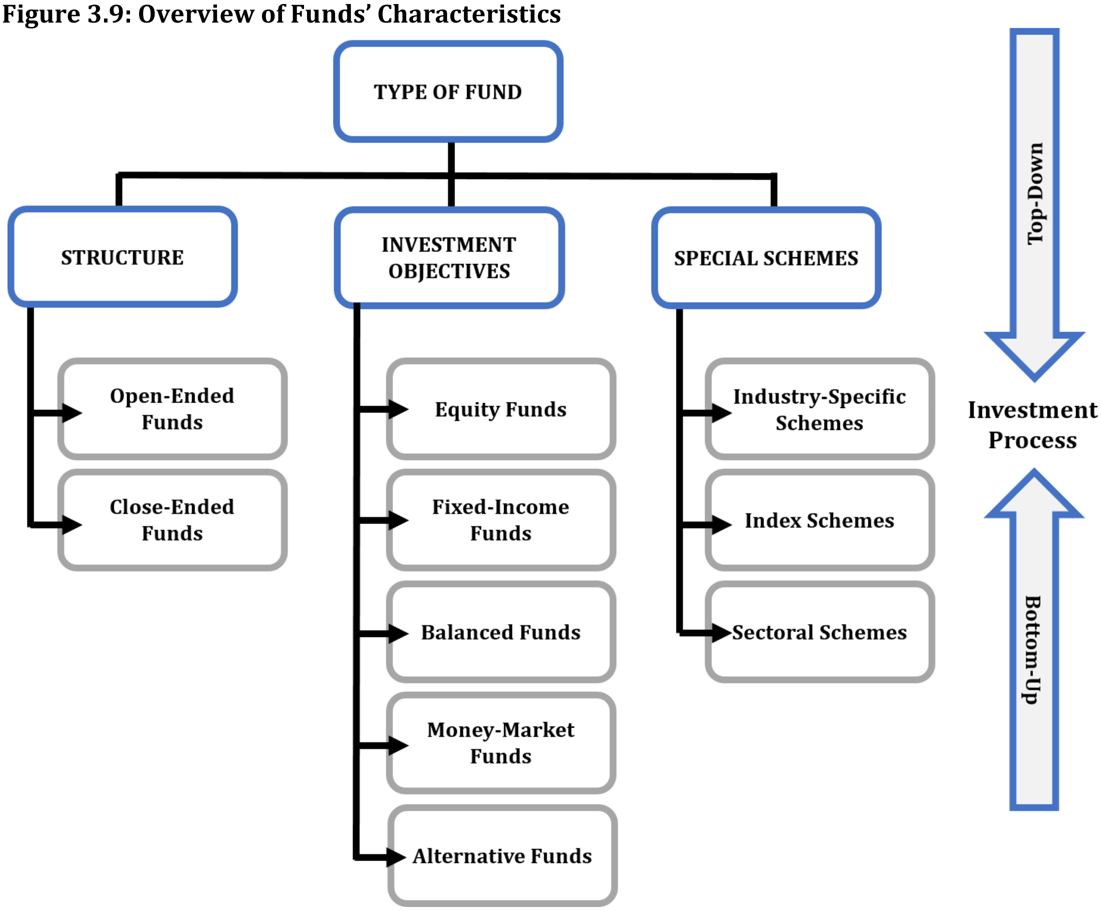
3.2.1 Factors Influencing the Decision-Making Process of Funds

Risk appetite varies from one investor to another. Accordingly, funds are structured to meet the wide-ranging risk appetites of investors. Understanding the different risks and rewards of available funds is important in managing investment objectives. A general rule of thumb is: the higher the risk, the higher the return and/or loss. Although some funds are less risky than others, all funds entail some level of risk. A review of publicly available fund prospectuses is the first step towards understanding the types of risks involved.

As described in **Figure 3.9**, each fund will have a predetermined investment objective that tailors the fund's asset size, type of investments, investment strategies and/or schemes. At the fundamental level, funds can be classified based on the following parameters:

1. Fund structure
2. Investment objective
3. Type of special scheme

Figure 3.9: Overview of Funds' Characteristics



Sources: Mutual Funds (2013), RAM

Fund Structure

Funds can be structured as open-ended or close-ended. Most of the funds in circulation have open-ended structures. The key distinctions between the two are explained in **Table 3.5.**

Table 3.5: Comparison between Open-Ended and Close-Ended Funds

Type	Open-Ended Fund	Close-Ended Fund
Feature	A fund which can issue and redeem units at any time (e.g. most mutual funds, ETFs).	A company (investment company) which issues shares for subscription (e.g. REITs). Redemption period is specified.
Characteristic	Refers to a fund operated by the fund manager that makes an offer to the public and invests the proceeds in a group of assets, in accordance with the fund's objectives.	Refers to a fund with a fixed number of outstanding units. Similar to a stock, units can be redeemed/sold by investors on the stock exchange. Once listed, the fund manager will not create new units.
No. of Units	No restriction on the number of units the fund will issue.	Limited number of units.
Tradability	Buying and selling through unit trust companies.	Appoint broker to buy and sell the units on the stock exchange.
Price – NAV	Computed daily: $\frac{\text{(Fund's Total Assets – Liabilities)}}{\text{No. of Outstanding Units}}$	Based on market demand—higher or lower than the NAV per share.

Source: SC

Investment Objectives

As highlighted earlier in **Figure 3.9**, investment objectives are generally based on the following themes:

- **Equity Funds:** The aim of growth funds, which include income funds, is to achieve capital appreciation over the medium to long term. Such funds have comparatively high risks.
- **Fixed-Income Funds:** Funds that invest in medium to long-term debt instruments issued by private companies, financial institutions, governments and other entities in various sectors.
- **Balanced Funds:** These funds provide both growth and regular income as they invest in both debt and equity. The NAVs of these schemes are less volatile than those of pure equity funds.
- **Money Market Funds:** Invest in short-term (maturing within one year) fixed-income securities. These instruments are highly liquid and provide investment safety. Money market funds are therefore the safest investment option relative to other types of mutual funds.

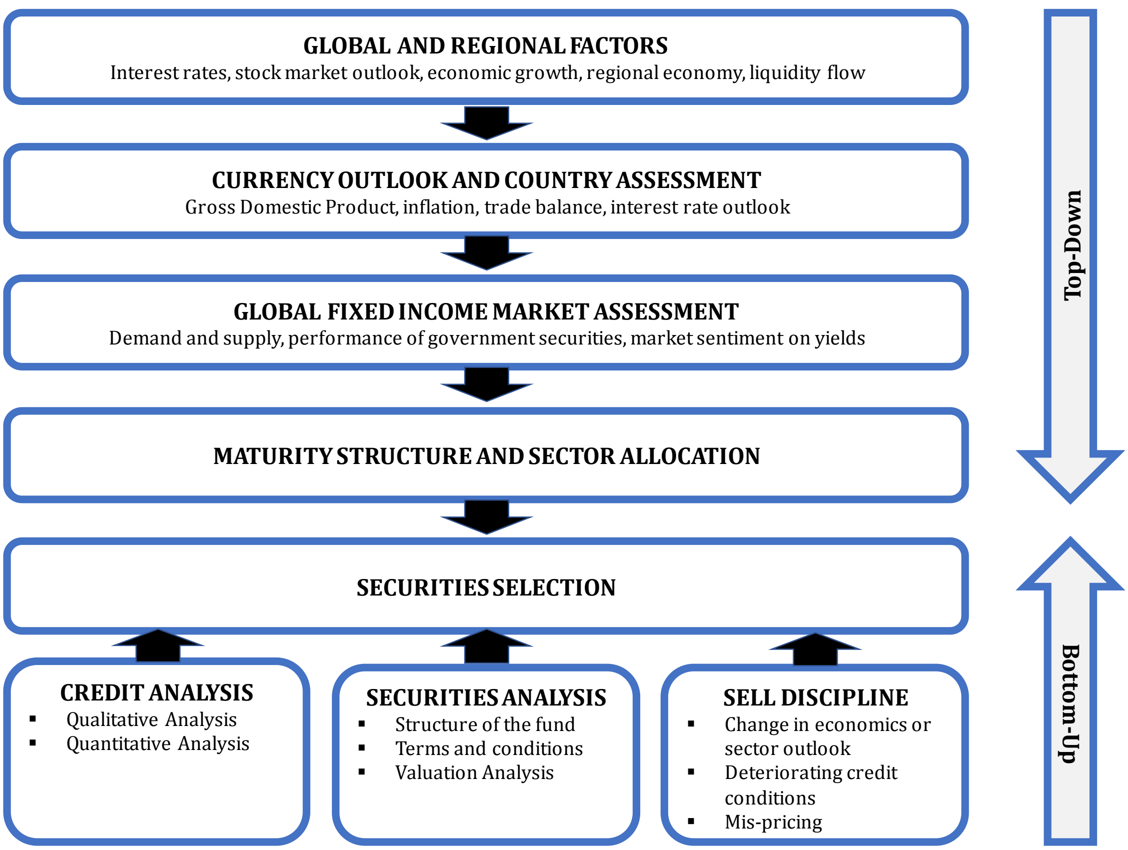
Special Schemes

- **Industry-Specific Schemes:** Only invest in the industries specified in the offer documents. The investments of these funds are limited to specific industries, e.g. infrastructure-related industries such as toll roads, power or water concessionaires.
- **Index Schemes:** The money collected by mutual funds are invested in the underlying shares of stock exchange indices, such as the Dow Jones or MSCI-related indices.
- **Sectoral Schemes:** These are funds which invest in a sector of the market, e.g. banking, financial technology. Sector funds are riskier than equity diversified funds since they invest in the stocks of a particular sector and reduce their diversification opportunities.
- **Alternatives:** These funds include venture capital, private equity, hedge funds and specialist funds, which carry higher risks.

Investment Process

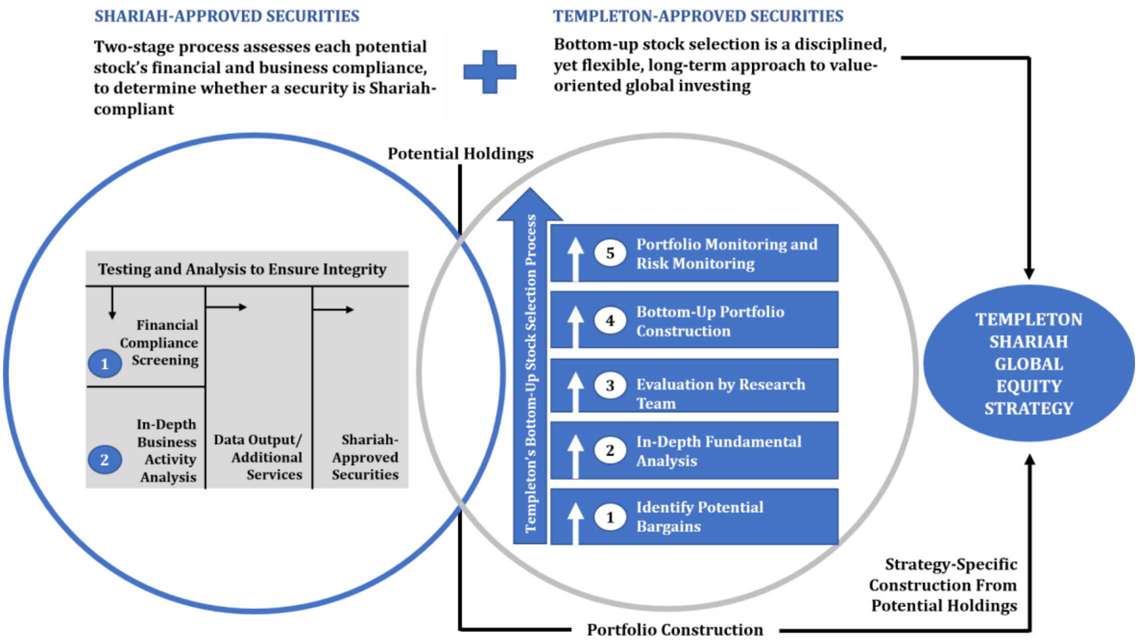
Each AMC will adopt its own unique investment processes, based on its competitive advantage and inherent strengths. **Figure 3.10** and **Figure 3.11** show examples of investment processes.

Figure 3.10: Example 1 of an Investment Process



Sources: Opus Asset Management Sdn Bhd, RAM

Figure 3.11: Example 2 of an Investment Process



Source: Franklin Templeton Investments (2018, p. 9)

3.2.2 Comparison of Transaction Costs

Investments in funds attract a variety of transaction costs, all of which will reduce an investor's potential return. According to O'Shea (2016), examples of common investment and brokerage fees include the following:

- **Brokerage account fees:** These include annual fees to maintain a brokerage account, subscriptions for premium research to help with trading strategies, and fees to access trading platforms.
- **Trade commissions:** Charged by a broker when the investor buys or sells certain securities, such as stocks.
- **Mutual fund transaction fees:** Charged by a broker to buy and/or sell some mutual funds.
- **Expense ratios:** Annual fees charged by all mutual funds, index funds and ETFs, as a percentage of the investor's investment in that fund.
- **Sales loads:** A sales charge or commission on some mutual funds, paid to the broker or salesperson who sold the fund.
- **Management or advisory fees:** This is stated as a percentage of AuM, paid by the investor to a financial advisor or robo-advisor.

Based on **Table 3.6**, the transaction cost for an Islamic equity fund—in the case of Malaysia—is the highest compared to other types of investments, particularly ETFs. As explained earlier, due to the passive management of ETFs, the management and trustee fees are substantially lower.

Table 3.6: Comparison of Transaction Costs by Asset Class – the Malaysian Experience

Type of Fund / Type of Fee	Equity Fund	Fixed-Income Fund	ETF
	CIMB Islamic DALI Equity Growth Fund	Franklin Malaysia Sukuk Fund	MyETF Dow Jones US Titans 50
Minimum Investment	RM500	RM1,000	Minimum lot of 100 units based on the market price
Initial Fee (Upfront)	Sales charge: Up to 6.50% of the NAV per unit	Sales charge: Up to 3.00% of the NAV per unit	Brokerage fee: Up to 0.70% of the contract value (subject to a minimum of RM40)
Management Fee	1.50%	0.95%	0.40%
Trustee Fee	0.06%	0.06%	0.035%
Switching Fee	Difference of application fees between the two funds	-	-
Redemption Fee	-	-	-
Annual Index Licence Fee	-	-	0.04%
Bursa Securities Clearing Fee	-	-	-
Total Fee	**Up to 8.06%**	**Up to 4.01%**	**Up to 1.175%**

Sources: CIMB Islamic DALI Equity Growth Fund Prospectus (2016, June), Franklin Malaysia Sukuk Fund Prospectus (2016, November), MyETF Dow Jones US Titans 50 Prospectus (2017, September)
Note: The table above provides a comparison of basic transaction costs. Other applicable costs are detailed in the respective prospectuses.

In the case of Pakistan, as shown in **Table 3.7**, the total transaction costs for Islamic equity funds and Islamic commodity funds are more or less the same, except that the former charges higher management and trustee fees.

Table 3.7: Comparison of Transaction Costs by Asset Class – the Pakistani Experience

Type of Fund / Type of Fees	Islamic Equity Fund		Islamic Money Market Fund		Islamic Commodity Fund	
	National Investment Trust (NIT) Islamic Equity Fund		HLB Money Market Fund		Meezan Gold Fund	
Minimum Investment	PKR5,000		PKR1,000		PKR5,000	
Management Fee	2%		1%		1%	
Trustee Fee = Actual custodial expenses/Charges plus the specified tariff	Net Assets (million)	Tariff	Net Assets (million)	Tariff	Net Assets (million)	Tariff
	Up to PKR1,000	PKR0.7 million or 0.20% p.a. of NAV, whichever is higher	PKR 1-PKR1,000	PKR0.6 million or 0.17% p.a. of NAV, whichever is higher	PKR1-PKR1,000	0.17% p.a. of NAV
	Above PKR1,000	PKR 2.0 million plus 0.10%	Above PKR1,001-PKR5,000	PKR1.7 million plus 0.085	Above PKR1,001-5,000	PKR1.7 million plus 0.085

Type of Fund / Type of Fees	Islamic Equity Fund		Islamic Money Market Fund		Islamic Commodity Fund	
	National Investment Trust (NIT) Islamic Equity Fund		HLB Money Market Fund		Meezan Gold Fund	
		p.a. of NAV, on amount exceeding PKR1,000 million		%p.a. of NAV, on amount exceeding PKR1,000 million		%p.a. of NAV, on amount exceeding PKR1,000 million
			Above 5000	PKR5.1 million plus 0.07% p.a. of NAV, on the amount exceeding PKR5,000 million	Above 5000	PKR5.1 million plus 0.07% p.a. of NAV, on the amount exceeding PKR5,000 million
Front-End Load	Currently 0%, but can charge up to 3% of NAV (for Class C only)		Currently 0%, but can charge up to 5% of NAV		Currently 2%, but can charge up to 5% of NAV	
Back-End Load	-		-		-	
Transfer of Units Fee	0%		Up to 1% of NAV on the date the request is lodged		Up to 1% of NAV on the date the request is lodged	

Sources: NIT Islamic Equity Fund Offering Document (2015, April), HBL Islamic Money Market Fund Offering Document (2011, May), Meezan Gold Fund Offering Document (2015, April)
Note: The table above provides a comparison of basic transaction costs. Other applicable costs are detailed in the respective offering documents.

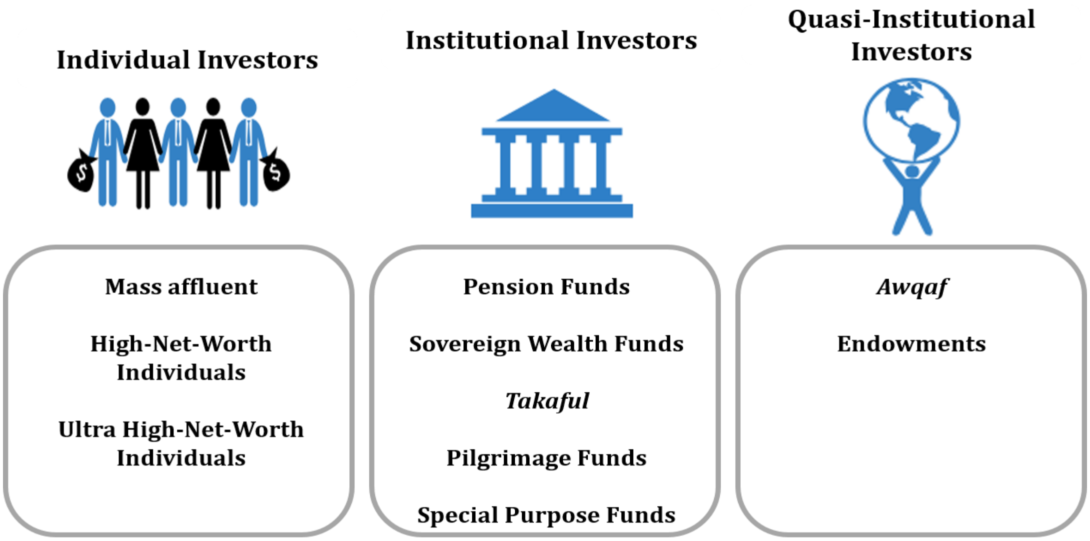
3.2.3 Target Investors and Geographical Distribution

There are three main groups of investors: individuals, institutions and quasi-institutions. The first group can be differentiated by wealth into mass affluent, high-net-worth, and ultra high-net-worth individuals (refer to **Figure 3.12**). Mass affluent individuals (with USD50,000-USD500,000 of liquid wealth) usually invest in short-term, safe and simple products (e.g. insurance- and annuity-linked ones). High-net-worth individuals (with at least USD1.0 million of liquid wealth) and ultra high-net-worth individuals (with at least USD30.0 million of liquid wealth) tend to focus on safe assets and capital preservation (IRTI-UNDP, 2017).

Institutional investors include *takaful* and pilgrimage funds, which solely invest in Shariah-compliant instruments, sovereign wealth funds and pension funds. Sovereign wealth funds may turn to Islamic finance if they seek ethical investments. According to IRTI-UNDP (2017), these institutions are mostly interested in 'sophisticated, structured products and exposure to international markets', as well as competitive returns and top-notch service. Pension funds, which by nature seek long-term investments, focus on international investments in mature markets.

Quasi-institutions, consisting of *waqf* (by definition, Shariah-compliant) and endowments (not necessarily Islamic), seek long-term capital growth and preservation as well as fund management. Consequently, they mostly invest in real estate and, to a much smaller extent, equities (IRTI-UNDP, 2017).

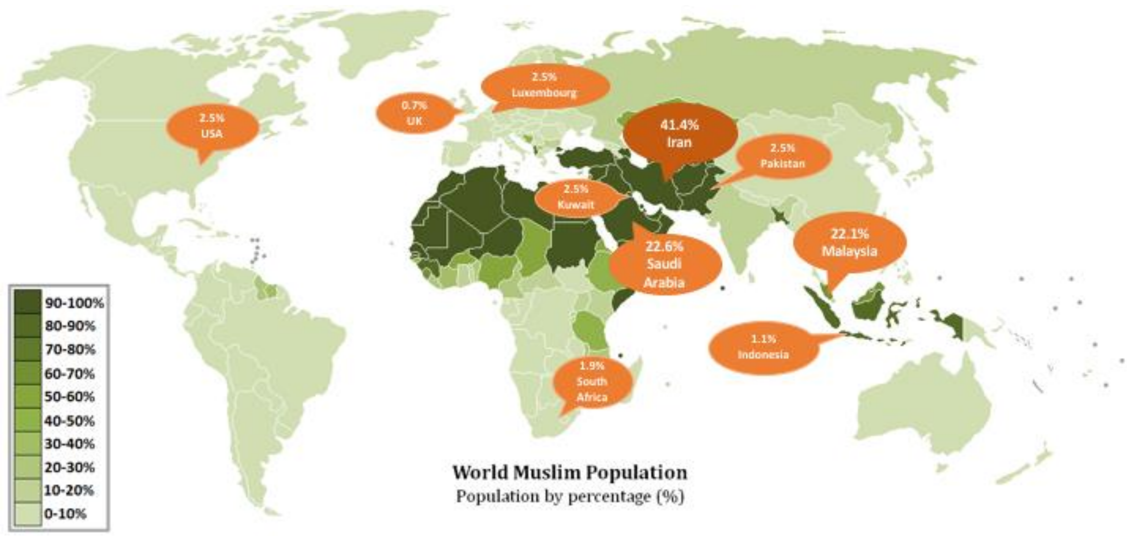
Figure 3.12: Key Investor Profiles in Islamic Finance



Source: IRTI-UNDP (2017), RAM

Based on **Figure 3.13**, the growth of Islamic AuM is strong in Muslim-majority countries due to their demand for Shariah-compliant investments. The level of progress of domicile Islamic fund management industries, however, depends on the stage of Islamic finance inclusion within each market. Geographically, Malaysia is the leader in South-East Asia while Saudi Arabia leads the Middle East. Interestingly, South Africa—despite its small Muslim population—accounts for 1.9% of global Islamic AuM. South Africa's matured conventional market supports greater penetration of Islamic funds from neighbouring African countries, which have larger affluent Muslim populations.

Figure 3.13: Geographical Distribution of Islamic AuM against Muslim Population



Source: RAM
Note: Figures sourced from ICD-Thomson Reuters Report (2017)

3.3 Key Factors Underpinning the Development of Islamic Fund Management

As described earlier under item 3.1, the five core pillars set the basic critical success factors required for the development of an Islamic fund management industry. Other important factors are listed below while the findings are summarised in **Table 3.8**.

Table 3.8: Stage of Country's Islamic Funds Development and Macroeconomic Factors

Country and Credit Ratings	Stage of Market Development	% of Shariah-Compliant Stocks Against Total Market	Macroeconomic Brief
Malaysia A- (S&P), A3 (Moody's), A- (Fitch), A2 (RAM)	Matured	▪ Shariah-compliant stocks represent **76.2**% (688 stocks vs 903 listed stocks)	According to RAM, Malaysia's credit ratings reflect the country's resilient economic growth, the government's fiscal consolidation efforts and stable GDP growth (i.e. estimated at 5.8% in 2017). These positive conditions have significantly supported the growth of the country's capital markets. The Malaysian capital markets expanded 12.6% to RM3.2 trillion as at end-2017, making it the fifth largest in Asia.
Pakistan B (S&P), B3 (Moody's), B (Fitch)	Developing (Advanced)	▪ Shariah-compliant stocks represent **44.7**% (250 stocks vs 559 total stocks)	According to S&P, Pakistan's GDP is expected to grow at an average rate of 5.7% in 2017-2020. This stronger growth projection reflects the large-scale investments under CPEC in the energy and infrastructure sectors of the economy. Nonetheless, the rating remains constrained by a narrow tax base and domestic as well as external security risks.
South Africa	Developing (Intermediate)	▪ Shariah-compliant	According to Moody's, the earlier weakening of South Africa's institutional framework will gradually reverse

Country and Credit Ratings	Stage of Market Development	% of Shariah-Compliant Stocks Against Total Market	Macroeconomic Brief
BB (S&P), Baa3 (Moody's), BB+ (Fitch)		stocks represent **40**% (160 stocks vs 400 total stocks)	under a more transparent and predictable policy framework. Nevertheless, political and policy uncertainties remain as dampers that prevent a change in its credit rating. GDP was lifted 1.3% in 2017, exceeding the National Treasury's projected 1.0% growth.
Morocco BBB- (S&P), Ba1 (Moody's), BBB- (Fitch)	Infancy	Nil	According to Moody's, the factors supporting Morocco's rating include an improving external position and fiscal imbalances. Moody's also takes into account the continued progress in the country's industrialisation strategy, which aims to increase the manufacturing sector's share to 23% of GDP by 2020, from 16% in 2017.

Sources: Credit rating agencies news releases, Regulator's reports

1. Healthy Macroeconomic Factors

The bedrock of any capital market is a country's macroeconomic factors, the most influential of which are the stability of economy and currency, GDP growth, rate of inflation and unemployment rate. As a country's macroeconomic health improves, so will its capital markets, which will in turn have linkages to the performance of the fund management industry.

2. Robustness of ICM Activities

The overall performance of a country's capital markets will support the progress of its ICM. Since ICM activities, i.e. equities and sukuk, will feed the development of funds, it is important to ensure focus is given to the overall development of a domestic ICM. Without it, the Islamic fund management industry will face a dearth of Shariah-compliant assets.

3. Build-up of Listed Shariah-Compliant Companies

The rise in Islamic finance assets over the years has been predominantly demand-driven, with Islamic banking and sukuk representing 89% of total Islamic assets. This solid demand has encouraged more listed corporates across different jurisdictions to undergo Shariah screening. The matching of common values between Islamic finance and SRI investors has further incentivised corporates to comply with international Shariah screening methodologies in a bid to attract these SRI funds. As market awareness grows, the number of Shariah-compliant listed securities is envisaged to rise in tandem. In preparation for this, the infrastructure of the local stock exchange must be enhanced and its systems upgraded to cater for more listed stocks.

4. Captive Demand for Shariah-Compliant Investments or Assets

Having a captive market for Shariah-compliant investments or assets will have a ripple effect on the pipeline for Islamic funds. Overall, Islamic banks, *takaful* operators, and institutional and retail investors constitute the large pool of investors seeking Islamic funds. As a market matures in building up its Islamic finance industry, the captive base is expected to grow alongside, with an increase in the number of Islamic banks and *takaful* operators.

3.3.1 Key Issues and Challenges in Islamic Fund Management

Recent Developments

Islamic funds will face increasing challenges, particularly when diversifying into non-Islamic jurisdictions. Recent regulatory developments in Europe (such as the incoming Alternative Investment Fund Managers Directive) will impose further restrictions on fund managers.

Many of the tenets of Islam already comply with the latest European regulations. The risk-reward profile of Shariah-compliant investment funds is mirrored by the increased focus of European regulators on the suitability of products provided by wealth managers to their clients. There is a clear obligation on the part of the wealth manager, who makes a personal recommendation or exercises its discretion to trade to ensure that the recommendation or trade is suitable for a client. This obligation flows from the mainstream principles to act in the best interests of clients and to treat them fairly.

Islamic fund managers are very much more restricted in their ability to exercise discretion on behalf of their investors, and must satisfy the additional requirement of linking investments to moral objectives.

The key issues and challenges associated with the current Islamic fund management industry include the following:

Issues and Challenges Related to Infrastructure Development of Islamic Funds

1. Lack of Regulation in Certain Jurisdictions

The regulation of the asset management industry, particularly funds, varies significantly between jurisdictions in the GCC and the Far East. Such regulation remains largely weak in comparison to the developed markets. Although the regulatory environment is improving, several jurisdictions remain under-regulated. This could expose both the industry and the investors to unnecessary risks such as industry-wide reputational risk and the risk of Shariah non-compliance, which could arise if an Islamic financial institution were to run into financial difficulties or be accused of not conforming to Shariah. Such an incident will be further compounded by the nascent state of the industry and may undermine its existence. An under-regulated jurisdiction also affects market confidence and ultimately hinders the development of the industry. Therefore, further regulation of the fund management industry will assist in the maturity and growth of this nascent segment of the Islamic finance industry (The Islamic Fund and Investment Report, 2008). Apart from that, the regulation needs to be clear and enabling, and must be accompanied by strong market supervision.

Lack of transparency and disclosure is particularly true about the Islamic investment industry, as opposed to Islamic banking. The reason for this lack of regulation and disclosure is not the fault of the Islamic finance industry itself. These funds have grown without the scrutiny they may have needed; proper regulations and closer scrutiny may contribute much to market transparency (Siddiqi & Hrubi, 2008). This will boost investor confidence in both the Islamic and conventional segments, which in turn will contribute to the further expansion and development of the Islamic fund management industry.

Logically, the regulation of Islamic financial institutions will work best when there are already regulations in place for conventional financial institutions. There are usually enough regulations in many areas, although a few may require new guidelines due to the lack of an existing regulatory framework. All said, there is a need to strike a delicate balance between over- and under-regulation. Over-regulation could have counterproductive results, including reducing the number of financial products, raising transaction costs and hampering efficiency. Therefore, the main challenge is to adopt the existing regulations in a way that will protect clients or investors. The regulatory framework should not be copied blindly, but should instead be adopted judiciously (Siddiqi & Hrubi, 2008).

2. Additional Disclosure Requirements

Disclosure is imperative in Islamic funds. Nevertheless, the degree of the disclosure may vary, depending on the sophistications of investors and their willingness to absorb losses related to their investments. As such, investors have the right to understand the risk-return parameters of their investments so that they can make informed decisions that best suit them. Given the nature of investment funds, investors should be provided additional disclosure pertaining to different areas (McMillen, 2018, p. 94), including the following:

- Investment objectives, criteria and parameters.
- Fee structures (which are often difficult to understand, even by the most sophisticated investors).
- Valuation of assets, pricing and net asset valuations.
- Redemption rights and restrictions.
- Credit enhancements.
- Yield and payment provisions, including the basis and priority of payments.

Given the robust growth of global Islamic funds, this aspect should be accorded greater scrutiny and emphasis.

3. Lack of Talented Human Capital

According to the Islamic Fund and Investment Report (2008), the demand for human resources is strong throughout the entire Islamic finance industry. With the growth and development of the Islamic fund management industry, this demand will strengthen. This contrasts against the conventional fund management industry, where access to global resources prevents staffing from becoming a major risk. Due to the lack of qualified human resources, an institution's ability to attract and retain quality staff is a competitive advantage. Financial incentives and an attractive working environment as well as opportunities are key contributing factors in the retention of qualified staff, who may be inclined to change jobs when better opportunities arise. The expertise of human resources is essential if Islamic products are to match their conventional counterparts.

4. Inconsistent Financial Statements

Screening is an important aspect of Islamic investment and fund management. For accurate screening, the accuracy of information is vital. Nonetheless, the availability (or lack) of accurate information is a challenge. Many organisations report incomplete and/or erroneous financial disclosures on a quarterly or annual basis. Similarly, many companies do not report interest income as a part of their quarterly/annual financial statements. As a result, the data a fund manager uses can be erroneous, thus leading to improper selection of a Shariah-compliant stock or portfolio. Likewise, many companies do not differentiate between cash and cash equivalents (e.g. money market instruments and treasury bills that can be readily converted into cash) in their financial reports. By the same token, many companies use old financial data to calculate various financial ratios, which result in misleading information. In other cases, data providers may miss out on important announcements by corporates, such as stock splits, bonus declarations and dividend payments (Cognizant 20-20 Insights, 2012).

5. Adapting to Fintech

Another emerging challenge stems from new realities like changing client demographics and preferences for modern and digitalised distribution methods. The global asset management industry is being pushed to embrace new investment platforms in trying to meet the needs of an evolving clientele. These clients favour new distribution channels such as mobile devices. This situation poses unique sales challenges besides demanding transparency. If the Islamic fund management industry fails to adapt to these changing dynamics, it can exacerbate its competitive disadvantage (IFSB, 2017).

6. Scalability

Scalability is another challenge facing the Islamic fund management industry. Typically, fund management entails fixed costs that become more efficient as AuM increases. Because ICM is a niche market, achieving a minimum level of scale efficiency is a challenge. Fintech is helping to reduce the threshold required to achieve this minimum efficiency.

Issues and Challenges Related to Investment and Commercial Considerations

1. Smaller Universe of Shariah-Compliant Investible Assets

Although Shariah-compliant investment has made great strides since the 1990s, one of the major challenges has been the perceived lack of investment opportunities and Shariah-compliant financial assets (Chan, 2017). Islamic indices have a limited universe of stocks. Many companies are not included in these indices. Fund managers, therefore, find it challenging to select a stock no matter how appropriate it may be for his portfolio construction, in case that stock is not listed on the Shariah-compliant index that he adopts. Additionally, some sectors form an integral part of traditional funds but are not an option for an Islamic fund manager as they are excluded due to Shariah restrictions. A good example is the traditional banking and financial services sector. Almost all such companies (excluding Islamic financial institutions) are deemed Shariah non-compliant and are thus not an option for Islamic fund managers (Cognizant 20-20 insights, 2012). The screening process, which excludes many investment areas from the potential list, limits the options available to fund managers, thereby limiting their ability to take advantage of many profitable investment opportunities.

2. Higher Transaction Cost

Islamic funds are always more expensive to manage than their equivalent conventional counterparts; the former requires additional fees for the Shariah board/advisor and periodic Shariah audits if they are performed by external parties.

3. Reclassification of Securities

Many stocks which form part of a fund manager's Shariah-compliant portfolio in a year may become non-compliant with time. There are reasons for this change in status. For instance, a company may discontinue a Shariah-compliant business, thus excluding it from the Shariah-compliant list. Similarly, a hotel and residential services provider may stop bar services—with alcoholic drinks—which may then qualify it for inclusion in the list of Shariah-compliant securities. From the perspective of quantitative screening, there may be a rise or decline in market capitalisation due to certain external/internal factors, or merger and acquisition (M&A) activity that may render a stock non-compliant. In all these and similar cases, it is the responsibility of the internal compliance department of the AMC to keep a close eye on the changing situation so that they can inform the fund manager, who can then make the necessary adjustments to his portfolio and plan for any future adjustments, as and when required, to align with Shariah needs as well as the fund's objectives. It is also important to keep the Shariah board/advisor informed of such changes so that they can analyse the situation and issue a new *fatwa* if required (Cognizant 20-20 insights, 2012).

In view of the above, continuous monitoring of a stock's compliance with Shariah is a challenge for Islamic fund managers. This may also increase costs if it is undertaken continuously. Additionally, the adjustments needed after the reclassification of the Shariah-compliant securities may not be easy as stocks that are reclassified usually underperform over a certain period.

4. CASE STUDIES

4.1 Introduction: Methodology and Selection Criteria

The stage of development of selected countries' Islamic fund management industries has been analysed and these countries have accordingly been classified as matured, developing and in their infancy. To illustrate the factors considered in the analysis, a development-stage matrix (shown in **Table 4.1**) has been developed to facilitate the categorisation process; further details are provided in **Table 4.2**.

Indicators:  High  Moderate  Low

Table 4.1: Development-Stage Matrix for Islamic Fund Industry

	Matured	Developing (Advanced)	Developing (Intermediate)	Infancy
	Malaysia	Pakistan	South Africa	Morocco
Macroeconomic factors: - Level of macroeconomic stability (ratings of the country based on various factors such as geopolitical tensions, volatility of local currency, inflation rate)	A- (S&P) A3(Moody's) A- (Fitch) A2 (RAM)	B (S&P) B3(Moody's) B (Fitch)	BB (S&P) Baa3(Moody's) BB+ (Fitch)[3]	BBB- (S&P) Ba1(Moody's) BBB- (Fitch)
- Percentage of Muslim population to total population	61.3%	96.4%	1.5%[4]	99%
- Percentage of Islamic banking assets to total banking assets	25.8%	12.4%[5]	1-2%	3-5%[6]
- Market share of Islamic finance assets vs global Islamic finance assets	18.5%	1.2%	0.41%	0%
Legal framework: - Common law or civil law - Amendments to local law - Clarity of dispute resolution, bankruptcy act, arbitration				

[3] Trading Economics' website
[4] Live World Population Clock's website
[5] *Islamic Banking Bulletin*, Pakistan, December 2017
[6] Expected for 2018, based on Thomson Reuters Report 2014

	Matured	Developing (Advanced)	Developing (Intermediate)	Infancy
	Malaysia	**Pakistan**	**South Africa**	**Morocco**
Regulatory framework: - Strong and single regulatory framework to govern the Islamic financial market - Specific guidelines on Islamic fund management - Regulatory protection for investors in Islamic finance market	✓	−	✗	✗
Shariah governance framework: - Centralised Shariah board - Shariah resolutions/ standards on Islamic fund structures - Key functions such as advisory, review and audit - Shariah screening	✓	✓	✗	✗
Infrastructure: - Trading platform - Clearing and settlement - Listing and approval processes	✓	−	−	−
Tax neutrality and incentives: - Removal of taxes related to transfer of assets - Incentives for Islamic fund management industry	✓	−	✗	✗
Diversification of funds: - Diversity in Islamic fund structures and products	−	−	−	✗
Diversification of asset class: - Diversity in allocation of Islamic funds	−	−	−	✗
Diversification of investor base: - Institutional investors - Inclusion of retail investors	−	✗	✗	✗

	Matured	Developing (Advanced)	Developing (Intermediate)	Infancy
	Malaysia	Pakistan	South Africa	Morocco
Transparency of transaction costs: - All-in cost in terms of legal, pricing, issuance timeline	–	–	–	–
Capacity/Talent development: -Experts in Islamic finance and Islamic fund management industry	✓	–	✗	✗

Sources: RAM, ISRA

Further details on the development-stage matrix are provided in **Table 4.2**. The 'developing' category is further segregated into i) advanced; ii) intermediate; and iii) beginner to differentiate the level of market development in each country.

Table 4.2: Description of the Development-Stage Matrix

Country	Stage of Development	Rationale
Malaysia	Matured	Malaysia's Islamic finance industry is among the world's most advanced. Its level of maturity supports the sturdy performance of its ICM, including Islamic funds. This is reflected by the Malaysian ICM's share of the overall capital markets (2017: 59%). The country's strong GDP per capita of USD9,944.9 in 2017 further highlights its healthy economic growth.[7] The adoption of a two-tier quantitative Shariah screening approach has boosted the competitiveness of its Islamic fund management industry.
Pakistan	Developing (Advanced)	According to the Islamic Finance Development Indicator (IFDI) 2017 Rank, Pakistan is among the top five performers in Islamic finance. Its GDP per capita stood at USD1,547.9 in 2017. Out of the 559 companies listed on the Pakistan Stock Exchange (PSX), 250 were Shariah-compliant as at end-March 2018. In March 2018, Pakistan issued a draft Shariah Governance Regulation 2018, which will further strengthen its existing Shariah screening methodology. This supports its categorisation as a 'developing (advanced)' market.
South Africa	Developing (Intermediate)	South Africa's Islamic fund management industry is slowly emerging, coming in at eighth position with a 2.4% share of global Islamic funds as at end-2017. The lack of a harmonised approach to Shariah screening and the absence of a healthy sukuk pipeline are among the challenges hampering its current performance. Based on the latest data from JSE, there are now 160 Shariah-compliant companies out of 400. The GDP per capita of South Africa stood at

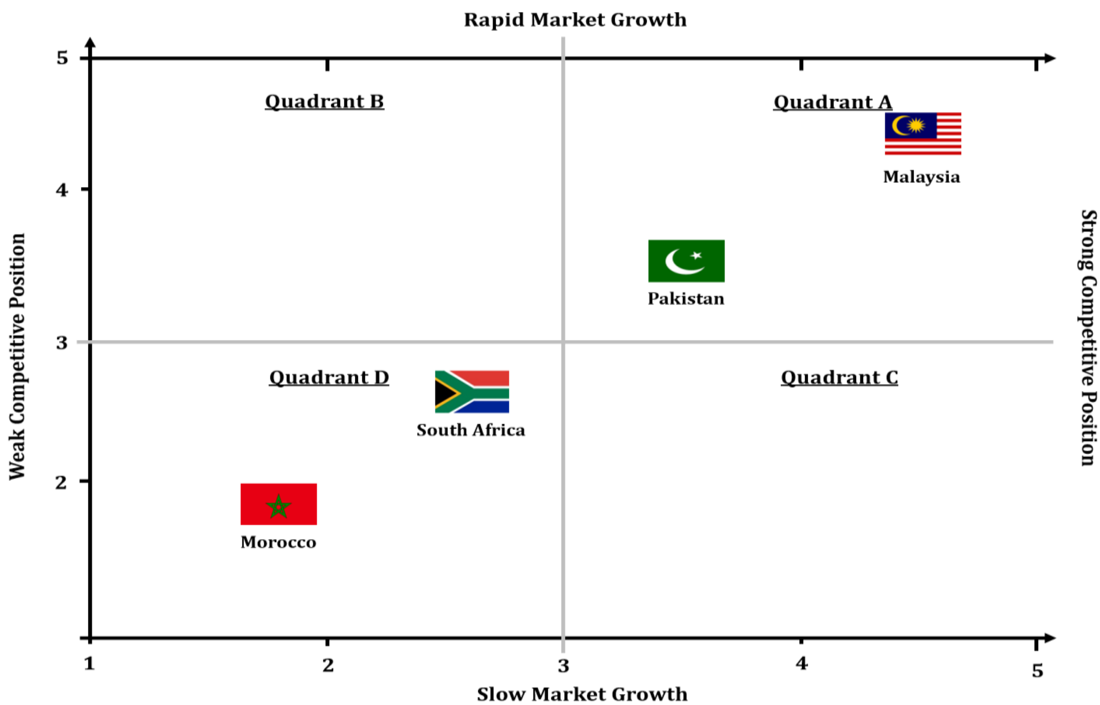
[7] The figure of GDP per capita for each country is extracted from The World Bank Data on 28 August 2018, available at http://data.worldbank.org/indicator/NY.GDP.PCAP.CD

Country	Stage of Development	Rationale
		USD6,160.7 in 2017. The country's classification as 'developing (intermediate)' depicts its budding potential, but requires concerted efforts by key stakeholders to identify a sustainable value proposition.
Morocco	Infancy	The Islamic finance industry in Morocco is still in its nascent stage. Islamic banking only commenced in 2017, following several financial reforms. To date, Morocco has yet to create a Shariah screening methodology since its Islamic fund management industry is officially non-existent, although two ethical funds have Shariah-compliant structures. Furthermore, the development of its capital markets still has much room to grow, with the banking sector dominating the financial market. Given this, Morocco falls under the 'infancy' category. As at end-2017, its GDP per capita was USD3,007.2.

Sources: RAM, ISRA

Based on the development-stage matrix, **Chart 4.1** further illustrates the position of each country in the four quadrants, which provided an overview of their level of progress relative to market growth and competitive position.

Chart 4.1: Positioning of Each Country in the Four Quadrants



Sources: RAM, ISRA

Each quadrant has its own unique opportunities and challenges, as described below:

Quadrant A:
Opportunity: Maintain momentum and embrace emerging trends.
Challenge: Risk of complacency and losing pace.

Quadrant B:
Opportunity: Leverage the rapid growth of the overall market to catalyse the ICM.
Challenge: Ensure that the ICM is not 'left behind' as the overall market develops.

Quadrant C:
Opportunity: Leverage the relatively strong position of Islamic finance to advance the overall capital markets.
Challenge: Ensure that the overall state of the capital markets does not constrain the ICM.

Quadrant D:
Opportunity: Make ICM a central component in spurring overall capital market growth.
Challenge: The improvements needed require a systemic approach for the entire capital markets (not only the ICM).

4.2 Malaysia

4.2.1 Overview of Malaysia's Islamic Finance and Islamic Fund Management Industries

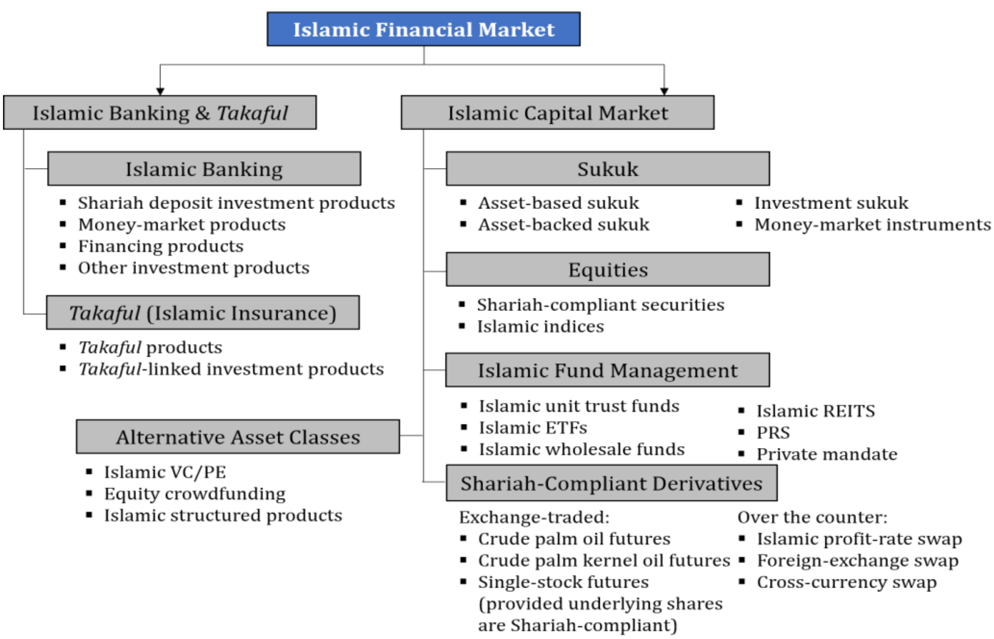
A Snapshot of Malaysia's Islamic Financial Market Landscape

As depicted in **Figure 4.1** and **Chart 4.2,** Malaysia boasts one of the world's most advanced Islamic financial markets. Its ICM hosts the world's largest sukuk market, with an average annual growth rate of 11.0% between 2007 and 2017. As at end-2017, Malaysia accounted for USD36.5 billion (or 34.6%) of the total USD105.5 billion of global sukuk issuance.

The country's Islamic fund management industry has been charting strong growth and is ranked second as at end-2017, after Saudi Arabia (excluding Iran). Malaysia has been chosen as a country case study and is categorised as 'matured' due to the following factors:

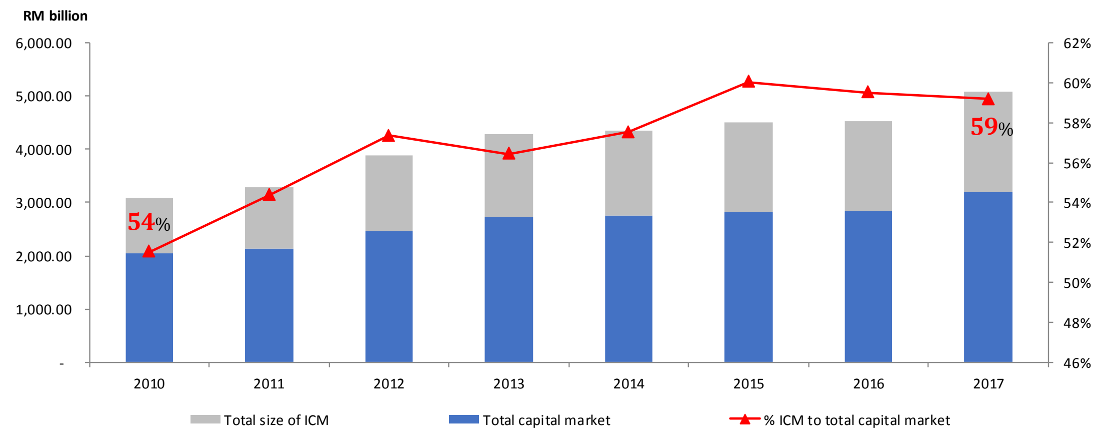
- Level of its Islamic financial market development and recognisable market share in global Islamic banking, ICM (e.g. sukuk, fund management) and *takaful*.
- Operates within a well-established and facilitative regulatory environment benchmarked to the IOSCO principles, supported further by its Shariah governance and tax frameworks.
- Clear methodology and guidelines on Shariah screening.
- Robust performance of its ICM has contributed significantly to a sustainable supply of investable Shariah-compliant assets.

Figure 4.1: Malaysia's Islamic Financial Market



Source: Adapted from SC

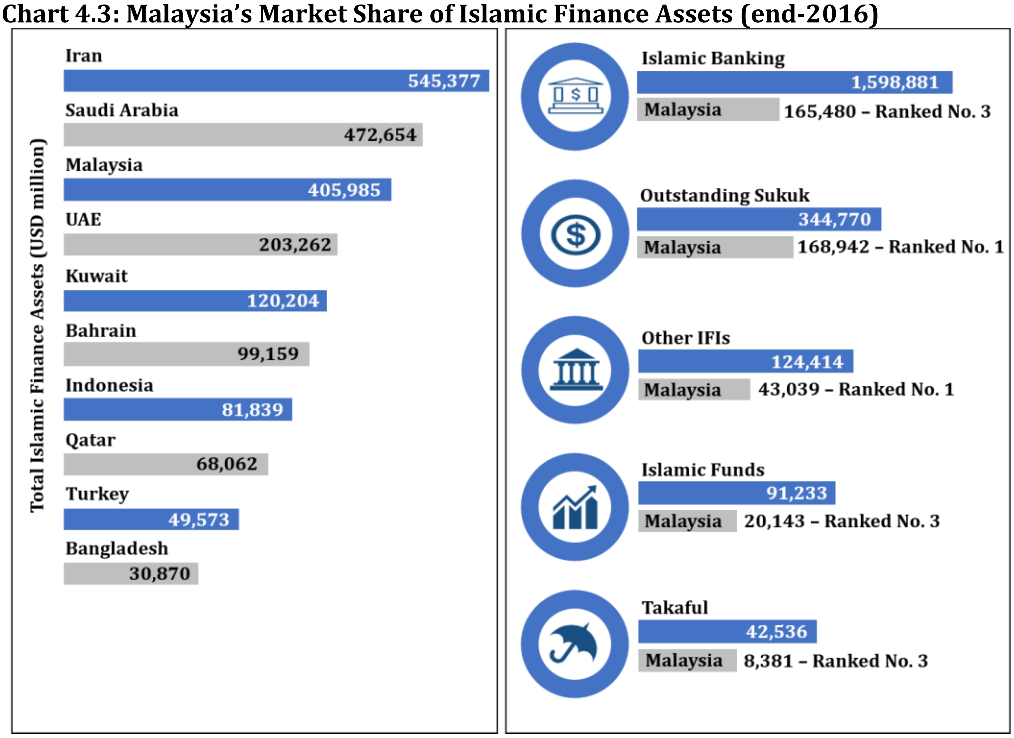
Chart 4.2: Growth of Malaysia's ICM (2010-2017)



Sources: BNM, SC
Note: Based on the SC's definition, the size of the ICM is equivalent to the total market capitalisation of Shariah-compliant securities and the amount of outstanding sukuk.

The robust performance of Malaysia's equity, sukuk and Islamic funds market have contributed to the strong growth of Islamic fund management industry. According to the ICD-Thomson Reuters Islamic Finance Development Report 2017, as depicted in **Chart 4.3**, Malaysia's share of global Islamic funds came up to 22.1% (or USD20.1 billion), ranking it third after Iran and Saudi Arabia as at end-2016. By 2022, the aforesaid report expects the global Islamic outstanding AuM to hit USD403.0 billion (end-2016: USD91.2 billion).

Chart 4.3: Malaysia's Market Share of Islamic Finance Assets (end-2016)

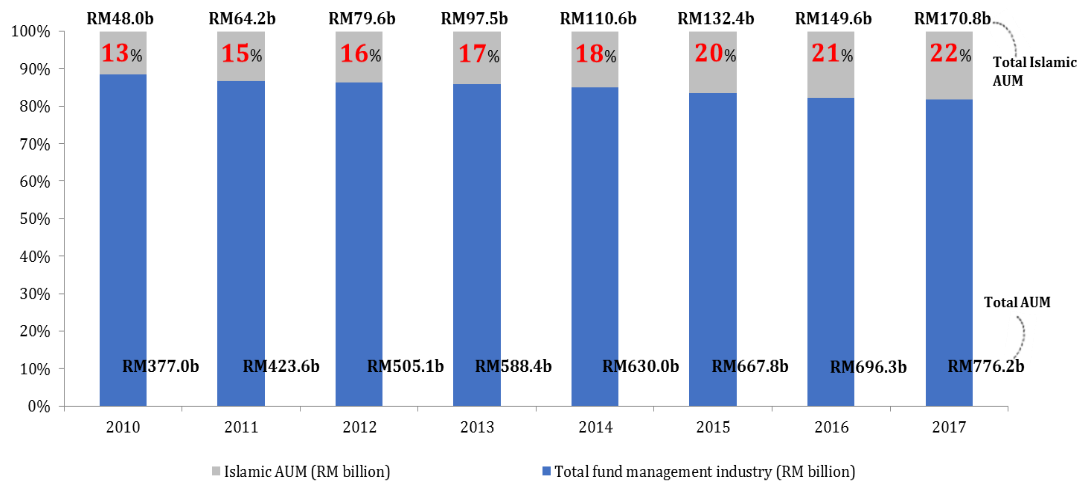


Source: ICD-Thomson Reuters Report (2017)

Share of Domestic Islamic Funds against Total Funds Managed

Development initiatives and industry-driven innovations have been achieved through the initiatives mapped out under the SC's Capital Market Masterplan (CMP) (2001-2010) and CMP2 (2011-2020). These have led to a comprehensive offering of Islamic investment and financing products for both retail and institutional (or wholesale) investors. Given the increasing demand for and supply of Shariah-compliant products, the country's Islamic AuM have been growing steadily and rapidly. **Chart 4.4** shows the rise in the percentage of Islamic AuM, from 13% (or RM49.0 billion) in 2010 to 22% (or RM170.8 billion) in 2017 of Malaysia's overall fund management industry, which was valued at RM776.2 billion as at end-2017.[8]

Chart 4.4: Malaysia's Islamic AuM as a Percentage of Total AuM (2010-2017)

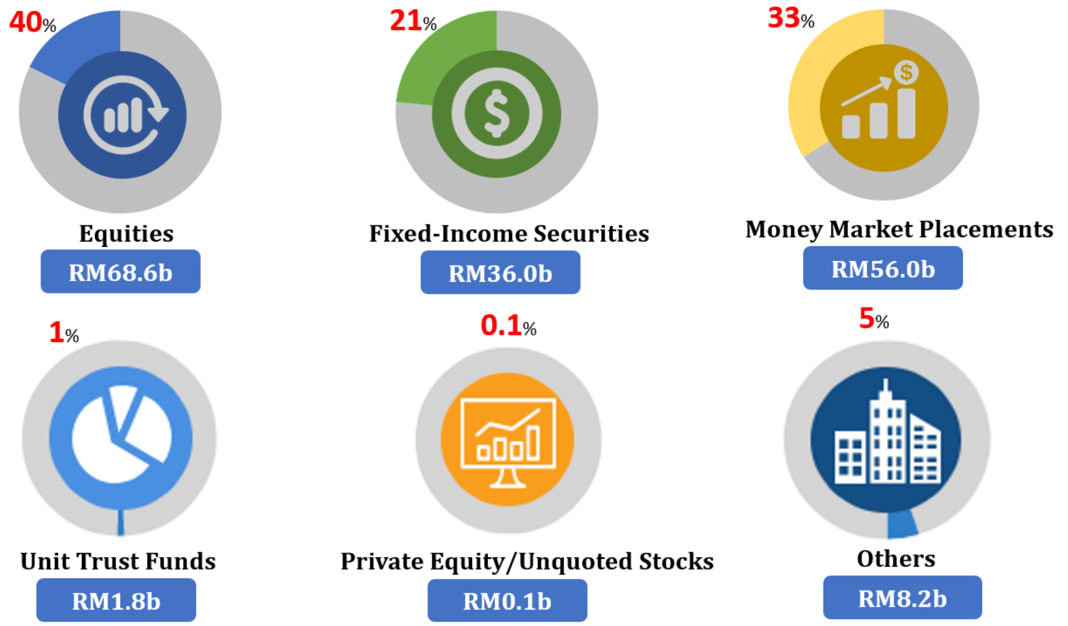


Source: SC

Islamic AuM is further segregated into various categories of asset allocation, as depicted in **Chart 4.5.** As at end-2017, by asset class, Shariah-compliant equities accounted for the largest slice (40%), followed by money market placements (33%) and fixed-income securities (21%).

[8] Data extracted from SC's website on 27 July 2018.

Chart 4.5: Allocation of Shariah Investment Assets from Total AuM (end-2017)



Source: SC

Note: Balance of RM8.21 billion is classified as 'others', which include uninvested cash, REITs, wholesale funds, ETFs, derivatives, business trusts, futures and close-ended funds.

Demand for Shariah-compliant assets can be traced back to Tabung Haji, which acted as a catalyst for product innovation when it was founded in 1963. It had shaped the value chain for Shariah-compliant assets. Apart from equities and sukuk, Malaysia's ICM also offers a diverse range of Islamic funds consisting of CIS which include unit trust funds, wholesale funds, REITs and ETFs, private retirement scheme (PRS) and private mandate.

Table 4.3 provides a broad description of the performance of key ICM segments. Given the industry's robust performance, Malaysia took second place in terms of global Islamic AuM (excluding Iran) as at end-2017, with RM170.8 billion, and also boasted the world's most numerous Islamic funds.

Table 4.3: Performance of Key Segments of ICM in Malaysia

Islamic AuM as a percentage of Total Funds Managed	Shariah-compliant Securities	Sukuk	Islamic REITs
As at end-2017, Islamic AuM stood at RM170.8 billion (or **22.2**%) of Malaysia's total funds managed, valued at RM776.23 billion.	As at end-2017, 688 stocks (or **76**%) listed on Bursa Malaysia complied with the SC's Shariah screening methodology. These had a market capitalisation worth RM1.1 trillion against the entire market's total market capitalisation of RM1.9 trillion.	As at end-2017, the value of domestic sukuk issuances stood at RM168.68 billion (or **53.3**%) of the total bonds issuances Domestic sukuk outstanding comprised 58.8% of total domestic debt securities.	As at end-2017, there were 4 Islamic REITs against a total of 18 REITS, with a market capitalisation of RM19.1 billion (or **41.0**%) compared to RM46.5 billion for the overall market.

Islamic ETFs	Islamic Unit Trusts	Islamic PRS	Islamic Wholesale Funds
As at end-2017, there were 5 Islamic ETFs among the 9 ETFs in total, with a market capitalisation of RM468.4 million (or **24.2**%) compared to RM1.9 billion overall.	As at end-2017, there were 213 Islamic unit trusts with a collective NAV of RM77.8 billion (or **18.2**%) compared to the entire market's RM427.0 billion.	As at end-2017, there were 25 Islamic PRS with an NAV of RM0.72 billion (or **32.3**%) compared to the overall market's RM2.23 billion.	As at end-2017, there were 77 Islamic wholesale funds, with an NAV of RM37.7 billion (or **44.5**%) compared to the entire market's RM84.7 billion.

Sources: SC, Bursa Malaysia, Eikon-Thomson Reuters

4.2.2 Evolution of Malaysia's Islamic Fund Management Industry

Malaysia's ICM operates within a well-established and facilitative regulatory environment under the umbrella legislation of the Capital Markets and Services Act 2007 (CMSA). Its capital market regulatory framework is benchmarked against the International Organisation of Securities Commissions' (IOSCO) principles of securities regulation, which are aimed at ensuring the protection of investors; maintaining fair, efficient and transparent markets; and reducing systemic risks.

The issuance and offering of all products and services, including Shariah-compliant, are subject to identical requirements for disclosure, transparency, governance and best practices, as well as oversight of intermediaries and their agents carrying out regulated activities, to be conducted within a single supervisory framework. Investors in the ICM, therefore, receive at least the same level of legal and regulatory protection as those in conventional markets.

The regulatory framework for the ICM is further enhanced by Shariah governance and tax frameworks. The SC has established a two-tier Shariah governance framework through a national-level SAC and the requirement of appointing Shariah advisers registered with the SC at the firms' level. Various Shariah rulings and scholarly reasonings are compiled and published in a transparent manner, to provide guidance and assurance to issuers, investors and intermediaries on the consistency of application of Shariah principles.

Table 4.4 outlines the developmental milestones and release of policies and guidelines that have had an impact on Malaysia's Islamic fund management industry.

Table 4.4: Timeline of Key Regulatory Initiatives in Malaysia

Year	Timeline Description
1995	▪ Guidelines on public offerings of securities of closed-end funds. ▪ Release of Shariah screening methodology.
2000	▪ Guidelines on the establishment of foreign fund management companies.
2002	▪ Release of CMP
2005	▪ Guidelines on the compliance function in fund management. ▪ Guidelines on Islamic REITs.
2007	▪ Guidelines on Islamic fund management. ▪ SC signed mutual recognition agreement (MRA) with Dubai Financial Services Authority.
2008	▪ Guidelines on unit trust funds. ▪ Guidelines of CIS.

Year	Timeline Description
2009	▪ Guidelines on ETFs. ▪ SC signed MRA with the Securities and Futures Commission of Hong Kong. ▪ Liberalisation of equity holdings in capital market intermediaries, to allow foreign ownership of conventional and Islamic fund management companies.
2011	▪ SC signed a memorandum of understanding (MOU) with Central Bank of Ireland. ▪ Launch of CMP2
2012	▪ SC signed MOU with Commission de Surveillance du Secteur Financier Luxembourg to facilitate the offering of Islamic undertakings for collective investment in transferable securities.
	▪ PRS framework. ▪ SAC amended the Shariah screening methodology and adopted a two-tier quantitative approach.
2014	▪ Launch of the ASEAN CIS framework by Malaysia, Singapore and Thailand to facilitate cross-border offering of CIS, including Islamic CIS.
2017	▪ SC's Islamic Fund and Wealth Management Blueprint. ▪ Guidelines on SRI funds. ▪ Digital investment management framework.

Source: SC

International managers managing a significant portion of Islamic funds in Malaysia as the liberal environment permits full foreign ownership, with no restrictions on overseas investments. As a result, as at end-2017, 20 full-fledged Islamic fund management companies are operating in Malaysia, half of which are entirely foreign-owned while one is a local-foreign joint venture.

A major deliverable by the SC under the CMP2 is the development of Malaysia's private retirement landscape. The key goals of the CMP2 includes facilitating markets' effective utilisation of domestic savings for capital formation, increasing the capacity and efficiency of the capital markets in financing the investment requirements for economic growth, and addressing the efficiency of savings intermediation, which includes the development of PRS, as described in **Box 4.1**.

Box 4.1: Malaysia's PRS landscape

The retirement landscape in Malaysia has been boosted by the development of a PRS framework,

Under Budget 2012, the Government of Malaysia (GOM) announced a tax relief of up to RM3,000 per annum for eligible individuals from YA2012 to YA 2022. An additional incentive was provided under Budget 2014, whereby RM500 contributed by persons aged between 20 and 30 will be matched by the GOM. Budget 2017 raised the incentive to RM1,000. As a result of these initiatives, the PRS sector has been expanding about 30% annually since its launch in 2012, although the relatively small number of contributors suggests that more needs to be done to encourage investment in this scheme.

Fact sheet	As at Dec 2017
Number of members	301,279
NAV	RM2.2 billion

Source: SC

Since its launch in 2012, the AuM of PRS has swelled from RM66.0 million (contributed by 22,000 members) to RM1.7 billion (from 248,000 members) in 2017. Notably, the number of contributors still constitutes fewer than 1% of the Malaysian population. In contrast, the AuM of the unit trusts industry augmented from RM505.0 billion to RM750.0 billion during the same period, suggesting that PRS is growing at a slower rate than unit trusts.

Source: FIMM Today – State of the Malaysian Investment Management Industry, December 2017

At present, Malaysia's main government-backed retirement fund is the Employee Provident Fund (EPF), which collects mandatory contributions from registered workers. The funds are invested in a range of asset classes. Based on the EPF's 2017 annual report, its AuM amounted to RM791.5 billion (equivalent to USD208.3 billion) as at end-2017. Annual contributions from both employees and employers sum up to some RM65.5 billion. The fund has 13.8 million members, of which 7.1 million are active contributors. Due to the EPF's sizeable AuM, it plays a significant role in developing Malaysia's fund management industry. The channelling of private savings through Tabung Haji, PRS, EPF, insurance/*takaful* operators and other key institutions have had a profound impact on the development of the fund management arena. Malaysia's sizeable Muslim population (61.3% of its total) has further fuelled demand for Shariah-compliant investments and the growth of Islamic funds.

4.2.3 Investment and Commercial Considerations

Value Proposition of Islamic Funds

Malaysia's Islamic fund management industry thrives because of the following key value propositions:

1. Recognised Leader in Islamic Finance and Key Marketplace for Islamic Financial Activities

Malaysia's Islamic financial ecosystem offers a full range of Islamic financial services with comprehensive ICM capabilities complemented further by vibrant Islamic banking and *takaful* segments. Its Islamic funds and sukuk markets ranked among the largest in the world. The development and growth of the Islamic fund management industry can be attributed largely by the well-established ICM ecosystem.

Key ICM ecosystem includes Shariah governance framework and relevant regulatory frameworks that have provided guidance and clarity on Shariah matters which in turn facilitate the introduction of Shariah-compliant products and services. The frameworks also contributed significantly in boosting market participants' confidence in and providing credibility to the ICM. In this regard, Malaysia is the only country in the world with a regulatory framework for Islamic fund management companies. As at end 2017, there were 20 full-fledged Islamic fund management companies and 35 fund management companies (via Islamic windows) offering their Islamic fund management capabilities to the industry.

Tax frameworks and incentives have also played a key role in contributing towards the development of the Malaysian ICM, this is to facilitate the growth of existing and new market segments within ICM. Islamic fund management industry currently enjoys a tax exemption on management fee income from managing Islamic funds. Other relevant incentives for the fund management industry are delineated in **Table 4.5**.

Table 4.5: Tax Incentives for the Malaysian Fund Management Industry

Fund Management Company	Collective Investment Scheme
Licensed foreign fund management company: ▪ A 10% tax on chargeable income from the provision of fund management services to foreign investors. **Licensed fund management company:** ▪ Tax exemption on statutory income derived from the business of providing fund management services to: 1. Local and foreign investors in Malaysia. 2. Business trusts and REITs in Malaysia. The fund must be managed in accordance with Shariah principles and certified by the SC (until YA 2020) ▪ Tax exemption on management fee income from managing conventional and Shariah-compliant SRI funds, for YA 2018 to 2020. The SRI funds must be approved by the SC.	**Unit Trust:** ▪ Tax exemption on interest income from any licensed bank/financial institution/development financial institution. In the case of a wholesale fund which is a money market fund, the exemption will only apply if the fund complies with the criteria set out in the relevant guidelines of the SC. ▪ Tax exemption on gains following the realisation of investments. ▪ Tax exemption of interest or discount. **PRS:** ▪ The GOM will match RM1,000 per qualified person (aged between 20 and 30) if the individual made PRS contributions every year from YA 2014 to YA 2018. ▪ Tax relief of up to RM3,000 for PRS and deferred annuity scheme premium (YA 2012 to YA 2021). **REIT:** ▪ Tax exemption on all income if at least 90% of total income is distributed and the REIT is listed on Bursa Malaysia. ▪ Exemption of stamp duty on instruments of transfer/deeds of assignment relating to the purchase of real property, and instruments of transfer of real property to REIT. ▪ Exemption of real property gains tax on the disposal of real property to REIT. ▪ Final withholding tax of 10% on income distribution received by non-corporates or foreign institutional investors from a REIT which has been exempted from tax (until YA 2019). ▪ Final withholding tax of 24% on income distribution received by non-resident companies from a REIT which has been exempted from tax. ▪ Special single deduction for consultancy, legal and valuation service fees incurred in the establishment of a REIT. ▪ No balancing charge on the disposal of an industrial building by a company to a REIT. The REIT is eligible to claim the balance of any unclaimed industrial building allowance of the disposer if the disposer company owns 50% or more of the units in the REIT. ▪ An SPV established by a REIT is treated as a tax-transparent entity, where its income is deemed received by that REIT for income tax purposes. **Closed-end fund:** ▪ Tax exemption on gains following the realisation of investments. ▪ Tax exemption on interest or discount.

Source: 2018 Malaysian Budget announced on 27 October 2017

2. Comprehensive Offering of ICM Products and Services

A combination of developmental initiatives led by the SC and industry-driven innovation have resulted in a range of Islamic financing and investment instruments available in the marketplace. Significant milestones for the Islamic fund management industry include the introduction of Shariah screening methodology for listed securities in 1995 followed by the announcement of the first list of Shariah-compliant securities two years later.

In line with the maturity of the Islamic finance industry, the SC in 2012 revised the methodology and introduced two-tier benchmarks by adding the financial ratio benchmark to the existing business activity benchmark, as shown in **Figure 4.2**. This has boosted the competitiveness of the Malaysian Islamic equity market and Islamic fund management industry, by making available a steady supply of Shariah-compliant stocks to promote the development of Islamic funds.

Various type of investment products and services provide greater options for investors to meet their financial goals based on the specific risk-return profile. Notably, investing across a broad spectrum of asset classes helps diversify investment for investors; asset bases and spreads investment risk. For example, investments in Shariah-compliant equity ETF exposes investors to a basket of stocks without having to invest directly in each stock. Through REITs, common investors can diversify their investment portfolios by holding the units of REITs that hold selected Shariah-compliant properties.

Figure 4.2: SC's Shariah Screening Methodology

Business Activity Benchmarks

5%	Conventional banking, conventional insurance, gambling, liquor and liquor-related activities, pork and pork-related activities, non-*halal* food and beverages, Shariah non-compliant entertainment, interest income from conventional accounts and instruments, tobacco and tobacco-related activities, and other activities deemed non-compliant according to Shariah.
20%	Share trading, stockbroking business, rental received form Shariah non-complaint activities, and other activities deemed non-compliant according to Shariah.

Financial Ratio Benchmarks

$$= \frac{\textbf{Cash}}{\textbf{Total Assets}}$$

Cash only includes cash deposited in conventional accounts and instruments. Cash placed in Islamic accounts and instruments is excluded from the calculation. Ratio must be lower than **33%**.

$$= \frac{\textbf{Debt}}{\textbf{Total Assets}}$$

Debt only includes interest-bearing debt. Islamic debt/financing or sukuk is excluded from the calculation. Ratio must be lower than **33%**.

Source: SC

3. Wider Investor Base

Demand for Shariah-compliant investments has been increasing rapidly, driven by Malaysia's relatively large Muslim population. The level of financial inclusion has also grown in tandem with market education on the importance of savings and financial planning (e.g. children's education, retirement). The GOM's tax-related incentives for the channelling of private savings to institutional funds (e.g. PRS, children's education) have further fuelled demand for Shariah funds.

The presence of institutional investors in Malaysia's capital market has also played a critical role in deepening the market's liquidity. Additional players in the ICM (e.g. Tabung Haji, investors with a sole appetite to invest in Shariah-compliant assets) enables access to wider investors.

Islamic REITs

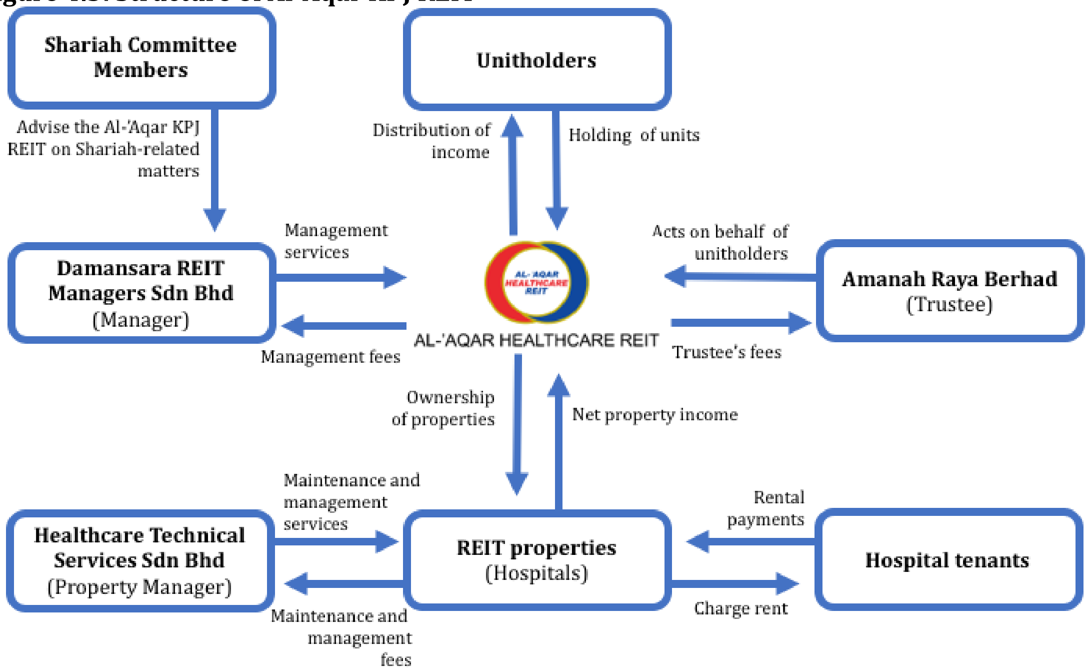
In 2005, Malaysia was the first country to introduce guidelines on Islamic REITs. This pioneering effort has become one of the many initiatives undertaken by Malaysian regulators to turn the country into a leader in Islamic finance. The response to the launch of the guidelines on the development of Islamic REITs had been positive, followed by the listing of four such REITs. **Table 4.6** provides a brief description of Malaysia's Islamic REITs while **Figure 4.3** and **Figure 4.4** depict the structures of selected Islamic REITs. Traditionally, REITs are close-ended funds that focus on holding/investing in real estate and related assets.

Table 4.6: Islamic REITs in Malaysia

	Al-Aqar KPJ REIT	Al-Hadharah Boustead REIT	AXIS REIT	KLCC REIT	Al-Salam REIT
Date listed	June 2006	January 2007	August 2005	May 2013	September 2015
Type of property	Healthcare	Oil palm plantations	Industrial and office buildings	Commercial building, shopping complex, land	Commercial building, shopping complex, restaurants
Market capitalisation (as at end-2017)	RM1.04 billion	Delisted in 2014	RM1.71 billion	RM13.45 billion	RM496.0 million

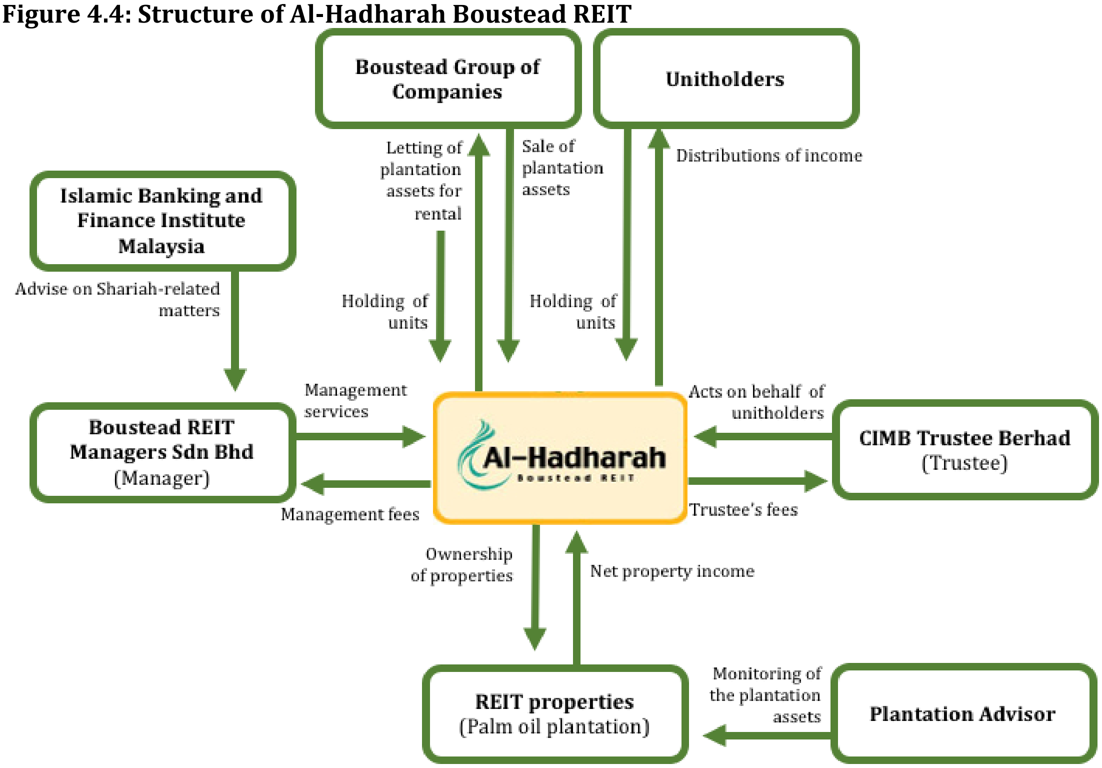
Source: Islamic REITs' websites
Note: AXIS REIT had originally been established as a conventional REIT, but was restructured into a Shariah-compliant REIT in December 2008.

Figure 4.3: Structure of Al-Aqar KPJ REIT



Source: Al-Aqar KPJ REIT website

Figure 4.4: Structure of Al-Hadharah Boustead REIT

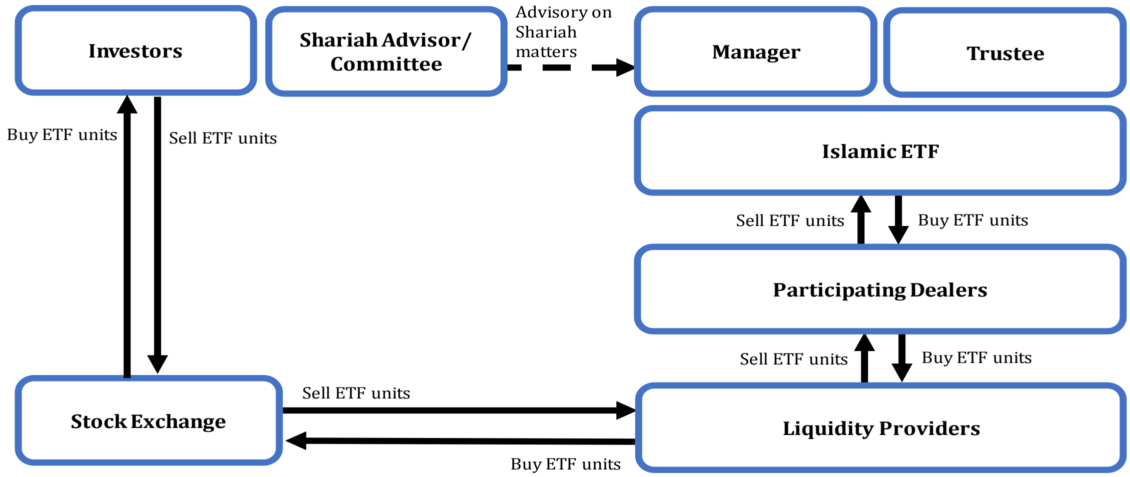


Source: Al-Hadharah Boustead REIT prospectus

Islamic ETFs

As at April-2018, there were six Islamic ETFs listed on Bursa Malaysia. The main difference between a conventional ETF and an Islamic ETF is the benchmark index that the latter tracks. An Islamic ETF only tracks an Islamic benchmark index, the constituents of which comprise Shariah-complaint companies. Islamic ETFs are considered a liquid and cost efficient financial instrument that offers investors lower transaction costs than buying and selling unit trusts. **Figure 4.5** depicts the basic structure of an Islamic ETF in Malaysia while **Table 4.7** summarises the Islamic ETFs listed on Bursa Malaysia as at April-2018. Typically, ETFs are structured as open-ended funds.

Figure 4.5: Basic Structure of an Islamic ETF in Malaysia



Source: Investment in Unit Trust Funds that are Listed and Traded on the Stock Exchange, SC

Table 4.7: Islamic ETFs Listed on Bursa Malaysia (as at April-2018)

	MyETF Dow Jones Islamic Market Malaysia Titans 25	MyETF MSCI Malaysia Islamic Dividend	MyETF MSCI SEA Islamic Dividend	MyETF Thomson Reuters Asia Pacific ex-Japan Islamic Agribusiness	GOLDETF	MyETF Dow Jones US Titans 50
Date listed	31 January 2008	21 March 2014	7 May 2015	3 December 2015	December 2017	28 February 2018
Fund background	MyETF-DJIM25 provides investors access to the performance of Malaysia's Shariah equity market	MyETF-MMID provides investors the opportunity to obtain potential periodic income and capital gains from Malaysia's Shariah equity market	MyETF-MSEAD provides investors the opportunity to obtain periodic income and capital gains from the vast universe of companies in South-east Asia	MyETF-AGRI provides investors the opportunity to invest in agriculture-based Shariah-compliant stocks listed on selected exchanges in the Asia-Pacific region	GOLDETF aims to provides investors with investment results that closely track the performance of gold prices, through a Shariah-compliant investment structure	MyETF-US50 is designed for investors wishing to invest in liquid financial instruments, with an index-tracking feature that focuses on blue-chip companies in the US
AuM (as at end-April 2018)	RM304.9 mil	RM29.8 mil	RM44.1 mil	RM20.0 mil	RM41.2 mil	RM45.1 mil

Source: Islamic ETFs' annual reports.

Note: The listed Islamic ETFs are all managed by i-VCAP Management Sdn Bhd, except for GOLDETF, which is managed by Affin Hwang Asset Management Berhad.

Malaysia's ETF industry started with the incorporation of ValueCAP Sdn Bhd (ValueCAP) on 16 October 2002. **Box 4.2** gives a snapshot of the evolution of Islamic ETFs in Malaysia.

Box 4.2: Evolution of ETFs in Malaysia

ValueCAP, equally owned by Khazanah Nasional Berhad, Kumpulan Wang Persaraan (Diperbadankan) and Permodalan Nasional Berhad, commenced operations as an investment-holding company of entities listed on Bursa Malaysia. Following its strong investment performance, ValueCAP's business model had then transformed into a holding company with investments in two licensed AMCs—i-VCAP Management Sdn Bhd (i-VCAP), which manages the Islamic ETFs, and VCAP Asset Managers Sdn Bhd (VCAM) which manages conventional funds.

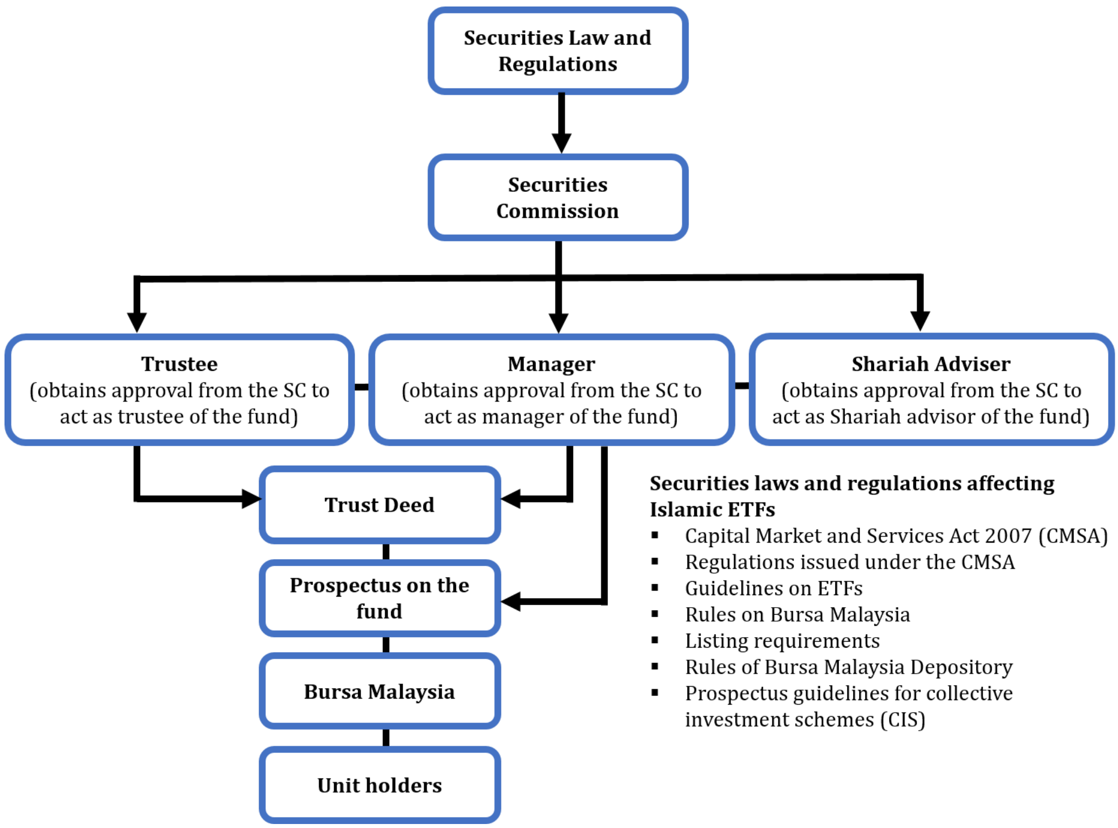
Chart 1: Growth of ETFs by market capitalisation

As at end-2017, i-VCAP managed 4 of the total 5 Islamic ETFs listed on Bursa Malaysia. These Islamic ETFs' collective market capitalisation stood at RM468.4 million as at the same date, representing a 24.2% share of the market (ETFs' total market capitalisation stood at RM1.9 billion). Penetration of ETFs has been slow, as depicted by Chart 1. In terms of market capitalisation, it is the lowest compared to other funds (refer to **Table 4.3** for comparison). Lack of market awareness and accessibility (i.e. investing is undertaken by brokers and individuals with CDS accounts) have been identified as some of the challenges faced by the ETF industry.

Source: i-VCAP

The establishment, operation and listing of Islamic ETFs in Malaysia are subject to the various provisions and requirements of the SC. **Figure 4.6** provides an overview of Malaysia's regulatory environment for Islamic ETFs.

Figure 4.6: Concept and Regulation of Islamic ETFs in Malaysia



Source: Investment in Unit Trust Funds that are Listed and Traded on the Stock Exchange, SC

4.2.4 Key Factors Underpinning the Development of Malaysia's Islamic Fund Management Industry

Legal and Regulatory Framework

Malaysia adopts a comprehensive legal and regulatory framework that transcends the various facets of the financial markets. The country's financial stability has been supported and upheld by the Capital Markets and Services Act 2007 (which governs capital market activities), the Financial Services Act 2013 and Islamic Financial Services Act 2013 (which oversee the respective conventional and Islamic banking sectors), as well as other various policies and guidelines released through the years.

Specifically for the Islamic fund industry, and as mentioned earlier in **Table 4.4**, the regulators have put in place various measures to support the development and expansion of products, as well as to attract a wider array of investors, both domestically and internationally.

Shariah Governance Framework

The hallmark of developing a successful Islamic finance landscape is the lofty ethical values under the Shariah governance framework. In 1996, the SC established the SAC, which was given the mandate to ensure that the implementation of the ICM complied with Shariah principles. The SAC advises the SC on all matters related to the development of the ICM and functions as a reference centre for all ICM issues. This centralised approach promotes the transparency of Shariah rulings and resolutions, which in turn builds investor confidence.

Market Infrastructure

The transformation of the Malaysian economy into becoming more diversified and private sector-driven has been key to propelling the debt securities and sukuk markets, thereby reducing its reliance on the banking sector following the Asian financial crisis in 1997. In ensuring the efficient functioning of the market, mechanisms had been put in place to improve liquidity and enhance the overall price-discovery process. At its core had been a comprehensive and modern depository, delivery and settlement system to facilitate the issuance, trading and settlement of debt securities in the market. MyClear, a 100%-owned subsidiary of BNM, operates as an integrated large-value payment and securities settlement system, known as RENTAS. RENTAS functions as a real-time gross settlement system, which is also integrated with a central depository system (CDS) and handles the settlement of unlisted government, BNM and corporate debt securities. Similarly, Bursa Malaysia handles the clearing and settlement of securities and derivatives on the stock exchange. Over the years, listing and other fees have been reduced to encourage the listing of private companies and facilitate faster time to market for IPOs. On the Shariah-compliant side, Bursa Suq Al-Sila (BSAS) was established to facilitate Islamic liquidity management and financing by Islamic financial institutions.

With such infrastructure in place, Malaysia's debt securities and sukuk market is the third largest in Asia. Its equity market houses the largest number of listed companies in ASEAN (SC Annual Report, 2017).

Tax Framework

To promote the role of Islamic finance in the economy, Malaysia's tax framework has undergone several amendments. Lawmakers have introduced different amendments to address the tax treatment of Islamic financial products, bringing about changes to the Income Tax Act 1967, the Stamp Act 1949 and the Real Property Gains Tax Act 1976. These initiatives had been undertaken to remove tax discrimination between the application of conventional and Islamic instruments. Today, Malaysia's tax-friendly framework stands as a core pillar that supports its conducive eco-system for Islamic finance.

Demand Side

Strong base of institutional investors: Malaysia has one of the deepest capital markets in South-east Asia, characterised by its broad base of institutional investors. According to the figures quoted by the SC, approximately 97.8% (or RM167.08 billion) of domestic investors in Islamic funds, which amounted to RM170.83 billion as at Dec 2017, had been sourced from corporates, statutory bodies and government agencies.

Initiatives prompted by the GOM such as: (i) tax relief for PRS (up to RM3,000 per year); (ii) tax relief for children's education savings through the National Education Savings Scheme/Skim Simpanan Pendidikan Negara (or SSPN) (up to RM6,000 per year); and (iii) EPF withdrawal for investment in approved unit trust funds have slowly increased participation by retail investors. The scheme to allow EPF members to transfer part of their savings to approved unit trust funds was announced in May 2015.

In Malaysia, Muslim investors have a choice of investing directly in Tabung Haji while bumiputras (Muslim citizens and locals from Sabah and Sarawak) can invest in government-backed Amanah Saham Berhad (ASB) funds that have good historical dividend payout track records. For 2017, Tabung Haji and ASB announced respective dividend rates of 6.25% and 8.25%. For the same period, the EPF declared a dividend payout of 6.90% for conventional funds and 6.40% for Shariah-compliant funds. Given the stable performance of Tabung Haji, ASB and the EPF, retail investors have a choice of maximising their investment returns through these institutions; the dividends received are also tax-exempt.

Strategic support from the GOM and regulators to develop the Islamic fund management industry: In January 2017, the Islamic Fund and Wealth Management Blueprint was launched, followed by the Guidelines on SRI Funds in December 2017. The string of policies and frameworks that have been issued by the SC over the last decade depicts its prominent role in facilitating the initiatives that have been outlined by the GOM under the 11th Malaysia Plan 2016-2020 and CMP2. In attracting the attention of the private sector, retail and institutional investors, fiscal stimuli have been offered to provide the necessary push. The concerted efforts of the government, regulators and market players have contributed to turning Malaysia into the world's second largest Islamic fund management industry, with most numerous Shariah-compliant funds globally.

Attractive tax incentives to develop personal wealth management: The tax incentives listed earlier in **Table 4.5**, along with personal tax relief for individuals, underline the government's commitment to educating and supporting the development of personal wealth management. The spill-over effects from this momentum is slowly raising the number of retail investors vis-à-vis the various funds available in the market. As at end-2017, overall individual private mandates came up to RM9.67 billion (end-2016: RM8.36 billion).

Supply Side

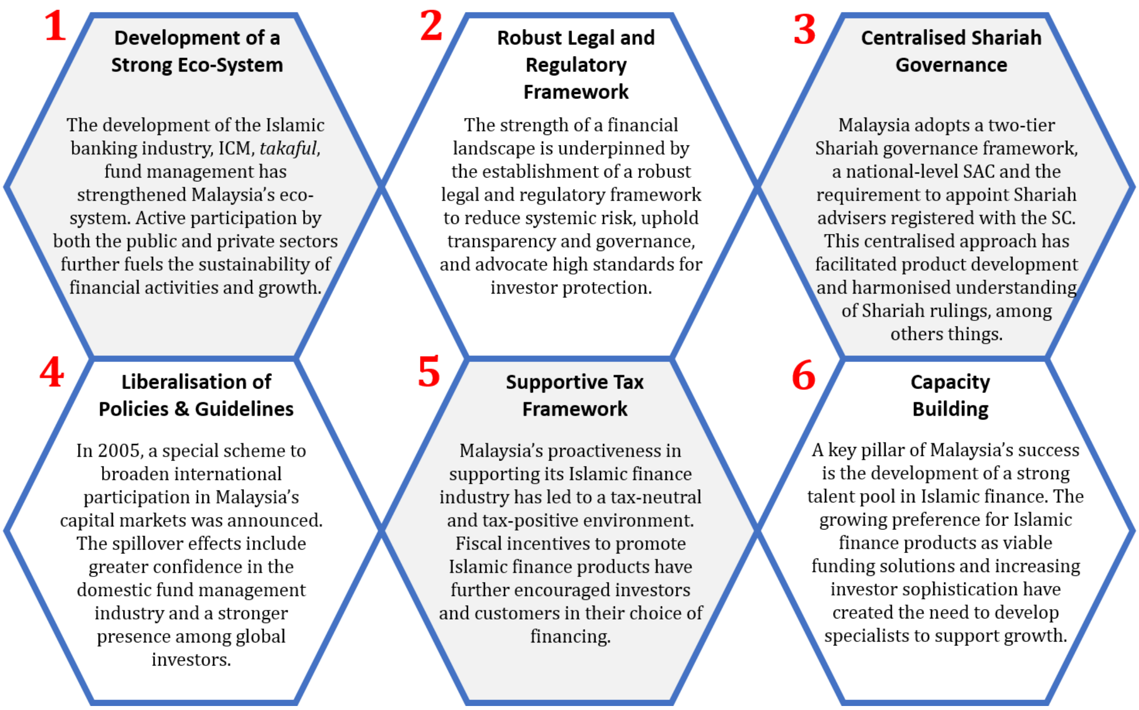
Availability of a wide range of high-quality Islamic assets: Various efforts have been taken to build a sustainable supply of Shariah-compliant assets in order to match the demand within the Islamic fund management industry. The pillars established under the CMP and CMP2 have contributed to the development of Malaysia's strong ICM, underpinned by a healthy pipeline of public and private sukuk issuances, Shariah stocks and Islamic money market instruments, among others.

Yield benchmarks to support appetites of various investors: The diverse appetites of various market players, e.g. financial institutions with their demand for short-term (less than 1-year maturity) and medium-term (up to 10-year maturity) papers, institutional investors (with potential holding maturities of more than 10 years), have facilitated the development of yield benchmarks that support price discovery.

4.2.5 Country-Specific Recommendations

Malaysia's competitive advantage in its offering of ICM has been developed based on the policies and recommendations proposed under the CMP and CMP2. The lessons learned from the Asian financial crisis vis-à-vis bolstering the non-banking financial sector have been deployed towards building a stronger eco-system for the country's financial landscape, including Islamic banking and the ICM. As a result of the concerted efforts of the GOM and regulators (i.e. BNM and the SC), Malaysia has evolved into one of the world's most advanced and leading Islamic financial centres. **Figure 4.7** encapsulates the key milestones in Malaysia's journey:

Figure 4.7: Lessons from Malaysia's Experience

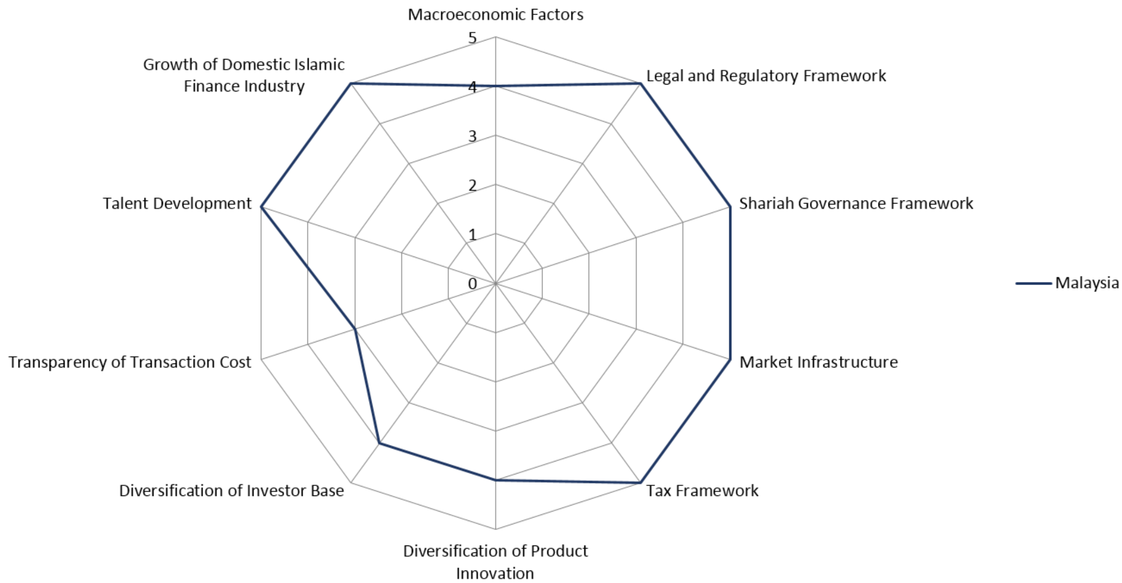


Source: RAM

Note: Systemic risk refers to the potential of any widespread effect on the financial system and, thereby, on the wider economy. Factors which can give rise to systemic risk may include the design, distribution or behaviour under stressed conditions of certain investment products; the activities or failure of a regulated entity; market disruption; or the impairment of a market's integrity as well as the gradual erosion of market trust or confidence (SC's Regulatory Philosophy, 2015).

Given its well-developed eco-system, Malaysia is the leader in terms of the number of Shariah funds launched. **Chart 4.6** depicts the factors influencing the development of Malaysia's domestic Shariah funds market while **Table 4.8** and **Table 4.9** outline the policy recommendations to further strengthen the progress of the Islamic funds landscape.

Chart 4.6: Factors Influencing the Development of Malaysia's Islamic Fund Management Industry



Sources: RAM, ISRA

Table 4.8: Recommendations on Improving Demand (Buy Side)

Issues and Challenges	Demand (Buy Side) Opportunities
1. Continuous enhancement of financial literacy, education and awareness programmes for retail investors.	▪ The need for investor education and financial literacy has never been greater. As the financial marketplace continues to evolve and innovate, investment products are becoming increasingly complex and financial services increasingly diverse. Greater understanding of key financial concepts is required on the part of retail investors to understand and evaluate the choices available to them and avoid fraud. Investor education and financial literacy programs also have the potential to help improve financial outcomes for retail investors. Benefits include more informed savings and investment decision-making, better financial and retirement planning, greater confidence and higher participation in the securities markets, greater wealth accumulation, and increased awareness of investor rights and responsibilities.
2. Strengthening Malaysia's value proposition as an international hub for SRI funds	▪ There are opportunities to attract foreign investments into domestic funds. Growing interest and popularity of SRI segment from developed market provide an opportunity for Malaysia to profile Islamic funds internationally as both Islamic investing and SRI adopt similar underlying principles. Global sustainable investment AuM reached USD22.89 trillion in 2016, compared with USD18.28 trillion in 2014, an increase of 25%. With Islamic funds being recognised as part of the SRI

	universe, Malaysia is currently the largest SRI funds market in Asia (excluding Japan) with 30% market share. The SC recently issued the Guidelines on Sustainable and Responsible Investment (SRI) Funds to facilitate and encourage further growth of SRI funds in Malaysia, in anticipation of an uptrend in SRI assets in this region. The new Guidelines will widen the range of SRI products in the market and attract more investors into the SRI segment.
3. Facilitating new digital business models and seamless interaction with mass affluent investors.	▪ The next step forward will be the digitalisation of wealth management and financial planning. The creation of seamless platforms and mobile applications will gain greater traction among mass affluent investors and improve financial inclusion.

Source: RAM

Table 4.9: Recommendations on Improving Supply (Sell Side)

Issues and Challenges	Supply (Sell Side) Opportunities
1. Enhance regional collaboration for cross border offerings.	▪ Regional collaboration via bilateral and multilateral arrangements can be further enhanced for broader market access and greater international connectivity. Luxembourg success in becoming a global funds centre can be a good business case.
2. Earmarking of institutional funds for Shariah-compliant investment or SRI investing.	▪ The EPF has led the way through the launch of its RM100 billion Simpanan Shariah in 2016, which had catalysed market players to increase the supply of Shariah-compliant assets. As more institutions (e.g. Khazanah, KWAP) move to provide similar fund allocations, this will further strengthen the pipeline for Shariah-compliant assets.
3. Advance Malaysia's position as a hub for investment support services.	▪ Malaysia actively promotes shared services and outsourcing activities under the segment of the Business Services industry. This segment has been successfully built and has hosted many international providers. These competitive strengths can be leveraged on in operational, tax and human capital infrastructure to attract more international fund administration service providers to establish their regional and international base in Malaysia. At the same time, further development of domestic firms operating in this market segment will also be facilitated. ▪ The presence of a broad range of international and domestic firms will enhance competitive positioning of the industry, providing a spectrum of fund administration service offerings including custody, trustee, clearing, fund accounting and transfer agency services. Recognition as an international hub for fund administration will enhance Malaysia's competitiveness in attracting a wide array of international funds, especially Islamic and sustainable responsible investment (SRI) funds, to be domiciled in the country.

Source: RAM

4.3 Pakistan

In the 2000s, Pakistan started to implement Islamic finance within a dual financial system. Since then, the country has been one of the key global players in this sphere. The Pakistan government has indicated its strong commitment to building sound foundations for Islamic finance; a Steering Committee for Promotion of Islamic Banking was formed in December 2013 to assess the main challenges facing the industry and come up with recommendations to address them. In 2015, the Ministry of Finance established an Implementation Committee, consisting of four sub-committees, i.e. (i) Sub-Committee on Legal & Regulatory Framework; (ii) Sub-Committee on Taxation; (iii) Sub-Committee on the Islamic Capital Market; and (iv) Sub-Committee on Awareness & Capacity Building, to execute the recommendations submitted by the Steering Committee (SBP, 2017).

The selection of Pakistan as a country case study in assessing the development of the Islamic fund management industry is based on the following:

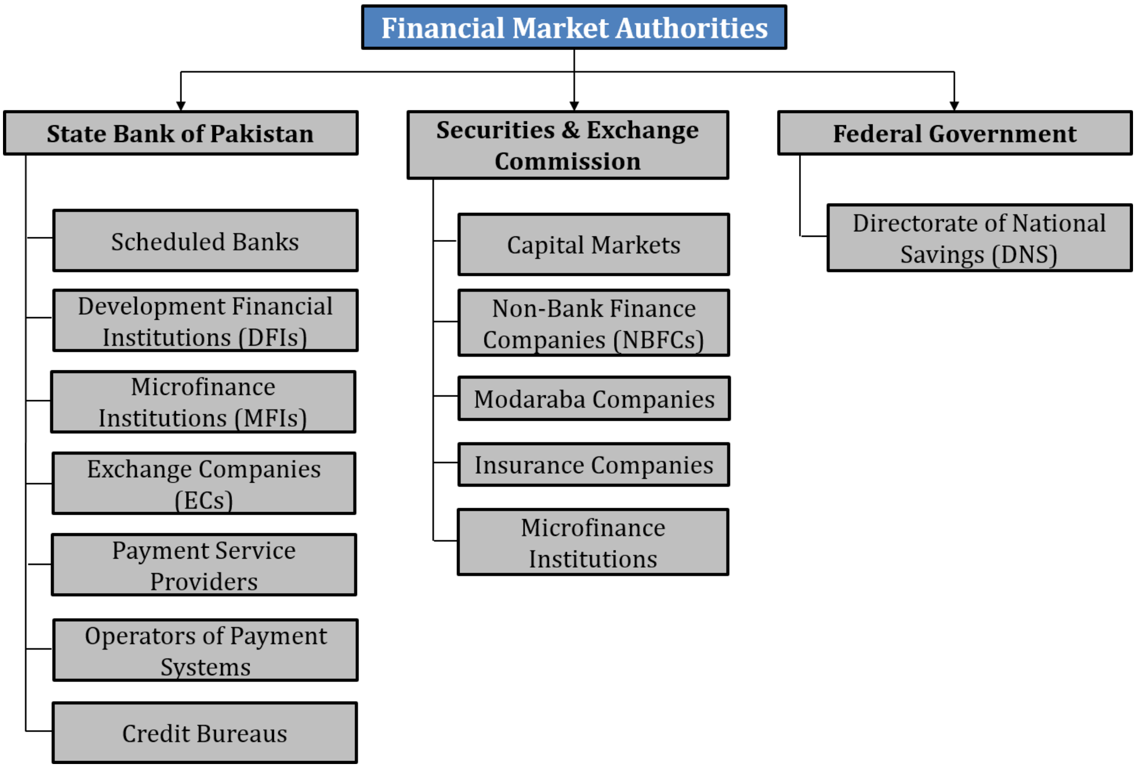
- Pakistan's growth in the overall Islamic finance industry at the global level.
- Pakistan is considered a developing market in Islamic finance, representing South Asia. Its population is 95%-98% dominated by Muslims, which provides a strong untapped demand base for Shariah-compliant investments.
- Pakistan was ranked number 5 in terms of global assets in Islamic fund management as at end-2016.

4.3.1 Overview of Pakistan's Islamic Finance and Islamic Fund Management Industries

A Snapshot of Pakistan's Islamic Financial Market Landscape

Pakistan's financial sector is regulated by three key regulators, i.e. the State Bank of Pakistan (SBP), the Securities and Exchange Commission of Pakistan (SECP) and the federal government, as depicted in **Figure 4.8**. The banking sector, which includes scheduled banks, development financial institutions (DFIs), microfinance banks (MFBs), exchange companies (ECs), payment service providers, and operators of payment and credit bureaus, are regulated by the SBP. The capital markets, non-bank finance companies (NBFCs) or non-bank financial institutions (NBFIs), insurance companies, *modaraba* companies, microfinance institutions and other corporate entities fall under the purview of the SECP. On the other hand, Pakistan's federal government oversees the directorate of national savings (DNS).

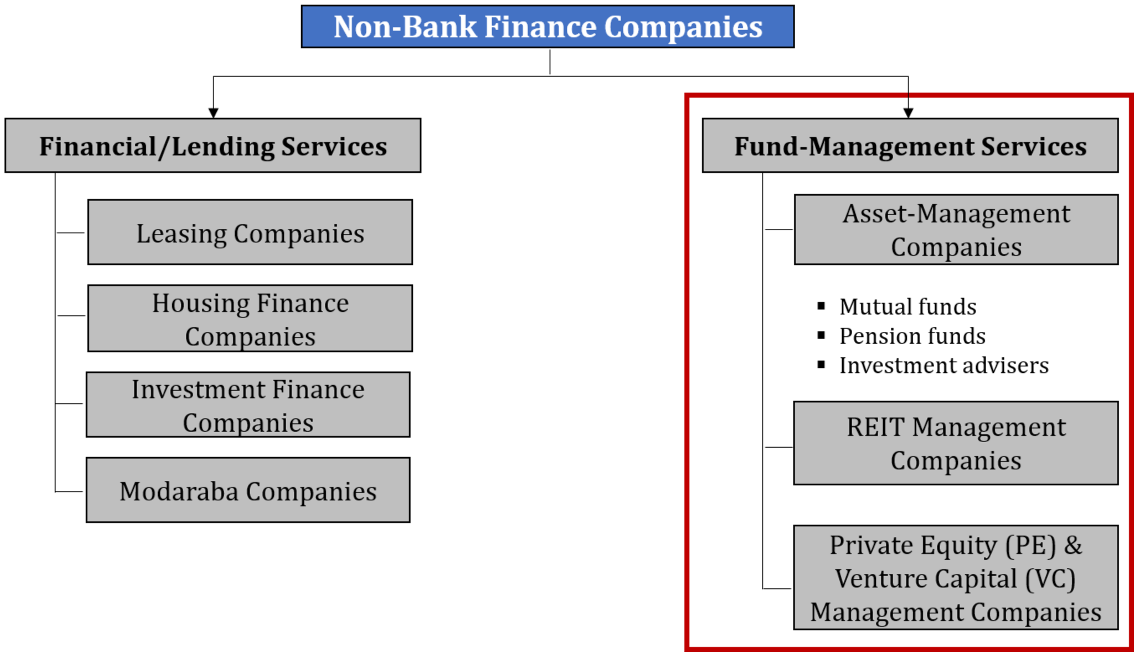
Figure 4.8: Overview of Pakistan's Financial Sector



Sources: SBP (2016), SECP (2013)

NBFCs, based on the types of services offered, are segregated into two broad categories, as shown in **Figure 4.9.** Pakistan introduced *modaraba* companies in early 1980 (based on a Shariah-compliant financial model) to stimulate the NBFC sector. These are regulated by the Modaraba Companies and Modaraba Ordinance 1980 and Modaraba Companies and Modaraba Rules 1981. Fund management services, which include AMCs, REIT management companies (RMCs) as well as PE and VC companies, are also classified as NBFCs.

Figure 4.9: Broad Categories of NBFCs in Pakistan



Source: Adapted from Pakistan Islamic Finance Report (2016)

The overall development of the Islamic finance industry in Pakistan lags far behind the conventional finance market and requires strong regulatory support. This is especially so for NBFIs/NBFCs that have been dwarfed by commercial banks, which offer similar financial services at lower costs due to their extensive outreach and economies of scale (Pakistan Islamic Finance Report, 2016).

As part of the government's initiatives to spur the growth of Islamic finance in the country, the SBP issued a Strategic Plan for the Islamic Banking Industry (2014-2018). The SBP targets Islamic banking assets to account for 15% of the total market by end-2018. The SECP established the Islamic Finance Department (IFD) in 2015. Its main responsibilities are to regulate and supervise the Islamic capital market, and to ensure that Shariah-compliant companies adhere to the principles of Shariah in conducting their business operations. Among commendable initiatives undertaken by the IFD is the incorporation of provisions pertaining to Shariah-compliant companies and securities under the Companies Act 2017 (Section 451), the release of Shariah Advisor Regulations 2017, and the issuance of the Draft Shariah Governance Regulations 2018 and several Shariah standards of the AAOIFI for adoption and consultation. In addition, the SECP has also issued the Capital Market Development Plan (CMDP) (2016-2018), which provides a short-term roadmap for the initiatives envisaged by the SECP in developing the country's capital markets within three years. **Box 4.3** gives an overview of the CMDP.

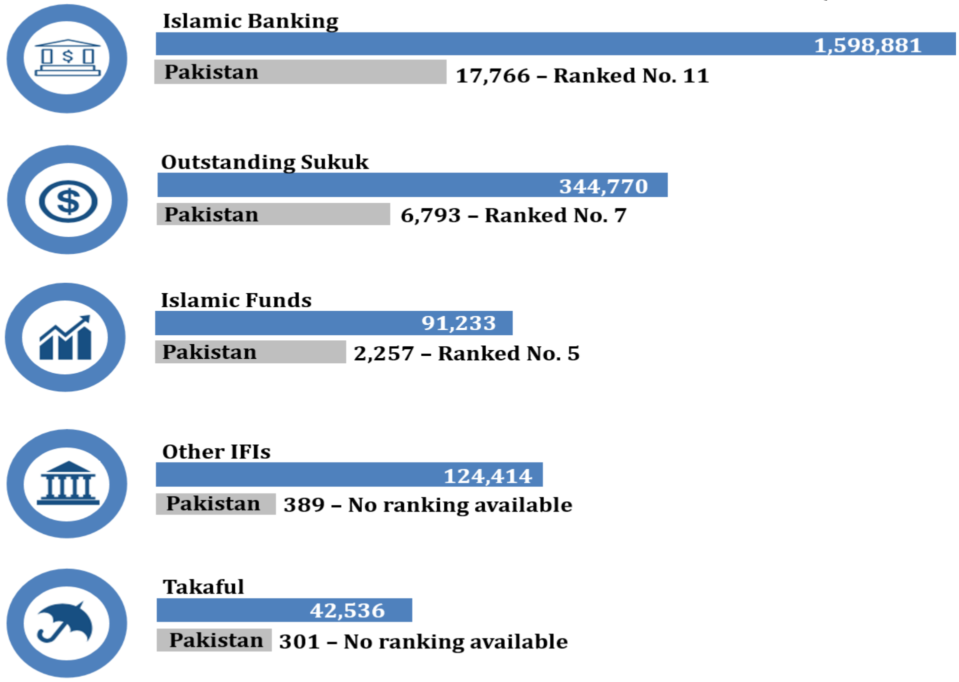
Box 4.3: SECP's CMDP (2016-2018)

Mission:	A. Key Strategic Objectives:
To be a fair, modern, efficient and globally competitive market that is responsive to the needs of its stakeholders, and based on sound regulatory principles that provide the requisite impetus for robust economic growth, and is the major facilitator of investments and fund-raising in the country. **Vision:** To contribute effectively towards the overall economic development of the country and foster an investment climate in the country, based on the principles of fairness, efficiency and transparency and driven by innovation and investor protection, governed by a sound regulatory framework aligned with international legal standards and best practices, coupled with a strong risk management system.	1. Legal and regulatory reforms. 2. Structural reforms and developmental initiatives under the SROs—PSX, CDC, NCCPL, PMEX. 3. Reforms for capital market intermediaries. 4. Product and market development. 5. Reforms for issuers in the capital market. 6. Reforms for investors' access, awareness, protection and facilitation. 7. Improving marketability, image building and compliance with international standards.

Source: SECP (2016, p. 16)

The market share of Islamic finance assets has been growing steadily since the adoption of a dual financial system in the early 2000s (Pakistan Islamic Finance Report, 2016). According to the Islamic Finance Development Indicator (IFDI) 2017, Pakistan was ranked among the top five performers (IFDI 2016: 6) after Malaysia, Bahrain, the UAE and Oman. The higher ranking (in 2017) was due to several factors, including the issuance of both global sovereign sukuk—after a two-year absence—and domestic sukuk, the better performance of Islamic funds, and the funding of infrastructure projects under the China-Pakistan Economic Corridor (CPEC) via Islamic finance (ICD-Thomson Reuters, 2017). **Chart 4.7** summarises Pakistan's position in terms of global market share in Islamic finance assets by sector as at end-2016, as reported by ICD-Thomson Reuters Report 2017.

Chart 4.7: Global vs Pakistan's Total Islamic Finance Assets in 2016 (USD million)

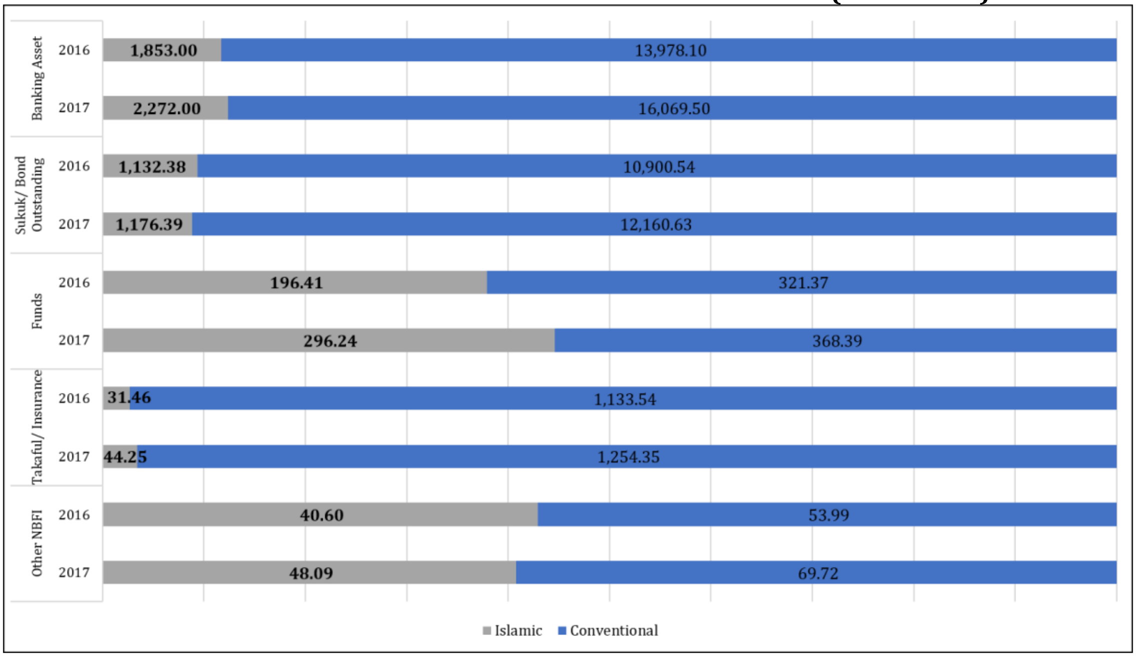


Sources: SBP (2017), SECP (2017), ICD-Thomson Reuters Report (2017)
Note: Only data on sukuk and Islamic funds are sourced from the ICD-Thomson Reuters Report 2017, to ensure consistency with other case studies; data on Islamic banking assets are sourced from the SBP and the rest are from the SECP.

Chart 4.8, on the other hand, presents Pakistan's Islamic finance assets vis-à-vis the conventional counterpart. As at end-2017, Pakistan's Islamic banking assets summed up to PKR2,272 billion (2016: PKR1,853 billion), representing 12.4% of its overall banking industry. This figure is expected to be lifted 15% by end-2018. While total outstanding sukuk rose from PKR1132.38 billion in 2016 to PKR1176.39 billion in 2017, Islamic funds' AuM surged to PKR296.24 billion in 2017 (2016: PKR196.41 billion), translating into 45% of the overall fund management industry.[9] Other Islamic NBFC assets, i.e. *modarabas*' assets also trended upwards in 2017 with a total of PKR48.09 billion (2016: PKR40.6 billion). At the same time, *takaful* assets augmented from PKR31.46 billion to PKR44.25 billion over the same period.

[9] This includes Islamic mutual funds, Islamic voluntary pension schemes and Islamic REITs, but exclude discretionary and non-discretionary portfolios managed by AMCs.

Chart 4.8: Pakistan's Total Finance Assets – Islamic vs Conventional (PKR billion)

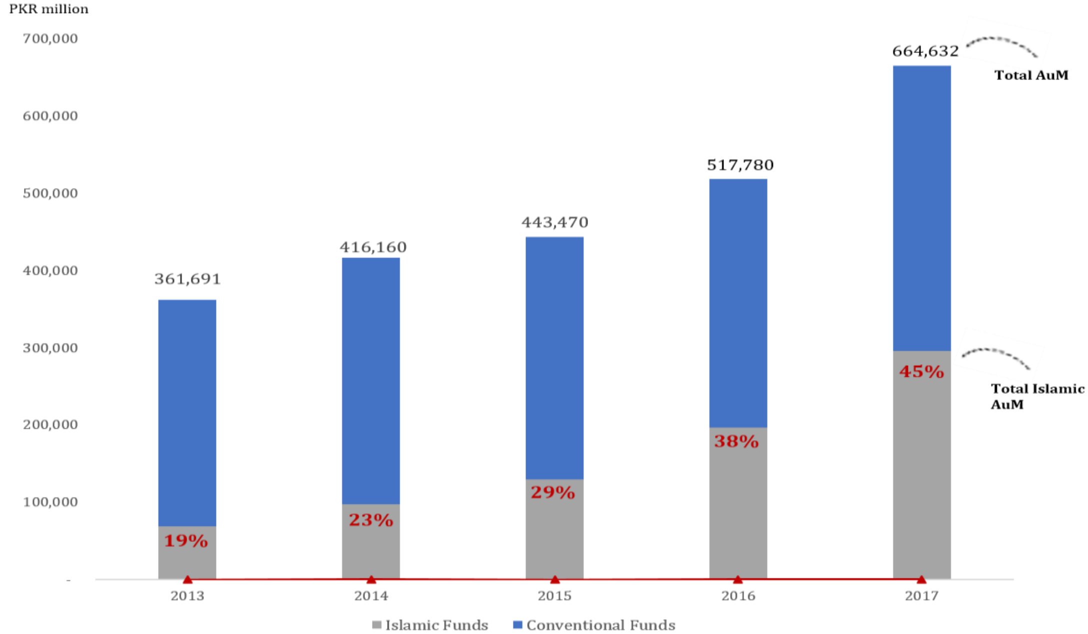


Sources: SBP (2017), MUFAP (2017), SECP (July, 2016), SECP (2017, June), SECP, SBP
Note: The total assets of the Islamic fund management industry, as shown in this chart, include Islamic mutual funds, Islamic voluntary pension funds managed by AMCs and Islamic REITs only, and exclude Islamic discretionary and non-discretionary portfolios managed by AMCs due to unavailability of sufficient data.
All numbers are as at end-2016 and end-2017 except for funds (as at June-2016 and June-2017).

Share of Domestic Islamic Funds against Total Funds Managed

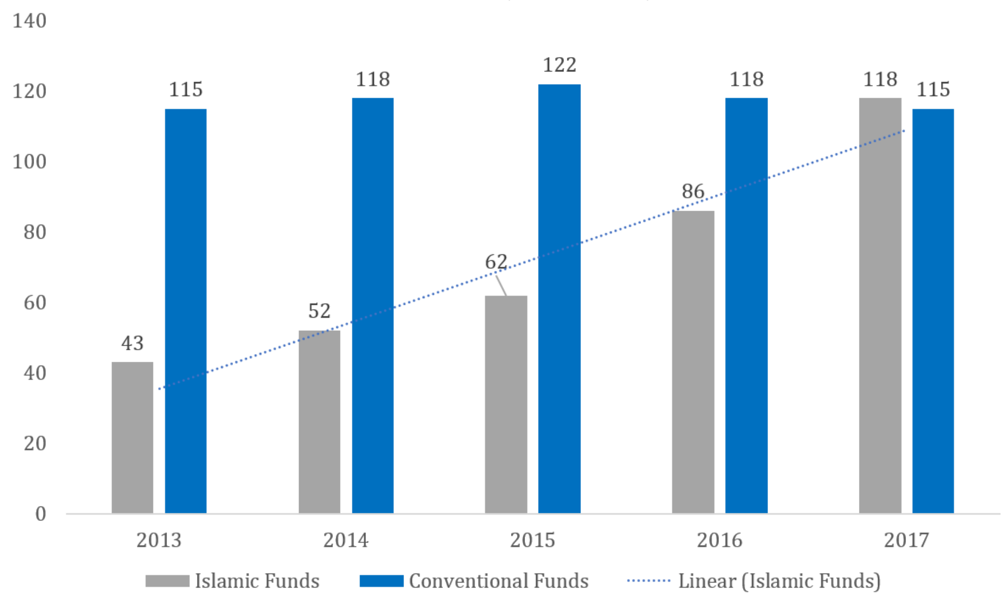
The size of the fund management industry in Pakistan is relatively small compared to other matured markets. However, the size of Islamic mutual funds has been growing positively. **Chart 4.9** shows that Islamic AuM climbed up from 19% (PKR69,299 million) in 2013 to 45% (PKR296,241 million) of Pakistan's total fund management industry (PKR664,632 million) in 2017. **Chart 4.10** depicts the number of Islamic funds vis-à-vis conventional funds between 2013 and 2017. The former indicates steady growth and outnumbered its conventional counterpart by 50.64% (118 of 233 funds) in 2017.

Chart 4.9: Pakistan's Islamic AuM as a Percentage of Total AuM (2013-2017)



Sources: MUFAP (2017), SECP (2017)
Note that total assets include Islamic mutual funds, voluntary pension funds managed by AMCs, and Islamic REITs managed by RMC. Although AMCs also manage discretionary and non-discretionary portfolios (both conventional and Islamic), their total assets are excluded due to the unavailability of sufficient data. However, it is estimated that the total size of Islamic portfolios outside the mutual fund structure stands at around PKR75 billion-PKR80 billion.

Chart 4.10: Number of Funds in Pakistan (2013-2017)



Source: MUFAP (2017)
Note that the number of Islamic funds, shown in this chart, includes: (i) open-ended funds; (ii) close-ended funds; and (iii) pension funds, but excludes REITs (only 1 Islamic REIT launched as at end-2017)

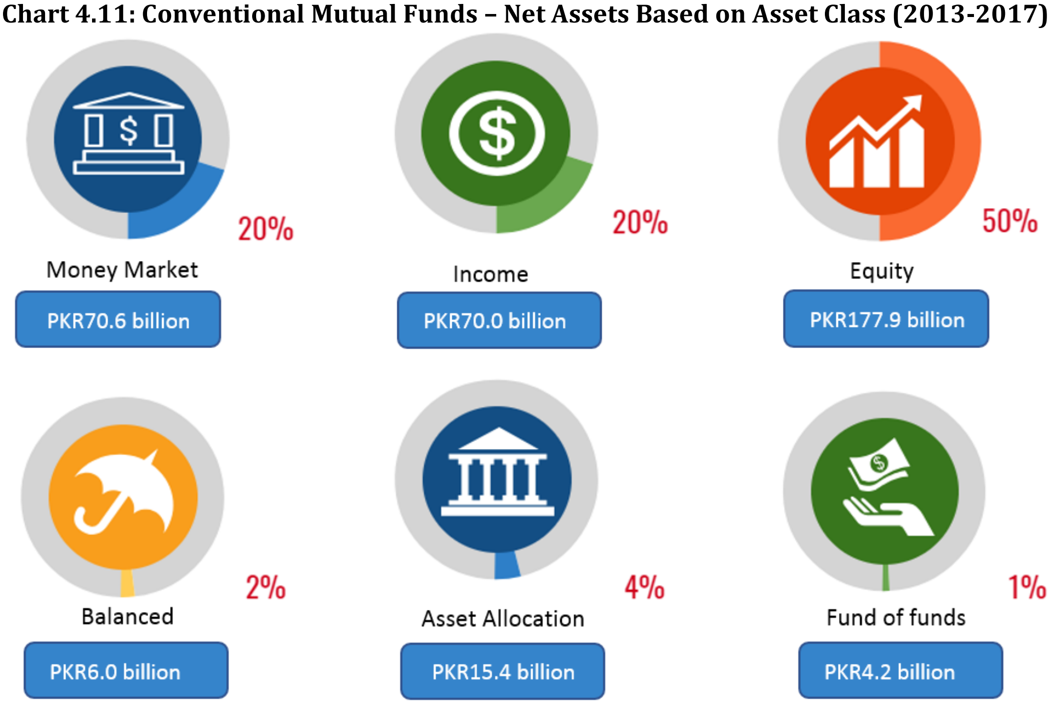
The AuM for Pakistan's mutual funds features a diversified portfolio comprising various asset classes. Equity funds have been commanding the lion's share in terms of both conventional and Islamic funds, as illustrated in **Chart 4.11** and **Chart 4.12**, respectively. This is partly due to the strong performance of the KSE Meezan Index (KMI-30), i.e. the benchmark Shariah equity index for Islamic investment, and the KSE-100 Index for the conventional space. In fact, the KMI-30 Index has significantly outperformed the other indices over the years. In addition, this index has generated a cumulative return of over 170% in the last few years—more than any other index, as illustrated in **Table 4.10**.

Table 4.10: Historical Returns of Indices in Pakistan (USD-Based Returns (%))

	FY12	FY13	FY14	FY15	FY16	FY17	FY18 (Apr)	Cumulative Returns	Annualised Returns
KMI-30 Index	3.0	47.1	30.0	16.4	12.0	18.4	-11.2	170.2	15.6
KSE-30 - Total Return*	N/A	N/A	17.5	8.8	3.9	17.5	-12.0	37.3	7.6
KSE-100 Index	0.2	45.0	41.3	12.4	6.5	22.9	-11.5	167.3	15.5

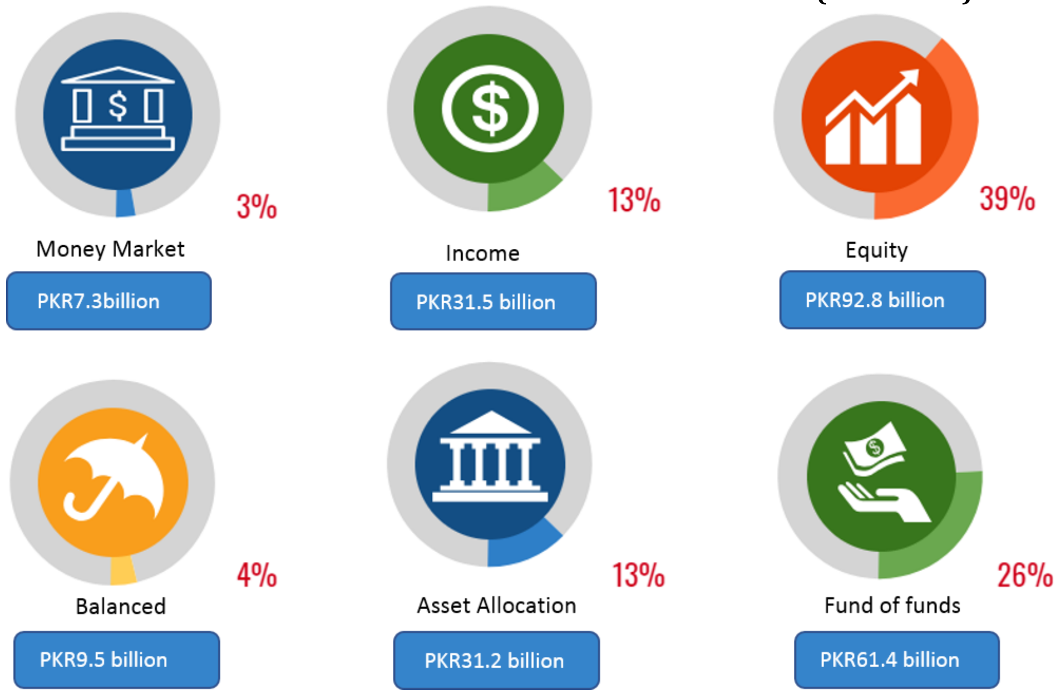
Source: Al Meezan (2018)
** The KSE-30-Total Return index was launched on 1 January 2014.*

Chart 4.11: Conventional Mutual Funds – Net Assets Based on Asset Class (2013-2017)



Source: MUFAP (2017)
Note: The balance of PKR5.61 billion is classified as 'others', which include capital protected, fund of funds (CPPI), aggressive fixed income, index tracker, commodities.

Chart 4.12: Islamic Mutual Funds – Net Assets Based on Asset Class (2013-2017)



Source: MUFAP (2017)
Note: The balance of PKR4.07 billion is classified as 'others', which include capital protected, fund of funds (CPPI), aggressive fixed income, index tracker and commodities

In conclusion, a broad spectrum of Pakistan's Islamic asset management industry, which comprises Islamic mutual funds (open- and close-ended funds), Islamic pension funds (i.e. Islamic VPS) and Islamic REITs, together with its performance are described in **Table 4.11**. Unlike Malaysia and South Africa, Pakistan had not introduced Islamic ETFs (not even conventional ETFs) as at end-April 2018, even though regulations governing ETFs for the Karachi Stock Exchange (KSE) was approved by the SECP in 2016. That said, the SECP formed an ETF committee in 2017 to develop a concept paper highlighting regulatory and operational issues that may impede the successful launch of ETFs in Pakistan (MUFAP, 2017).

Table 4.11: Performance of Pakistan's Islamic Fund Management Industry (2017)

Islamic AuM against Total Funds Managed*	Islamic Mutual Funds	Islamic Pension Funds	Islamic REITs
In 2017, the total AuM of Islamic funds stood at PKR296,241 million (or **45**%) of Pakistan's total fund management industry, which was valued at PKR664,632 million.	In 2017, there were 108 open- and close-ended Islamic funds, with an AuM of PKR237,819 million (or **39.8**%) compared to the entire market's AuM of PKR597,095 million.	In 2017, there were 10 Islamic VPS with a collective AuM of PKR16,142 million (or **64**%) compared to the overall market's AuM of PKR25,257 million.	In 2017, there was only 1 Islamic REIT PKR42,280 million of assets, representing **3.55**% of the assets of the NFBI industry.

Sources: MUFAP (2017), SECP (2017)
** The total AuM of the fund management industry in Pakistan includes pension funds managed by AMCs and Islamic REITs. Note that the numbers given for each segment are as at June-2017.*

4.3.2 Evolution of Pakistan's Islamic Fund Management Industry

In assessing the evolution of the Islamic fund management industry in Pakistan, focus has been given to three categories of fund management: Islamic mutual funds, Islamic pension funds, and Islamic REITs—as vital components of the industry. The key infrastructure developments and regulatory milestones that the Pakistan fund management industry has achieved since 1962 are summarised in **Table 4.12**.

Table 4.12: Key Milestones of Pakistan's Fund Management Industry

Year	Timeline Description
1962	▪ Introduction of National Investment (Unit) Trust (NIT)
1966	▪ Investment Corporation of Pakistan (ICP) launched closed-end funds
1971	▪ Introduction of Investment Company and Investment Advisers Rules
1983	▪ Establishment of first private-sector close-ended fund
1995	▪ Introduction of Asset Management Company Rules
1997	▪ Launch of first private-sector open-ended fund
2003	▪ Introduction of NBFC concept and regime for mutual funds via Non Banking Finance Companies (Establishment & Regulation) Rules ▪ Establishment of the first Islamic AMC, i.e. Al Meezan Investment, to launch Islamic funds
2005	▪ Introduction of Voluntary Pension System Rules
2008	▪ Introduction of a separate set of Non Banking Finance Companies and Notified Entities Regulations for mutual funds ▪ Introduction of REIT Regulations ▪ Launch of the KSE Meezan Index (KMI-30) as the first Shariah-compliant index
2015	▪ Revamped REIT Regulations ▪ Introduction of Private Funds Regulations ▪ Launch of first Islamic REIT – Dolmen City REIT ▪ Launch of PSX-KMI All Shares Index to screen all Shariah-compliant companies listed on the Pakistan Stock Exchange (PSX)
2016	▪ Approval of Regulations Governing ETFs on the Karachi Stock Exchange (KSE) ▪ Merger of three main stock exchanges (Lahore, Karachi and Islamabad) into a single trading platform, known as the Pakistan Stock Exchange (PSX)
2017	▪ Issuance of Shariah Advisors Regulations
2018	▪ Shariah Governance Regulations on Shariah-compliant companies and securities (in progress)

Source: SECP (2013), SECP

In terms of tax incentives, Islamic funds are treated the same as their conventional counterpart; all investors enjoy some benefits, as summarised in **Table 4.13**. AMCs, on the other hand, are not entitled to extra benefits for managing Islamic funds.

Table 4.13: Pakistan Government's Tax Incentives for Investing in Funds

<table>
<tr><th>Type of Fund</th><th>Tax Incentive(s)</th></tr>
<tr><td>Mutual Fund</td><td>

- Capital Gains Tax (CGT) on redemption of units of mutual funds as stated in Division VII, Part I of 1st Schedule of the Income Tax Ordinance 2001 is calculated based on the following rates:

Income Tax Rates:
(Where securities were acquired before 1 July 2016)

<table>
<tr><th><u>Holding Period</u></th><th colspan="2">Tax Rates</th></tr>
<tr><td></td><td>Filer</td><td>Non-Filer</td></tr>
<tr><td>Less than 12 months</td><td>15%</td><td>18%*</td></tr>
<tr><td>12-24 months</td><td>12.5%</td><td>16%</td></tr>
<tr><td>24 months or more but the security was acquired on or after July 1, 2013</td><td>7.5%</td><td>11%</td></tr>
<tr><td>Security acquired before July 1, 2013</td><td>0%</td><td>0%</td></tr>
</table>

**If security is acquired after July 1, 2016, the tax rate for non-filer will be 20%.*

Withholding Tax Rates:

<table>
<tr><th><u>Category</u></th><th>Rates</th></tr>
<tr><td>Individual and AoPs</td><td>10% for stock funds
10% for other funds</td></tr>
<tr><td>Company</td><td>10% for stock funds
25% for other funds</td></tr>
</table>

- *Provided further that in case of a stock fund if dividend receipts of the fund are less than capital gains, the rate of tax deduction shall be 12.5%*
- *Provided further that no capital gains tax shall be deducted, if the holding period of the security is more than 4 years*

</td></tr>
<tr><td>▪ Corporate</td><td>▪ Tax savings of 25%-35% compared to bank deposits.</td></tr>
<tr><td>▪ Individual</td><td>▪ Tax savings of up to 20% compared to bank deposits.
▪ Tax credit/relief on investment amount of up to PKR1.5 million or 20% of taxable income (whichever is lower) in open-ended funds if the investment is held for 2 years.</td></tr>
<tr><td>Pension Fund (Voluntary Pension Scheme)</td><td>▪ Tax credit on the actual contribution to a pension fund, 20% of taxable income.
▪ For participants joining the VPS at 41 years old and above, an additional tax credit of 2% is allowed. The maximum tax credit allowed is 30% of the annual tax credit.
▪ Additional tax credit is allowed until 30 June 2019.</td></tr>
<tr><td>REIT</td><td>▪ REITs distributing 90% of their income as dividends are exempted from payment of income tax at the REIT level.</td></tr>
</table>

Sources: Income Tax Ordinance (2001), JamaPunji (a)

Islamic Mutual Funds

The fund management industry in Pakistan started in 1962 when the National Investment Trust introduced the NIT as an open-ended mutual fund. In 1966, the ICP launched closed-end funds (MUFAP, 2012). The ICP had subsequently offered a series of close-ended mutual funds. In the early 1990s, 26 close-ended ICP mutual funds were floated (Shah & Hijazi, 2005). After more than 40 years, the mutual fund industry was opened to the private sector in 1995, i.e. through AMCs, with the introduction of the Asset Management Company Rules. Subsequently, the first private open-ended fund was launched in 1997 (SECP, 2013).

The first Islamic fund management company started about 5 years later when the SECP granted a licence to Al Meezan Investment Management Limited in 2003. However, growth only became more pronounced from 2011 onwards, when Islamic funds began expanding at a faster and steadier pace than conventional funds, as depicted earlier in **Chart 4.9**. Al Meezan Investment is the only full-fledged Shariah-compliant investment firm operating in Pakistan. It commanded the biggest share of the country's Islamic fund management industry, i.e. 41%, and 15% of the overall industry as at end-February 2018 (Al Meezan, 2018).

Unlike Malaysia, Pakistan's fund management industry is run by domestic firms, which offer conventional and Islamic funds via windows (except Al Meezan Investment which offers Shariah-compliant solutions only). As at end-June-2017, a total of 22 AMCs and IAs were registered and licensed by the SECP, managing 214 open- and close-ended funds as well as 19 pension funds.

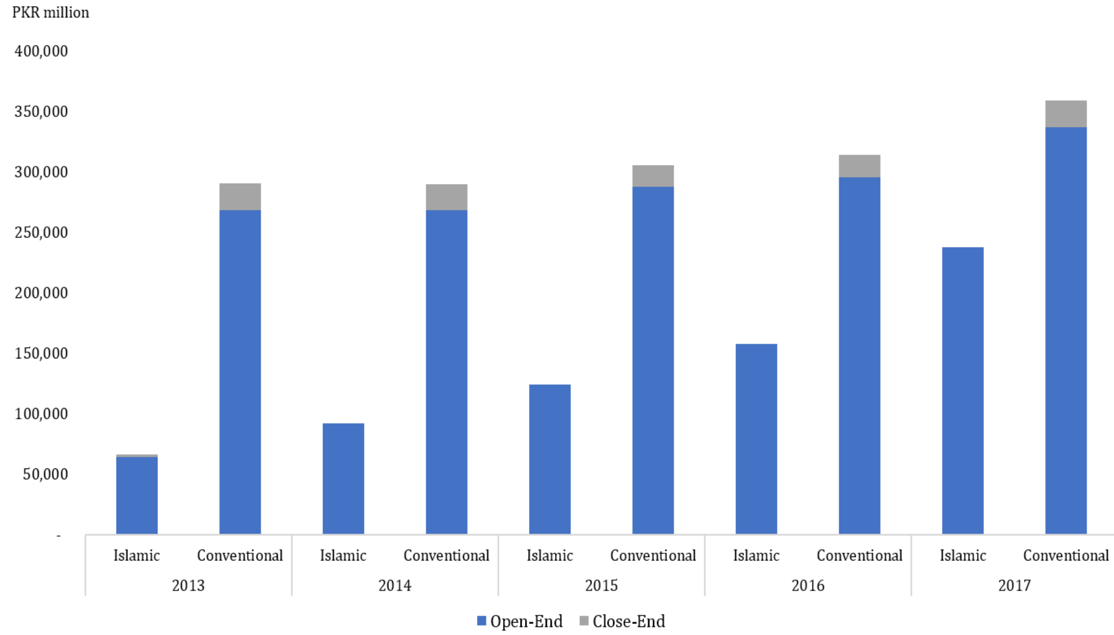
Effective from 2014, Islamic mutual funds have only been structured as open-ended funds, as shown in **Chart 4.13**. Conventional funds, however, still offer close-ended equity funds, with PKR22,805 million of AuM as at end-2017.

Based on NBFC Regulations 2008 (Rule 55 (6) and (9)), all Shariah-compliant funds must comply with the following regulatory requirements:

Exposure limits of the Islamic fund shall be lower of its net assets or the issued securities of a company:

▪ Maximum limit (equity securities)	=	15%
▪ Maximum limit (debt securities)	=	15% of single use
▪ Maximum limit per sector	=	35% or index weight, whichever is higher, subject to a maximum of 40%

Chart 4.13: Total AuM of Mutual Funds – Open-End and Close-End (2013-2017)

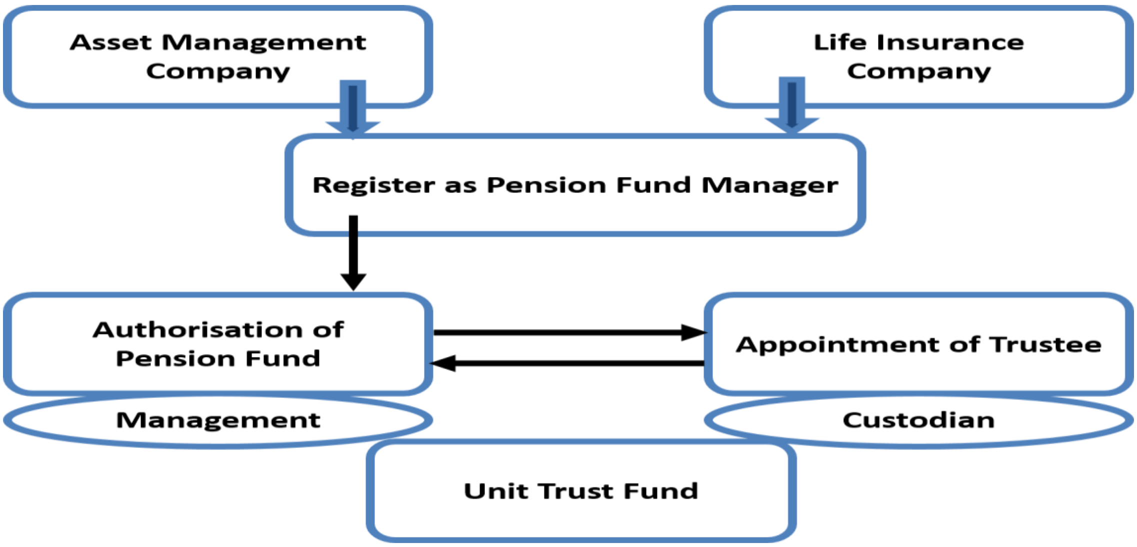


Source: MUFAP (2017)
Note that the figures exclude the total assets of pension funds.

Islamic Pension Funds/Voluntary Pension Schemes

As mentioned earlier, pension funds under the Voluntary Pension Scheme (VPS) represent another category of funds within Pakistan's asset management industry. VPS is a personalised, defined, savings-cum-investment vehicle that generates a stable source of income for employees after retirement. The VPS had been established under the Voluntary Pension System Rules 2005, under which employed and self-employed individuals can voluntarily contribute to a pension fund (either Islamic or conventional) during their working life. The structure of VPS, which comprises four main components (i.e. Approved Fund Manager, Approved Pension Fund, Trustee, and Participant/Investor), are depicted in **Figure 4.10**. There are stringent licensing requirements for pension fund managers under the SECP's regulation; the fees are lower than those of normal mutual funds. An individual can diversify his or her savings (contributions) among more than one fund manager and can transfer the account to other fund managers.

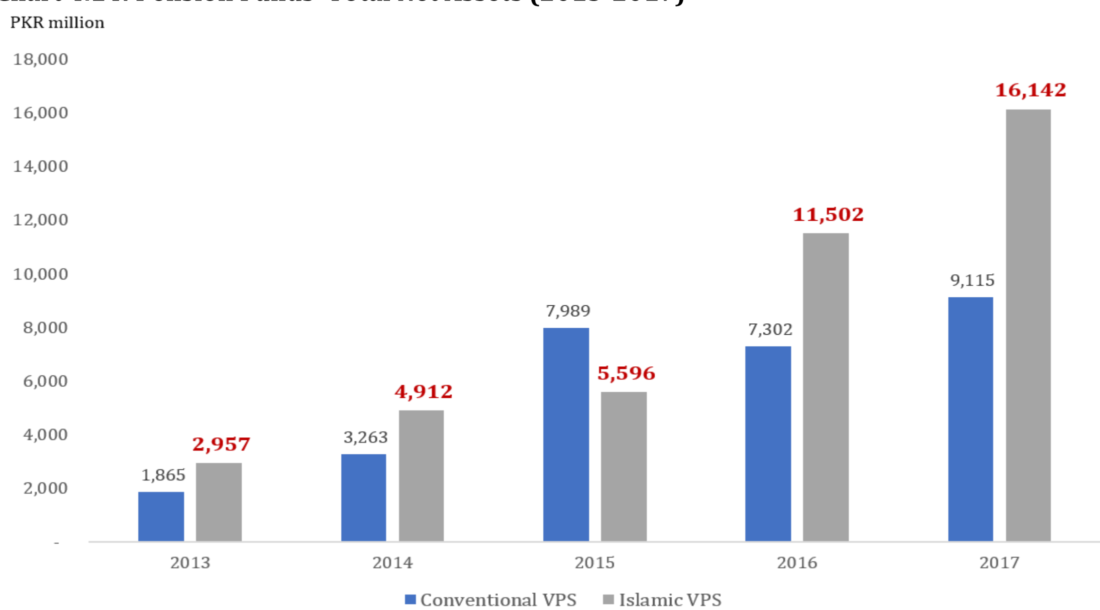
Figure 4.10: Structure of VPS



Source: JamaPunji (b)

The performance of VPS, which invest in specially set-up mutual funds, i.e. sub-funds of equity, debt and money market securities, had lagged somewhat after its establishment in 2005. Since 2013, however, this type of fund has made some strides, as shown in **Chart 4.14**. The Islamic VPS outperformed its conventional counterpart in 2016-2017, partly due to the regulators' more concerted efforts—particularly the SECP, via its JamaPunji awareness programme, and some tax relief for contributors/participants, as observed during our field visit and interviews.

Chart 4.14: Pension Funds' Total Net Assets (2013-2017)



Source: MUFAP (2017)

Islamic REITs

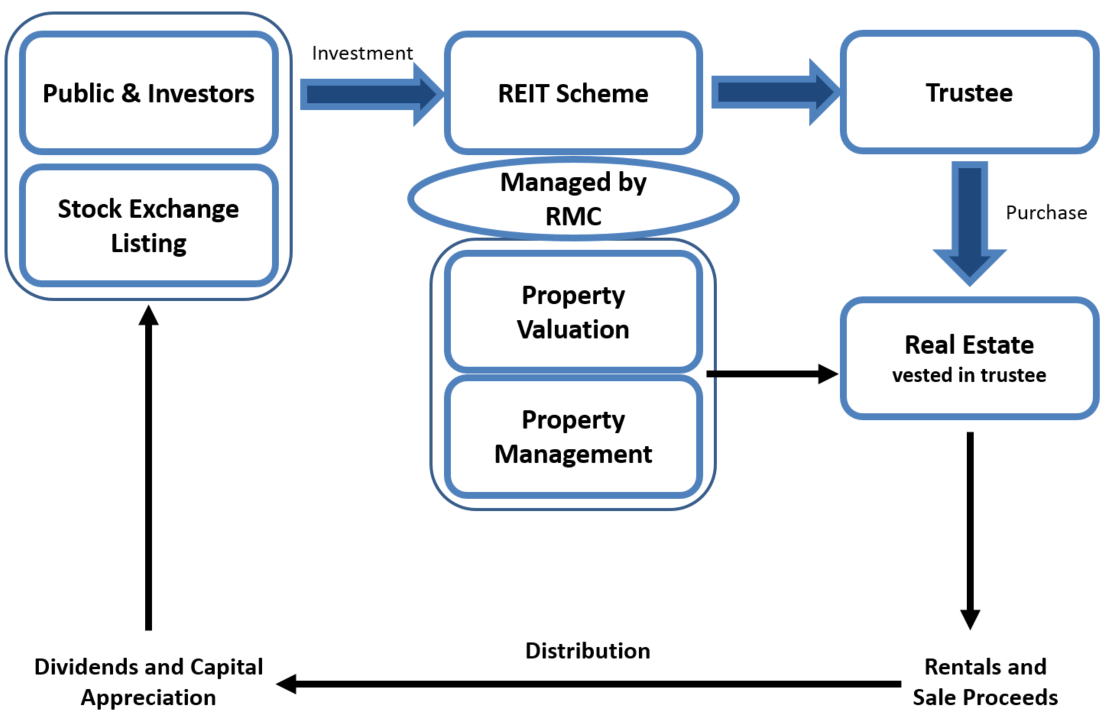
As part of the government's efforts to boost the fund management industry, the SECP issued REIT Regulations in 2008. Nonetheless, the industry only witnessed the launch of the first REIT in Pakistan and South Asia on 26 June 2015, i.e. Dolmen City REIT issued by Arif Habib Dolmen REIT Management Limited—a joint venture between Arif Habib Group and Dolmen Group, following the issuance of revised REIT Regulations 2015 by the SECP. The pioneer REIT was listed on the Karachi Stock Exchange (KSE) and the Lahore Stock Exchange (LSE) as a close-ended Shariah-compliant rental REIT, allowing investors to become the unit holders of two components of the Dolmen City project, i.e. Dolmen Mall Clifton and Harbor Front.

There are three types of REITs in Pakistan:

1. **Rental REITs:** Investments in commercial or residential real estate with the objective of generating rental income. In a rental REIT, the RMC buys a completed/constructed property and leases it out. Revenue from the rental is distributed to the unit holders.
2. **Developmental REITs:** Investment in real estate to develop it for industrial, commercial and residential purposes via construction or refurbishment. The property is subsequently sold or rented and the proceeds are distributed to the unit holders.
3. **Hybrid REITs:** An investment in a portfolio of buildings for rental and property for development.

The mechanics of Islamic REITs in Pakistan are explained in **Figure 4.11**.

Figure 4.11: Structure of Islamic REITs in Pakistan



Source: Arif Habib Dolmen (n.d)

Based on face-to-face interviews with selected market participants, REITs remain underdeveloped in Pakistan due to several reasons, namely:

1. **Tax regime for the real-estate sector:** The imposition of additional taxes on real estate (Federal Budget 2016-2017 and Finance Act 2016) had led a significant decrease in property transactions.
2. **Stringent capital requirement:** RMCs must have a paid–up capital of not less than PKR50 million before applying for a licence. They must also have an equity base of at least PKR50 million before seeking approval for the offering document of the REIT.
3. **Restriction on additional new projects:** REIT Regulation 2015 (Clause 14(v)) clearly states that a REIT cannot comprise more than one project (i.e. real estate on a single or multiple sites having exclusive ownership, lease, utilities and easement rights according to the law), and this restriction must be stated in the trust deed.
4. **Extensive due diligence imposed by the REIT Regulations:** Identification and transfer of property to the trust is a mandatory condition for the approval by the SECP. Since the real estate investment requires huge cost, therefore, the fund should be made allowed to raise money before identification and transfer or purchase of the property.

4.3.3 Investment and Commercial Considerations

The development process in launching an Islamic fund in Pakistan varies from one AMC to another, depending on the AMC's internal requirements and approval processes. Decisions to launch a certain category of funds also depend on the needs of investors. As the largest Islamic fund manager in the country, Al Meezan Investment's approach to developing and launching a fund is highlighted in **Figure 4.12** as an example.

Figure 4.12: Process Flow of Fund Development in Pakistan

Stage 1 Conceptualisation	Stage 2 Feasibility Study	Stage 3 Review/Feedback	Stage 4 Planning	Stage 5 Documentation
▪ Identify investor needs ▪ Develop product concept in a draft term sheet - investment policy, risk factors and fee structure ▪ Approve the proposed product concept – by Management Committee (MC)/Product Development Committee (PDC)	▪ Prepare financial model and feasibility of fund ▪ Test the model under various scenarios ▪ Discuss the feasibility study with the senior management and seek approval	▪ Circulate the proposed product concept to relevant departments – finance, operations, compliance and risk management for feedback	▪ Prepare timeline – approved by MC/PDC and agreed by other relevant departments ▪ Monitor the timeline – on-going basis until the product launch	▪ Prepare formal Constitutive Documents – Trust Deed and Offering Document ▪ Seek Compliance Department's feedback to ensure the product's compliance with the prevailing regulations

Stage 6 Shariah Approval	Stage 7 Trustee Consent	Stage 8 In-Principle Approval	Stage 9 Registration	Stage 10 Final Approval	Stage 11 Fund Launch
▪ Review of Trust Deed and Offering Document by the appointed Shariah Advisor ▪ Issue Shariah approval after ensuring the fund complies with the Shariah principles	▪ Review of Trust Deed and Offering Document – by the appointed Trustee ▪ Issue a Trustee consent if the terms of documents are satisfactory	▪ Review of Constitutive Documents – by the regulator, i.e. SECP ▪ Issue In-Principle approval if the terms and conditions of the documents are satisfactory	▪ Sign of Trust Deed between the Trustee and Fund Manager ▪ Register the Trust Deed	▪ Final approval of the registered Trust Deed and Offering Document – by the SECP	▪ Launch the fund in coordination with other departments

Source: Al Meezan Investment

As at end-2017, there are 11 categories of Islamic funds offered in Pakistan—as approved by the SECP. Investment in these funds is driven by individual investment objectives and risk appetites. **Table 4.14** highlights some key investment strategies, authorised asset allocation or investment avenue, and product suitability that AMCs in Pakistan consider when recommending a certain type of Shariah-compliant fund.

Table 4.14: Investment Strategies of Different Types of Islamic Funds in Pakistan

<table>
<tr><th>Type of Fund</th><th>Investment Strategy</th><th>Asset Allocation/ Authorised Investment</th><th>Product Suitability</th></tr>
<tr><td>Shariah-Compliant Equity Fund</td><td>To provide potential for high growth and returns with a relatively high level of risk.</td><td><table><tr><th>Asset allocation</th><th>Min</th><th>Max</th></tr><tr><td>Shariah-compliant listed securities</td><td>70%</td><td>100%</td></tr><tr><td>Islamic bank deposits (excluding term-deposit receipts (TDRs))</td><td>0%</td><td>30%</td></tr></table></td><td>Investors who seek:
▪ High risks with high returns on their investments.
▪ Long-term wealth creation.
▪ A diversified equity fund that aims for capital appreciation.</td></tr>
<tr><td>Shariah-Compliant Index Tracker Fund</td><td>To provide returns that are in line with the performance of benchmark indices such as the KMI-30.</td><td>Strive to invest 100% according to the stated index. Otherwise, the fund should invest in:<table><tr><th>Asset allocation</th><th>Max</th></tr><tr><td>Shariah-compliant securities covered by the index</td><td>85%</td></tr><tr><td>Cash in Islamic banks/Islamic banking windows (excluding TDRs)</td><td>15%</td></tr></table></td><td>Investors who seek:
▪ High risk with high returns on their investments.
▪ Cost-efficient way to invest in specific benchmark indices.
▪ A passive investment</td></tr>
</table>

<table>
<tr><th>Type of Fund</th><th>Investment Strategy</th><th>Asset Allocation/ Authorised Investment</th><th>Product Suitability</th></tr>
<tr><td></td><td></td><td></td><td>philosophy and do not wish to be dependent on security selection and sector allocation by fund managers.</td></tr>
<tr><td>Shariah-Compliant Balanced Fund</td><td>To provide both growth and income, hence investing in both equities and fixed-income securities.</td><td>
Investment avenues: Shariah-compliant listed securities, government securities, cash in bank accounts, money market placements, deposits, certificate of musharakas (COM) and sukuk.
<table>
<tr><th>Asset allocation</th><th>Ratio</th></tr>
<tr><td>Shariah-compliant listed equities at all times</td><td>30%-70%</td></tr>
<tr><td>Remaining net assets will be invested in fixed-income securities, where:
- The rating of the debt securities is no lower than A-</td><td>30%</td></tr>
</table>
</td><td>Investors who seek:
Moderate risk and return potential.
Balanced investment strategy, both in equities and debt markets, while avoiding the volatility of pure equity investments.
Portfolio diversification through just one fund without having to invest in multiple funds.
A balanced strategy to meet their financial goals within the short to medium term.</td></tr>
<tr><td>Shariah-Compliant Asset Allocation Fund</td><td>To invest in various asset classes based on the outlook on such asset classes, and may provide diversification benefits through a single investment.</td><td>
Investment allocation: any type of securities at any time, with a provision to diversify its net assets across multiple types of securities and investment styles, as specified in their offering documents.
The investment within each asset class will be governed by the criteria applicable to schemes of that asset class:
<table>
<tr><th colspan="2">Indicative minimum percentage of investment allocation</th></tr>
<tr><td>Equity</td><td>Fixed income/money market</td></tr>
<tr><td>0%-100%</td><td>0%-100%</td></tr>
</table>
Each scheme must disclose the following in its offering document:
i. Authorised investments
ii. Ratings of the securities that it will invest in
</td><td>Investors who seek:
Allocation of funds in both risky and non-risky assets, with an assurance that the fund manager will actively allocate assets between the two classes according to their outlook.
Capital appreciation over the long term.
Diversification by combining various asset classes in their overall investment portfolio.</td></tr>
</table>

<table>
<tr><th>Type of Fund</th><th>Investment Strategy</th><th>Asset Allocation/ Authorised Investment</th><th>Product Suitability</th></tr>
<tr><td>Shariah-Compliant Income/ Money Market Fund</td><td>To provide regular and steady income to investors.</td><td>
Income fund: government securities, cash in bank accounts, money market placements, deposits, certificate of musharakas (COM) and sukuk.
<table>
<tr><th>Asset allocation</th><th>Ratio</th></tr>
<tr><td>Exposure to CFS and spreads</td><td>Below 40% of net assets</td></tr>
<tr><td>Cash and near-cash instruments</td><td>At least 25%</td></tr>
<tr><td>Non-traded securities, with more than 6 months' maturity which is not a marketable security</td><td>Less than 15%</td></tr>
</table>
Money market fund: government securities, cash and near-cash instruments.
<table>
<tr><th>Asset Allocation</th></tr>
<tr><td>No direct/indirect exposure to equities, CFS and spread transactions.</td></tr>
</table>
</td><td>Investors who seek:
Moderate risk and return potential.
Protection of investments from stock market volatility, while providing diversification to the overall investment portfolio.
Long-term regular income.</td></tr>
<tr><td>Shariah-Compliant Fund of Funds</td><td>To invest in other mutual funds.</td><td>
Can only invest its net assets in other schemes.
Every scheme must mention its type with respect to the asset class, e.g. equity fund of funds or income fund of funds, in its offering document.
Every scheme will be invested in either the units of other collective investment schemes as per its investment policy, or in cash and/or near-cash instruments, including cash in bank accounts (excluding TDRs).
Every scheme must ensure that it does not invest in the seed capital of any other collective investment scheme.</td><td>Investors who seek:
Different allocation strategies that suit varying risk profiles.
A targeted investment strategy to achieve desired financial goals.
Investment in a disciplined manner through risky funds, but have the comfort of not being penalised should they miss any monthly payment.</td></tr>
</table>

Source: SECP Circulars on Categorization of Open-End Collective Investment Schemes[10]

[10] Note that the SECP, as at end-2017, has been issuing a series of circulars on the categorisation of open-end CIS starting with Circular No. 7 of 2009, followed by other circulars, including Circular No. 16 of 2010, Circular No. 4 of 2011, Circular No. 32 of 2012, Circular No. 9 of 2013, Circular No. 3 of 2015, Circular No. 1 of 2016 and Circular No. 10 of 2016.

4.3.4 Key Factors Underpinning the Development of Pakistan's Islamic Fund Management Industry

The growth of Pakistan's Islamic capital market in general, and its Islamic fund management industry in particular, has been more noticeable after the launch of the CMDP 2016-2018 by the SECP in 2016 (refer to the earlier charts depicting the growth of the NBFC sector). The key factors underpinning the growth of Islamic funds in Pakistan are analysed based on the following pillars:

Legal and Regulatory Framework

From the initial stage of NBFCs' setting up, including funds, the SECP has been issuing various regulations, rules and circulars governing these entities. In fact, several amendments have been made to the original rules and regulations to meet contemporary market requirements and expedite industry growth.

The rules and regulations governing the Islamic fund management industry issued by the SECP on existing conventional mutual funds include the following:

- Non-Banking Finance Companies (Establishment & Regulation) Rules, 2003 (the Rules)
- Non-Banking Finance Companies & Notified Entities Regulations, 2008 (the Regulations)
- Part VIII of The Companies Act, 1984 (the Ordinance)
- Income Tax Ordinance, 2001
- Trust Act, 1882
- Voluntary Pension System Rules, 2005
- REIT Regulations, 2008
- Circulars and directives issued by the SECP under the provisions of the Ordinance

The fund management industry is highly regulated in Pakistan, to the extent that the SECP has jurisdiction over the expenses chargeable to a fund and the amount of management fees that AMCs can charge to different categories of funds, as explained in **Box 4.4**. The regulation provides certainty to investors as fund managers must be transparent in disclosing the various types of fees imposed in the offering documents.

Box 4.4: Allowable Fees under NBFC Regulations 2008

List of Allowable Expenses:

- Remuneration of the AMC.
- Remuneration of the trustee or custodian.
- Shariah advisory fee.
- In the case of an investment company, directors' fees and related expenses for attending meetings.
- Listing fee payable to the stock exchange, including renewals.
- Charges and levies of the stock exchange, national clearing and settlement company, and central depository company.
- Rating fee under the CIS payable to the approved rating agency.
- Auditors' fees and out-of-pocket expenses, as billed.
- Brokerage and transaction costs related to investment in and divestment of the assets under the CIS.
- Expenses incurred by the trustee in effecting the registration of all registerable assets in the name of the trustee.
- Legal and related costs incurred to protect the interests of the unit, certificate or shareholders of the CIS.
- Bank charges as well as borrowing and financial costs.
- Printing costs and related expenses when issuing the quarterly, half-yearly and annual reports of the CIS.

- Formation cost under the CIS, not exceeding 1% of the pre-IPO capital in the case of an open-ended fund and 1% of the paid-up capital in the case of a close-ended fund, or five million rupees, whichever is lower.
- Taxes, fees, duties and other charges applicable to the CIS on its income or properties, including taxes, fees, duties and other charges levied by a foreign jurisdiction on investments made oversees.
- Fees payable to the Commission.
- Any other expense or charges as may be allowed by the Commission.

Maximum Limit for the Allowable Total Expenses of a Fund:

Equity, balanced, asset allocation and capital-protected (dynamic asset allocation-direct exposure) schemes	Up to 4%
Money market	Up to 2%
Income, aggressive income, capital-protected, index and commodity schemes (cash settled)	Up to 2%
Commodity schemes (deliverable)	Up to 3%
Fund of funds	Up to 2.5% if management fee is charged Up to 0.5% if no management fee is charged

Maximum Limit for Management Fees under Different Funds

Equity, balanced, asset allocation and capital-protected (dynamic asset allocation-direct exposure) schemes	2% of average annual net assets
Income, aggressive income, index, fund of funds and commodity schemes (cash settled)	1.5% of average annual net assets
Money market, commodity schemes (deliverable) and capital-protected schemes	1% of average annual net assets

Source: SECP (2008)

Nonetheless, the real challenge lies in the effective implementation and enforcement of the laws and regulations. Supervision and enforcement capabilities also need attention as there are some gaps, especially for self-regulatory organisations (SROs).

Shariah Governance Framework

Comparable to Malaysia, Pakistan has a robust Shariah framework vis-à-vis the governance and compliance of Islamic capital-market activities, particularly Islamic funds-related businesses. To comply with international best practices and to promote harmonisation and standardisation in the business operations of Shariah-compliant companies across the industry, the regulator, i.e. the SECP, has been issuing notices for the adoption of various AAOIFI Shariah Standards since January 2016.

The SECP has established its central Shariah Advisory Board to provide opinions on Islamic capital market-related matters. The Board regularly reviews the regulatory framework for Shariah compliance and evaluates Islamic financial accounting standards in consultation with industry stakeholders—to ensure uniformity in the Shariah governance and compliance processes.

The SECP issued Shariah Advisors Regulations 2017 to regulate the appointment of Shariah advisors, who are appointed by the AMC, [11] to approve any Shariah-compliant fund. The SECP also issued Draft Shariah Governance Regulation 2018, which is applicable to all Shariah-compliant securities, Shariah-compliant companies and Islamic financial institutions, all of which are required to obtain certificates of Shariah compliance from the SECP. The Draft also introduces centralised Shariah screening criteria, which are aligned with the AAOIFI Shariah screening methodology, to determine a company's Shariah-compliant status. This will strengthen the existing Shariah screening process, which is jointly undertaken by the PSX and Al Meezan Investment to launch Shariah-compliant indices, i.e. the KMI-30 Index and the PSX-KMI All Shares Index. The initiative will enhance market confidence in Shariah-compliant stocks.

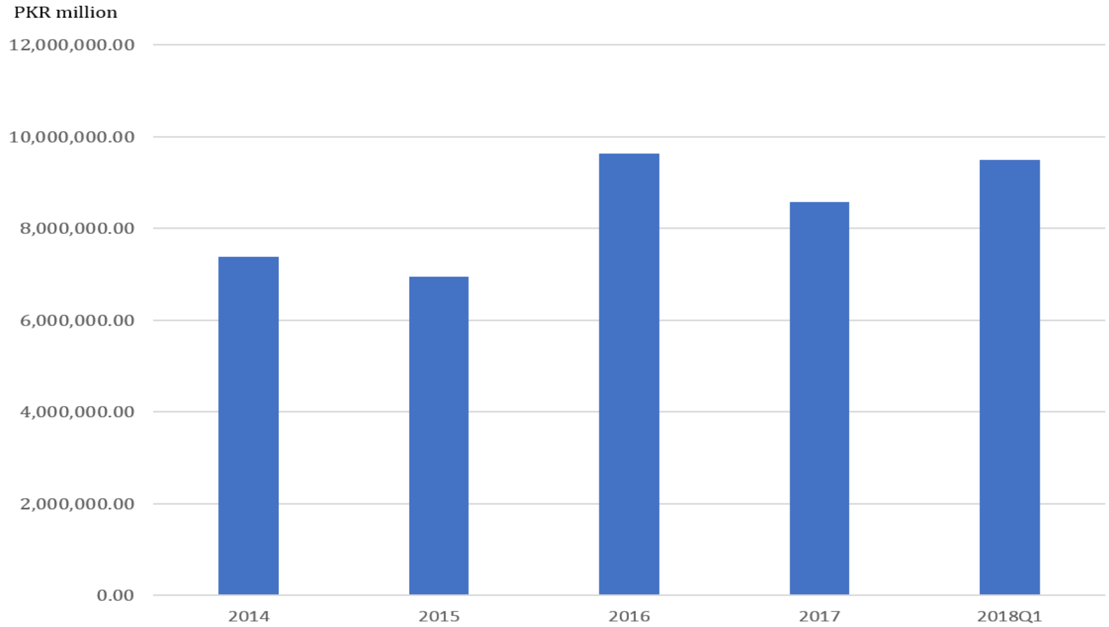
Market Infrastructure

To facilitate secondary trading and investment, Pakistan has developed a wide range of capital market infrastructure institutions or SROs, such as stock and commodities exchanges (the PSX and PMEX, custody and depository companies (the CDC), and clearing and settlement houses (NCCPL). Nonetheless, these entities have not been performing in the capacity of full-fledged SROs. They will need to assume greater responsibility by taking on the duties of full-fledged SROs, whereby they will be required to perform these tasks: rule-making, supervision and enforcement of the applicable laws by market participants/intermediaries. The CMDP 2016-2018 emphasises that 'SROs must focus on enhancing their supervision and enforcement capabilities by putting in place mechanisms for risk management, real-time monitoring of market information and use of technology to benefit from automation and reduce their cost of compliance' (SECP, 2016, p. 13).

Although the stock market's performance has improved after the integration of the Karachi, Lahore and Islamabad stock exchanges under one umbrella, i.e. the PSX, more efforts should be expanded to broaden the universe of listed companies, to particularly include SMEs. As at end-1Q 2018, the PSX played host to 559 listed companies, of which 250 were Shariah-compliant. The market capitalisation of the PSX has expanded in the last 5 years (2014-1Q 2018), as illustrated in **Chart 4.15**, although such growth has not been stable from year to year. The introduction of the PSX-KMI All Shares Index in November 2015 is aimed at further boosting the Islamic capital market and Islamic funds.

[11] Other Islamic financial institutions or companied that are governed by the SECP must also appoint Shariah advisors to approve any Shariah-compliant products.

Chart 4.15: Total Market Capitalisation of the PSX (2014–1Q 2018)



Source: Pakistan Stock Exchange

Tax Framework

Although investors enjoy some tax relief when investing in funds, this is still limited, as described earlier in **Table 4.13**. No tax incentive is provided to AMCs offering Islamic funds or at the fund level. Both conventional and Islamic funds are treated the same. This is different from the Malaysian experience, where some tax benefits are given to fund managers to incentivise them to develop more Islamic wealth-management products (refer to **Table 4.5: Tax Incentives for the Malaysian Fund Management Industry**).

Demand Side

Retail investors: Pakistan has a large untapped Muslim population that remains out of the financial system. Pakistan's population numbers about 200 million, and the vast majority of them are Muslims (about 95%-98%). Nonetheless, the financial inclusion rate for Pakistan is significantly lower than its peers'. Based on the SBP's Access to Finance Survey 2015, about 53% of the population are financially excluded while 24% have access to informal financial services such as cooperatives and local committees, and loans offered by shopkeepers and others. Only 23% have access to formal financial services (banks: 16%; NBFCs and national savings schemes: 7%); a clear majority of them live in Karachi, Lahore and Islamabad. The capital market presence and outreach are limited to these three main cities (SECP, 2016).

Accordingly, the government, spearheaded by the SBP, has launched the NFIS (2015-2020) to provide a comprehensive framework and roadmap for priority actions to increase access to and the use of quality financial services. **Box 4.5** provides an overview of the NFIS and its current progress in driving the growth of Islamic funds, particularly the introduction of Digital Transaction Accounts (DTAs)—mobile account scheme—in rural areas. This initiative facilitates the availability of a common technology-led platform for individuals to access and use a full suite of payment, savings, insurance and credit services (IMF, 2017).

As a result, the number of individuals that are holders of mutual funds has increased significantly since 2015, as depicted in **Table 4.15**. Even so, more concerted efforts are needed to create greater awareness among retail investors, particularly unbanked.

Table 4.15: Number of Investors' Accounts (Open- and Close-Ended Mutual Funds)

Category	2013	2014	2015	2016	2017
Individuals	203,560	209,297	228,906	246,043	270,386
Banking & financial institutions	839	787	682	724	819
Provident & pension funds	2,198	2,369	2,789	3,098	3,805
Public limited companies	612	734	600	601	305
Associated companies	451	435	401	420	320
Others	3,127	3,026	3,051	2,792	28,460
Fund of funds*					141
Total including fund of funds	**210,787**	**216,648**	**236,429**	**253,678**	**304,236**
Total excluding fund of funds	**210,787**	**216,648**	**236,429**	**253,678**	**304,095**

Source: MUFAP (2017)

** Effective 27 April, 2017, AMCs are required to exclude the amount invested by fund of funds schemes in the underlying funds managed by the same AMC while publishing the amount of assets under its management in advertisements.*

Box 4.5: Pakistan's NFIS (2015-2020)

Overview:
In May 2015, the Pakistan government launched and adopted the NFIS, the key objective of which is to set a national vision for the achievement of universal financial inclusion in the country. The NFIS underlines the government's vision, framework, action plans and target outcomes for financial inclusion. It aims to increase formal financial access to 50% of the adult population by 2020.

Key Enablers:
1. Public and private sector commitment
2. An enabling legal and regulatory environment
3. An adequate supervisory and judicial capacity
4. Financial, payment and ICT infrastructure

Key Drivers:
1. Promoting digital transactions and achieving scale through bulk payments
2. Expanding and diversifying access points
3. Improving the capacity of financial service providers
4. Enhancing financial capability

Key Milestones of the NFIS:

1. Enhancement of biometric infrastructure to aid real-time account opening (2015).
2. Payment systems interoperability of the MFS platform with core banking accounts through financial switch (1-Link) enabling ATM, POS and interbank funds transfers through m-wallets (2015).
3. The Government of Pakistan accepts membership of the UN's *Better than Cash Alliance* (2015).
4. Establishment of three centres of excellence in Islamic finance education to ensure an adequate supply of trained human capital for the industry (2015).
5. Incorporating the Pakistan Mortgage Refinance Company to address the long-term funding constraints hindering the growth of the primary mortgage market (2015).
6. Launch of the CGSMF with funding support from the Government of Pakistan, to share the losses with banks against their collateral-free financing to small and marginalised farmers (2016).
7. The NFIS Council approved key strategic actions such as:
   - The development of a National Payment Gateway.
   - Automation of government collections and disbursements.
   - Introduction of a warehouse receipt financing system.
   - Integration of the National Savings Scheme with the national payment system.
   - Initiation of new schemes for registered prize bonds.
8. Development of mobile accounts - DTA Scheme – AMA to support the rapid expansion of digital transactions, particularly in rural areas. The unified DTA scheme is expected to help design a common technology-led platform for individuals to access and use a full range of payment, savings, insurance and credit services (2017).
9. Launch of the Home Remittance Account (HRA), a branchless banking account to promote a swift and cost-effective mode of receiving money from abroad (2017).

Sources: SBP (2015), IMF (2017), Pakistan Economic Survey 2017-18 (2018)

Institutional investors: Apart from banks and financial institutions, Pakistan has a limited number of cornerstone institutional investors. Important government-linked institutions such as the Employees Old Age Benefits Institution (EOBI)[12] and the provident funds of companies do not invest in mutual funds. Rather, they manage their own investments. This is different from Malaysia's approach in the case of the EPF, as explained earlier (refer to the Malaysian case study).

Furthermore, banks and DFIs have some restrictions when investing in funds. The SBP in its Prudential Regulations for Corporate and Commercial Banking, 2015 (under Regulation R-6) sets the following limits:

- The aggregate equity investment limit for banks and DFIs that are mobilising funds as deposits/COIs from the public/individuals will be 30% of their respective equity.
- For Islamic banks and DFIs that are not mobilising funds as deposits/COIs from the public/individuals, the aggregate investment limit will be 35% of their respective equity.
- Exposure because of strategic investments and investment in the units of all forms of mutual funds, excluding NIT units until its privatisation, can also be considered part of the abovementioned limits.
- The aggregate investment limit for units of REITs will be 10% of the equity of the bank/DFI, exclusive of the above stated aggregate limits.

Foreign investors: Foreign investment in funds is very limited in Pakistan. All AMCs are domestic. The market does not have any liberalisation policies to attract foreign AMCs to open their businesses there.

Supply Side

Diversification of product innovation: As discussed earlier, the Islamic asset management industry in Pakistan is currently limited to mutual funds, pension funds and REITs while ETFs are still under development. This is due to a lack of investment avenues or investible assets.

Availability of Shariah-compliant investible assets: Pakistan's market suffers from insufficient short-term instruments. As at end-2017, the outstanding value of conventional treasury bills (T-bills), which are auctioned twice every month and serve as a liquidity instrument for the money market, was PKR7589.1 billion (SBP, n.d.). The government, however, has not issued any similar Islamic short-term papers. This has resulted in Shariah-compliant funds, especially the money market ones are not able to deploy their liquidity at a better yield compared to bank rates.

Similarly, the issuance of long-term sovereign sukuk, which can create a benchmark yield curve for corporate issues, is also lacking. As at end-2017, the outstanding value of federal

[12] The **EOBI** had been established under Employees' Old-Age Benefits Act, 1976. It is a semi-autonomous institution working under the auspices of the Ministry of Overseas Pakistanis and Human Resource Development. A tripartite corporate board of trustees manages the operations of the EOBI where, along with government officials, labour and employer representatives are also present. The EOBI Act is only applicable to the private sector and all firms (industrial or commercial, including banks) where at least five workers, whether contractual or regular, have been employed or were employed in the last 12 months. The laws remain applicable even if the number of persons employed is subsequently reduced to less than five. A business with less than five employees can get its employees registered with the EOBI on a voluntary basis. Refer: https://paycheck.pk/main/labour-laws/social-security-1/social-security-and-pension-system-in-pakistan

government bonds stood at PKR4,237.1 billion, of which Pakistan Investment Bonds (PIBs) dominated the market with PKR3850.8 billion while the Government of Pakistan (GoP) *ijarah* sukuk was 10 times lower, i.e. PKR385.4 billion only (SBP, n.d.). While PIBs are issued for tenures ranging from 3 to 20 years, GoP *ijarah* sukuk have not been issued except for 3 years tenure. In addition, the government has not been issuing enough GoP *ijarah* sukuk in comparison to PIBs which are auctioned monthly. Infrequent issuance of sukuk is a result of existing issues regarding documentation, titles of assets and taxation, among others. The lack of sukuk issuance from the government has led to a demand and supply mismatch which has resulted in lower cut-off yields in Islamic instrument auctions, compared to similar conventional instruments.

Modaraba—a unique financing model that represents the first step towards Islamisation of Pakistan's economy—has not been performing well. Such entities face difficulties in accessing the sources of appropriate funds due to a lack of investor confidence. As such, Islamic funds do not invest much in *modaraba* companies (i.e. Modarabas).[13]

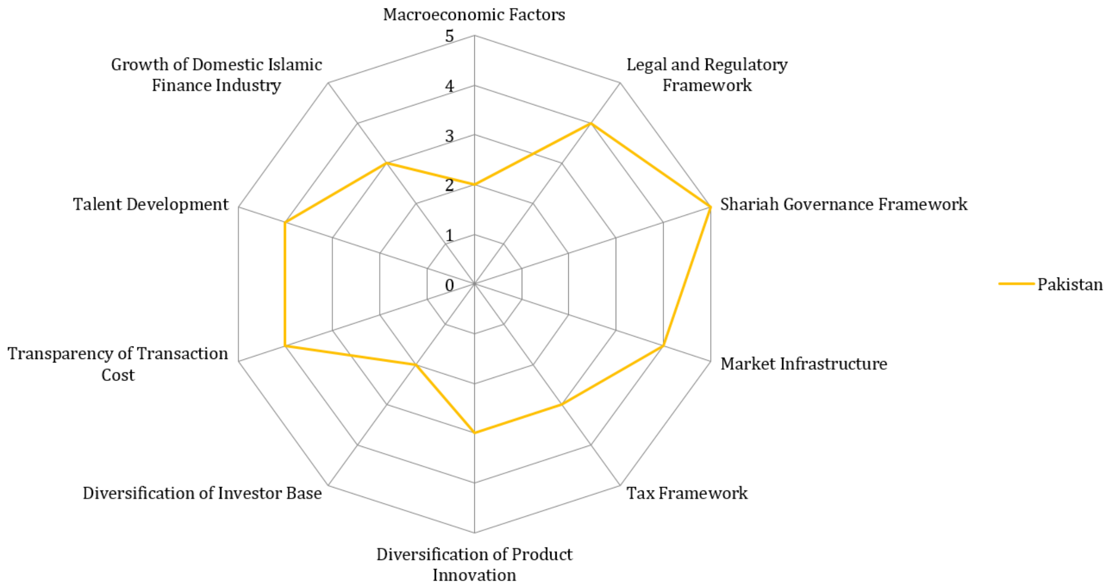
Lack of secondary trading in sukuk: The majority of GoP *ijarah* sukuk have been issued at a fixed rate. In a monetary tightening environment, this has resulted in a lack of secondary trading in these instruments as no one wants to hold a fixed-rate instrument while the market rates are continuously rising. Hence, there is a dire need for the government to issue Islamic floating-rate instruments so that the same can remain competitive in the market.

4.3.5 Country-Specific Recommendations

Based on the various issues and challenges faced by Pakistan in developing its Islamic fund management industry, **Chart 4.16** summarises its current position, taking into consideration the principal critical success factors outlined in the development-stage matrix. Although Pakistan has advanced in many aspects that are required for the development of an Islamic fund management market, more concerted efforts must be made to improve other vital areas where it has moderate scores such as diversification of products and investible assets, and the overall growth of Islamic finance assets. Of paramount importance is the improvement of macroeconomic conditions, which would attract foreign investors and foreign AMCs to invest and set up their businesses in the country.

[13] However, it is noted that Modarabas have recently improved their quality of management and corporate governance, owing to better monitoring and surveillance methods instituted by the SECP. In 2012, the SECP introduced the Shariah Compliance and Shariah Audit Mechanism (SCSAM) to help *modaraba* sector in the image building. Enhanced disclosure and improved compliance with Prudential Regulations have also assisted the sector to be more transparent; hence able to regain confidence of investors. As at May-2018, the total assets of *modaraba* sector stood at PKR51,500 milliion.

Chart 4.16: Factors Influencing the Development of Pakistan's Islamic Fund Management Industry



Sources: ISRA, RAM

The study proposes some recommendations, as explained in **Table 4.16** and **Table 4.17**, to facilitate the further development of Pakistan's Islamic fund management industry, particularly on the demand and supply sides.

Table 4.16: Recommendations on Improving Demand (Buy Side)

Issues and Challenges	Demand (Buy Side) Opportunities
1. Lack of awareness among retail investors about Islamic funds as a tool for savings and investment	▪ Although the SECP has kick-started its awareness programme via JamaPunji and other initiatives, there must be more concerted efforts by various stakeholders, particularly banks that have more branches than AMCs, to penetrate retail investors in the suburban and rural areas. Combo products (combining Islamic banking facilities with Islamic funds) should be introduced. ▪ The SECP's short-term CMDP 2016-2018 should be complemented by a long-term Capital Market Masterplan (5 to 10 years) that sets a certain target to attract more retail investors. ▪ To facilitate new digital business models: The creation of seamless platforms and mobile applications will attract mass investors and improve financial inclusion.
2. Limitation of third-party distributions	▪ To provide more incentives to third-party sellers/distributors of mutual funds as they can reach more clients at the grassroots level, thereby creating a vibrant distribution network.
3. Duplication of know-your-customer (KYC) identification process	▪ Centralised and seamless KYC process will increase transparency and facilitate investors with one-time-only registration. Given this, there is a need to establish a

Issues and Challenges	Demand (Buy Side) Opportunities
	Centralised KYC Organisation (CKO) with a centralised database to record, maintain and verify the registration of investors. The SECP's issuance of Centralised KYC Organisation Rules 2017, under which CKO licensing has been granted to the NCCPL, is expected to streamline the consolidation of KYC process for all AMCs.
4. Taxation issues and challenges	▪ The limit of a four-year holding period for CGT should be abolished to attract more investors to mutual funds. ▪ Grant more tax incentives to investors to promote long-term savings and investments, instead of the current practice of limiting it to two years.
5. Capital protection in National Savings Scheme	▪ The government should reconsider the policy of guaranteeing capital and providing higher returns under the National Savings Scheme, as it would hinder the growth of the overall fund management industry. Investors would prefer to invest in this scheme instead of Islamic funds which are more risky and may yield lower returns due to additional expenses incurred by the funds.

Sources: MUFAP (2017), SECP (2016), ISRA

Table 4.17: Recommendations on Improving Supply (Sell Side)

Issues and Challenges	Supply (Sell Side) Opportunities
1. Limited Shariah-compliant investment avenues	▪ Introduction of short-term Islamic money market instruments such as Shariah-compliant T-bills and other similar government instruments. ▪ Improving more transparency and good governance of Modarabas by promoting mergers between small companies. In addition, regulation on Modarabas can be further enhanced by either of the following: - Increasing the limit on capital for the establishment or operation of a *modaraba* company. - Increasing supervision to ensure compliance with regulations. This would eliminate the trust deficit that *modarabas* face, thus creating more avenues for investible assets. ▪ Deepening the Islamic domestic debt market by getting more corporates to issue sukuk. However, this should be preceded by long-term sovereign sukuk for benchmarking and price discovery. ▪ Realignment and consolidation of various occupational savings, pension and retirement schemes in terms of their investment avenues and criteria.
2. Limited product innovation	▪ Creating an enabling framework for the introduction of Islamic ETFs through: - The amendment of some regulations pertaining to authorised participants and market makers: to allow AMCs to invest in ETFs and a constituent basket of securities; to enable banks and DFIs to act as authorised participants or market makers; exposure

Issues and Challenges	Supply (Sell Side) Opportunities
	limit under PR-6 should be amended. - Amendments to tax laws: transfer of securities to/from authorised participants to ETFs should not attract any capital gains tax. - Amendments by the PSX/SECP pertaining to the removal of circuit breakers and the breaking up of marketable lots.
3. Limited foreign investors	▪ The introduction of a structured plan to attract more foreign investors and the liberalisation of policies for AMCs to open up their business will provide more opportunities for the growth of Islamic funds.
4. Small market capitalisation	▪ Studies show a correlation between stock market capitalisation and the growth performance of mutual funds. This is evident in the case of Pakistan, where equity funds hold the biggest market share. Although the PSX has become one of the best performers in South Asia in 2016, its market capitalisation is still limited. More concerted efforts are required to encourage the listing of new companies, particularly those that are Shariah-compliant.
5. Shortage of talent in Islamic fund management	▪ The establishment of three centres of excellence for Islamic finance has, to some extent, filled the knowledge gap in the overall Islamic finance industry. Nonetheless, more initiatives should be taken to train professionals and distributors of Islamic funds, particularly on product development.
6. Taxation issues and challenges	▪ Reduction of withholding tax for AMCs, from 8% to 2% (as proposed by the Mutual Funds Association of Pakistan (MUFAP)), should be given consideration by the Federal Bureau Revenue (FBR) to increase AMCs' capacity to operate and offer more competitive products. ▪ The requirement to obtain an exempt certificate for exempt entities like mutual funds should be withdrawn, as the process is operationally cumbersome. In the interim, tax is withheld while funds end up being owed refunds that are difficult to extract from the FBR. ▪ Granting tax incentives to companies listed on the PSX will help raise the Islamic market's capitalisation, which would eventually provide more avenues for Islamic funds to invest in.

Source: MUFAP (2017), ISRA

4.4 Morocco

Morocco is a newcomer to the Islamic finance market; its Islamic fund management industry is officially non-existent. The regulatory framework to accommodate the development of the industry was initiated in 2014, with the enactment of the participation finance bill (Law No 103-12 issued in 2015). The industry scaled new heights when the Moroccan central bank, Bank Al-Maghrib (BAM), issued licences to eight Islamic banks (known as participation banks) in 2017. The banks launched their activities in mid-2017, offering Shariah-compliant funding products for automotive and real-estate purchases.

Morocco is still in the infancy stage of development for different segments of the Islamic finance industry. Its regulatory framework and infrastructural set-up are still in the process of being formulated and implemented. Morocco is currently undergoing several reforms to its financial sector, in particular working towards its vision of establishing a complete Islamic finance ecosystem. It is making strides in the development of its Islamic banking industry, *takaful* sector and Islamic capital markets, including equities, sukuk and Islamic funds.

This case study on Morocco attempts to delineate the current state of development of its Islamic finance market, with a special focus on the fund management industry. We will discuss the challenges and growth prospects of Islamic capital markets in general and Islamic fund management in particular. The choice of Morocco as a country case study is based on the following factors:

- Morocco is an emerging market in the MENA region, which recently started promoting Islamic finance. The country enjoys strong government support in achieving its vision of developing the various segments of the Islamic finance market.
- The equity market in Morocco is still small compared to other OIC-African countries. As such, it meets the 'infancy' criteria of a low level of development for conventional and Islamic funds.
- While most OIC-African countries fall within the 'infancy' stage, Morocco's access to data is deemed relatively easier.

4.4.1 Overview of Morocco's Islamic Finance and Islamic Fund Management Industries

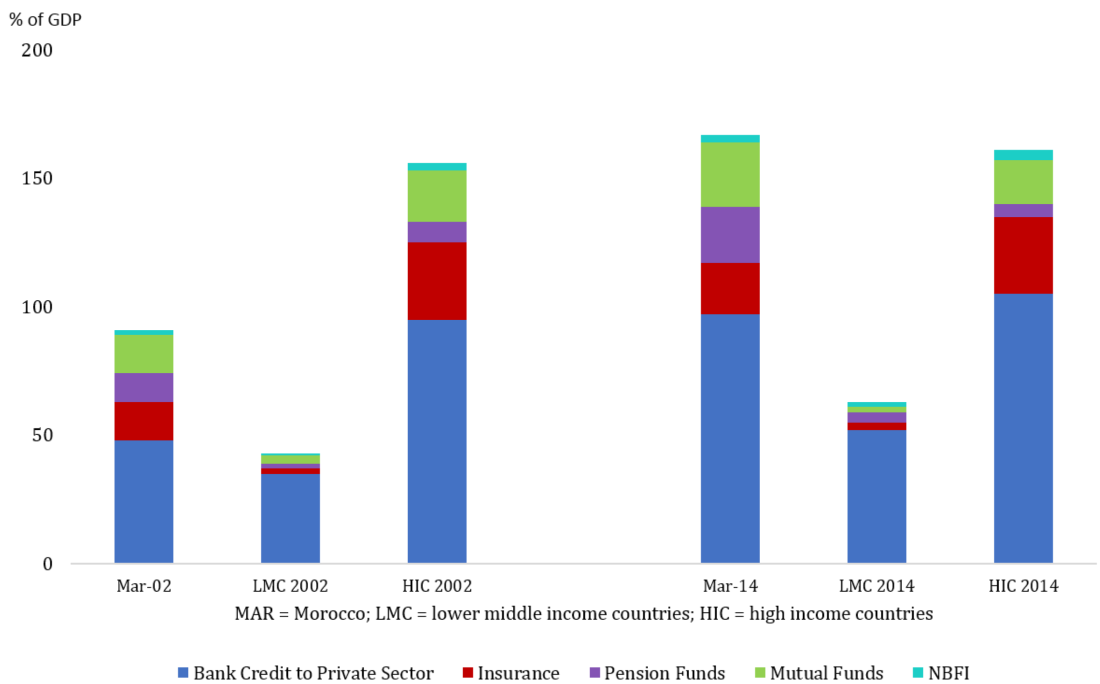
The Islamic Finance Country Index (IFCI) 2017, developed by Edbiz Consulting in 2011, ranked Morocco last (48th position) in terms of the state of development of Islamic banking and finance. This ranking had been announced at a time when the implementation stage of the various reforms to boost the industry had yet to commence in Morocco. Its Islamic banking industry only began in 2017, with eight participation banks.

The development of Morocco's Islamic banking and finance industry is in line with the country's efforts to rebuild its financial markets after the effects of the global financial crisis in 2007–2009, which had affected liquidity and curbed foreign investments. The stance was that Islamic finance could attract both liquidity and foreign investments, especially given Morocco's strategic connection with Europe, Africa and the Gulf region. The development of Islamic finance markets also aligned with the country's vision of developing Casablanca Finance City (CFC)—created under law No. 44-10 and enacted in December 2010, as amended and completed by Law 68-12 enacted in June 2014—as an international business hub and a leading financial centre in Africa (www.casablancafinancecity.com). The development of Islamic finance complements and expands the range of financial products offered, and increases the attractiveness and dynamism of Casablanca as a leading financial centre in Africa. Casablanca ranked 32nd in the Global Financial Centre Index 2018—and first among the African financial centres—ahead of Johannesburg (52nd) and Mauritius (56th) (GFCI 23, 2018). It featured among the 15 financial centres likely to become more significant in the near future.

Morocco's financial system is mostly concentrated on the banking sector while capital market development is still nascent. Its banking system is among the largest in the region, with total banking assets accounting for about 140% of GDP (IMF, 2016). This explains the country's strategy of venturing into Islamic banking first, before considering the development of other segments of the Islamic financial sector, such as *takaful* and Islamic capital markets.

The IMF's Financial Sector Assessment Report on Morocco (2016) notes that its financial system assets (banking, insurance, pension funds, asset management) have reached levels comparable to high-income countries, as reflected in **Chart 4.17**. The country's insurance sector represents 8% of GDP and is inter-connected with the banking and asset management sectors. The financial system also comprises microcredit associations and finance companies, the assets of which account for 10.5% of GDP. Morocco started upgrading its legal and regulatory framework in 2014, with a new banking law enacted the same year, and independent regulators created for the capital markets (Autorité Marocaine du Marché des Capitaux, AMMC) and insurance sector (Autorité de Contrôle des Assurances et de la Prévoyance Sociale, ACAPS). The regulator for the banking sector is Bank Al-Maghrib while the Ministry of Economy and Finance oversees financial sector policies and development.

Chart 4.17: Assets of Main Intermediaries in Morocco's Financial System

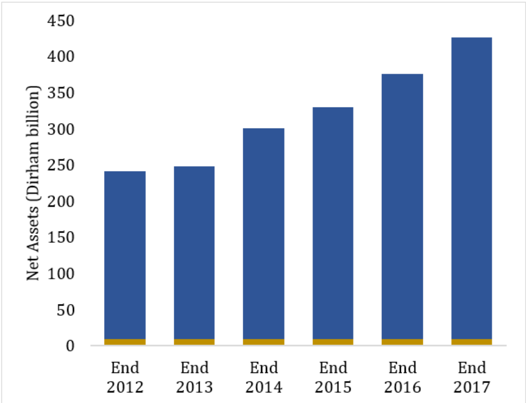


Source: IMF (2016)

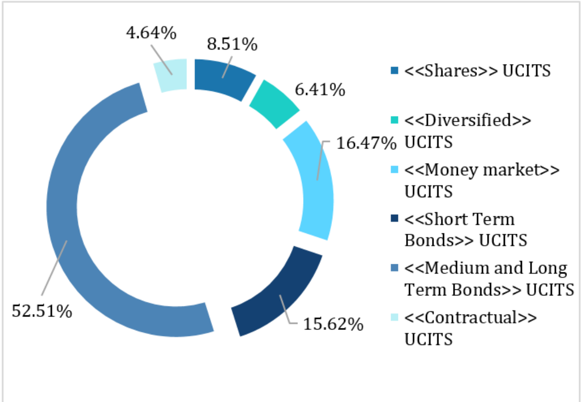
With regard to the fund management industry, UCITS reportedly constituted about 37% of Morocco's GDP as at end-2016, with changes in UCITS net assets having progressively increased through the years (AMMC, 2016, p 37). **Chart 4.18** depicts the changes in UCITS net assets from 2012 to 2017 and the breakdown of UCITS net assets by category as at end-2017.

Chart 4.18: Net Assets of UCITS

Changes in UCITS's Net Assets (2012-2017)



Breakdown of UCITS's Net Assets (end-2017)



Source: AMMC (2016, p. 38-40), AMMC (2017)

The fund management industry is relatively small in Morocco. The number of UCITS increased from 425 as at end-2016 to 432 as at end-2017 (AMMC, 2017), with about USD43 billion of AuM. These UCITS are managed by 17 asset managers. Their investments mainly comprise fixed-income securities (more than 80% of AuM) while the main investors are pension funds and the insurance sector. The fixed-income market is well developed, with risk diversity and tenors of up to 30 years. Besides these companies, 3 other asset managers also specialise in securitisation funds. As at end-2017, the number of securitisation funds stood at 9, about 6.3 billion Moroccan dirhams (about USD630 million) of net assets. In addition, 7 companies have been licensed as managers of PE funds. Only 4 PE funds have been created; their net assets came up to 500 million dirhams (about USD50 million) as at end-2017. General economic and financial statistics on Morocco are provided in **Figure 4.13**.

Figure 4.13: Morocco's Economic and Financial Fundamentals

Population: 36 million
Median age: 28.3 years

FDI inflow growth (2012-2016): 6%
GDP growth (2012-2016): 3.2%
GDP growth estimate: 3% (2018) and 4% (2019) (IMF)
GDP Distribution: Services (57%), Industry (29%), Agriculture (14%)

19 banks and 7 offshore institutions
Top 3 banks account for over 2/3 of banking assets and deposits
Banking sector accounts for about half of the financial system, with total assets making up 140% of GDP.
Banking penetration of population stands at 60%-70%.

Casablanca Stock Exchange is Africa's 3rd largest bourse after the Johannesburg and Nigerian stock exchanges. Houses 81 listed entities, with a total market capitalisation of USD71,136 billion in 2018.

Credit rating of Morocco: BBB- (S&P and Fitch), Ba1 (Moody's)

Morocco ranked 71st in the World Economic Forum's Global Competitiveness Index 2017-2018; 5th in Africa after Mauritius (45th), Rwanda (58th), South Africa (61st), Botswana (63rd).

Morocco ranked 5th largest economy in Africa by the IMF, based on 2016 GDP estimates (after Nigeria, Egypt, South Africa, Algeria).

Morocco ranked 69th in the World Bank's *Doing Business Index 2018*, 3rd in Africa after Mauritius (25th) and Rwanda (41st).

Sources: Moroccan Investment and Export Development Agency, IMF, Global Competitiveness Index 2017-2018, Doing Business Index 2018, Global Financial Report 2017-2018

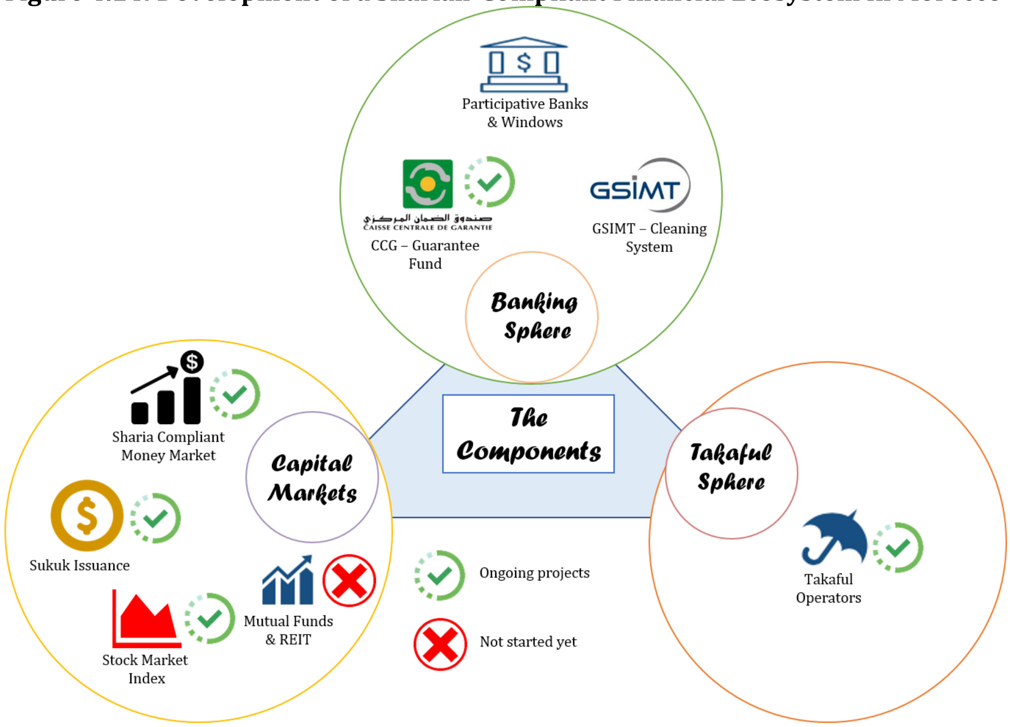
Developing a Shariah-Compliant Financial Ecosystem

The national objective of Morocco is to build a Shariah-compliant financial ecosystem, with an initial move towards the development of the Islamic banking sector and instituting regulatory changes to launch the *takaful* and sukuk markets. Jouti (2017) identified the initial priorities of the authorities as follows:

- First sovereign sukuk issuance and definition of a programme of issuances.
- *Takaful* operators launching their activities.
- Establish the deposit guarantee fund for Islamic banks, which will be managed by the Société Marocaine de Gestion des Fonds de Garantie des Dépôts Bancaires (the Moroccan Bank Deposits Guarantee Funds Management Company or SGFG).

The Islamic equity and funds markets are expected to follow thereafter, as the industry gains further traction. This segmented approach to developing the Islamic finance market is likely because the financial system is not regulated by a single authority (Jouti, 2017). Each sector is under the supervision of a defined entity, which requires more coordination in the implementation of this vision of developing an Islamic finance ecosystem. While operations in the banking sphere have started, work on the *takaful* and Islamic capital market sectors are still in progress, as shown in **Figure 4.14.**

Figure 4.14: Development of a Shariah-Compliant Financial Ecosystem in Morocco



Source: Jouti (2017)

Therefore, the current Islamic finance market in Morocco only constitutes participation banks. In January 2017, the central bank announced that 8 participation banks, of which 5 were full-fledged banks and 3 Islamic windows, had been granted licences to operate in Morocco. The full-fledged banks comprised joint ventures between Moroccan banks and foreign Islamic banking operators from the Gulf region, as detailed in **Figure 4.15**. The participation windows were 3 affiliated French banks which had operations in Morocco.

Figure 4.15: Participation Banks in Morocco – 5 Full-Fledged Banks and 3 Windows

4 joint ventures between local banks and foreign Islamic banking operators				1 Local Islamic Bank	3 Islamic Windows
Islamic Bank	Islamic Bank	Islamic Bank	Islamic Bank	Islamic Bank	Islamic Windows
• Crédit immobilier et hotelier (CIH) Bank in partnership with Qatar International Islamic Bank (QIIB) - launched **Umnia Bank**	• BMCE Bank of Africa jointly with the Saudi/Bahraini group Dalla Al Baraka - launched **Bank Tamwil wal Inmae (BTI)**	• Banque Centrale Populaire with the Guidance Financial Group – launched **Bank Al Yousr**	•Crédit Agricole du Maroc in partnership with the Islamic Corporation for the Development of the Private Sector (ICD), a subsidiary of the Islamic Development Bank, Jeddah, Saudi Arabia – launched **Al Akhdar Bank**	• Attijariwafa Bank, currently acting alone, although it has started negotiation with possible partners – launched **Bank Assafa**	•Banque Marocaine du Commerce et de l'Industrie (BMCI) •Crédit du Maroc – launched **Arreda** •Société Générale Marocaine de Banques - launched **Dar al Amane**

Sources: Rodríguez and Bensar (2017), Tantaoui (2017), Jouti (2017)

The current banking products approved by the Council of Scholars, a specialised committee in Islamic finance set up by the Higher Council of Ulemas, are:

- Deposit investment products.
- Financing products, notably *murabahah* for vehicles, homes and real estate.

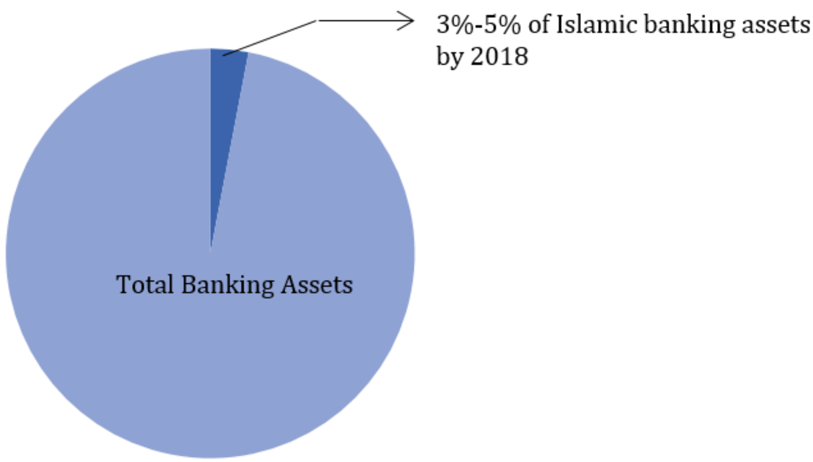
Global and Domestic Market Shares of Islamic Finance Assets

With the launch of participation banks in Morocco, Fitch Ratings (2017) estimated that the growth of Islamic banks in the initial years of development would be strong, similar to countries such as Turkey and Indonesia. Thereafter, the growth potential may be limited by the rapidly expanding banking segment, where there are approximately 70 accounts for every 100 Moroccans. According to Fitch Ratings, this suggests that Muslims in Morocco have not shied away from the conventional banking system based on their faith. It is therefore unlikely that participation banks would wrest significant market share from the existing and well-established conventional banks. The deposit bases of banks could increase by 5% to 10%.

Nonetheless, two market surveys have found substantial interest from the population in Morocco in participation banking. A survey by the Casablanca Stock Exchange (2017), which interviewed 1,003 individuals aged over 18 years from 12 urban and rural areas, revealed that there was interest from 34% of the sampled population in Islamic banking products from participation banks. An earlier survey conducted by Islamic Finance Advisory and Assurance

Services (IFAAS) in June 2012 (Thomson Reuters 2014) had sampled 813 individuals aged between 18 and 55 years from a variety of socio-economic backgrounds from cities and the surrounding rural municipalities of Casablanca, Rabat, Marrakech, Agadir, Fes, Tangier and Oujda. It revealed that 79% of the respondents said they would be 'very interested' in participation banking services once available, but that they were price-sensitive. A Thomson Reuters report (2014, p. 16) estimates that the participation banking sector could account for 3%-5% of Morocco's banking assets by 2018, with participation banking assets making up USD5.2–USD8.6 billion and generating USD67–USD112 million of profit to Islamic finance providers (see **Chart 4.19**). Nonetheless, with the current evolution of the Islamic banking industry and still a lack of understanding and awareness on the industry among the Moroccan population, this figure may be grossly overestimated. Updated figures from the Moroccan authorities are not available.

Chart 4.19: Participation Banking Assets against Total Banking Assets



Source: Thomson Reuters (2014)

With regard to the development of the other sectors of the Islamic finance market, laws have already been enacted for the launch of *takaful* companies under a new insurance law passed in 2016, and for the issuance of sukuk under a sukuk bill passed in February 2018, which amended Morocco's securitisation law. However, no *takaful* company or sukuk has been launched so far. Details of a sukuk issuance are currently being firmed up, with the first issue expected in 2018. As regards Islamic asset management, there has been no development to date in terms of a legal and regulatory framework. The global shares of the various segments of Islamic finance assets and the development outlook for Morocco are discussed in **Figure 4.16**.

Figure 4.16: Global Market Shares of Islamic Finance and Outlook for Morocco

	ISLAMIC BANKING	SUKUK	ISLAMIC FUNDS	TAKAFUL
Global Market Share (as at end-2016)	Total Islamic banking assets reached USD1.6 trillion.	Global outstanding sukuk increased to USD344.8 billion.	Global Islamic AuM summed up to USD91.3 billion, with 1,394 Islamic funds.	Total *takaful* gross contributions stood at USD42.5 billion.
Outlook for Morocco	With legal and regulatory frameworks in place and participation banks already operational, healthy demand prospects are expected to further boost the sector and increase Islamic banking assets to 3%-5% of total banking assets by 2018.	The sukuk bill was passed in February 2018, amending Securitisation Law 2014. It aims to offer a wider range of sukuk structures and facilitate the sale of these instruments. The sukuk market is poised for development with the first dirham-denominated sovereign issue planned in 2018.	Legal and regulatory framework still non-existent for the Islamic fund-management industry. This segment of the market is expected to be developed in due course.	Laws have been enacted for the launch of *takaful* companies; a new insurance law was passed in 2016. Work is under way for the launch of *takaful* operators and market activities.

Source: ICD-Thomson Reuters (2017), ISRA

4.4.2 Evolution of Morocco's Islamic Finance and Islamic Fund Management Industries

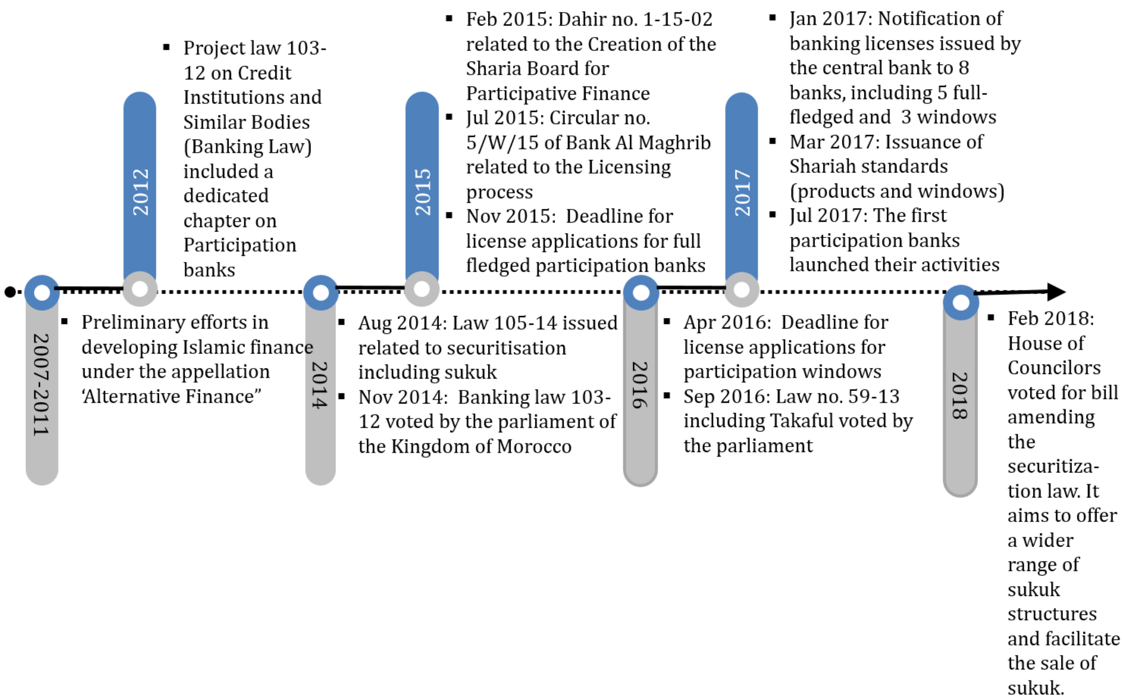
Morocco's attempt to introduce Islamic finance started in 2007, under the appellation of 'alternative finance' (Thomson Reuters, 2013). The development was on a small scale and drew little response from most of the population. A study by Soudi and Cherkaoui (2015) reports the following:

- The central bank developed a regulatory framework allowing local banks to offer *ijarah*, *murabahah* and *musharakah* products through their own distribution networks or the creation of dedicated subsidiaries.
- The authorised products only concerned financing and not deposits, as the central bank allowed customers to deposit their money in the form of 'non-productive deposits' accounts.
- Four of the 19 local banks offered Islamic banking products, notably Attijariwafa Bank, Banque Populaire, BMCE and BMCI. The focus was more on *murabahah* products rather than *ijarah*, while *musharakah* was not offered. Transactions had yet to exceed 1 billion Moroccan dirhams by 2012.
- Constraints faced included taxation issues, the high cost of the products, marketing issues and market participants' weak commitment.

Enactment of the New Banking Law 2014 had revived the development of Islamic banking in Morocco. Project Law 103-12 on Credit Institutions and Similar Bodies (Banking Law) provides a revised legal framework to regulate the activities of banks and similar organisations conducting business in Morocco, and includes a chapter on participation banks (Jouti, 2017). The new wave of development, backed by strong political support, lends consideration to the building of a robust legal and regulatory framework for the development of a comprehensive

Islamic finance ecosystem; puts in place an appropriate Shariah governance framework; adopts a progressive approach to developing the market with an initial focus on Islamic banking, *takaful* and sukuk; and secures the commitment and collaboration of the market players to jointly build the Islamic finance ecosystem. The key milestones in the recent development of the Islamic finance industry are detailed in **Figure 4.17**.

Figure 4.17: Key Milestones of Morocco's Islamic Finance Industry



Sources: Jouti (2017), IFN (2018)

While the Islamic fund management industry is not regulated yet, there is some interest from fund managers to manage Islamic funds. One of the fund managers that offers an ethical fund (Shariah-compliant in principle) under its thematic funds scheme is Wafa Gestion. **Box 4.6** provides some salient information on this fund.

Box 4.6: Wafa Gestion – Attijari Al Moucharaka Fund

Wafa Gestion was established in 1995. It is a subsidiary of Attijariwafa Bank (the Pan-African bank listed on the Casablanca Stock Exchange) and Amundi (one of the world's top 10 asset managers). It was rated 'Excellent (mar)' by Fitch Ratings for its vast experience and skills in asset management, leadership position in the Moroccan market, trained personnel and product offerings. It has 81 funds under management, with an estimated 110 billion dirhams of AuM. Its share of the asset management market stands at around 27.11%.

Wafa Gestion launched two funds, not marketed as Shariah-compliant and without formal endorsement by Morocco's Council of Scholars, but specifically structured to be compliant in the eyes of major investors. Its first ethical fund is named the Attijari Al Moucharaka Fund. It has a retail focus and its AuM is approximately 430 million dirhams. The fund aims to provide capital appreciation over a minimum investment period of 5 years, and has been specifically structured so that its listed securities will outperform the MASI index over a 5-year period.

Investible assets: Shariah-compliant listed securities
Reference index: 100% MASI
Recommended investment period: Minimum 5 years
Maximum upfront fee: 3%
Maximum redemption fee: 1.5%
Maximum management fee: 2.4%

Wafa Gestion employs two filters to determine the Shariah-compliance of equities:

- Sectoral (excluding banks, insurance, leisure and alcohol)
- Financial (Debt/Total assets < 33%, Financial income/Net income < 10%)

The screen provides for 35 compliant stocks (representing more than 55% of total market capitalisation) out of the total 75 stocks listed on the exchange.

Attijari Al Moucharaka has a different investor's structure compared to the local asset management industry. More than 2/3 of its clients are individuals while the industry has more institutional investors. Some are Islamic-only investors. The fund has generally performed well, with a 20% alpha over the Index in the last 10 years.

The second Shariah-compliant fund is considerably smaller with 6 million dirhams of AuM; it is an ethical retirement fund targeting retail investors.

Source: Wafa Gestion (nd)

4.4.3 Investment and Commercial Considerations

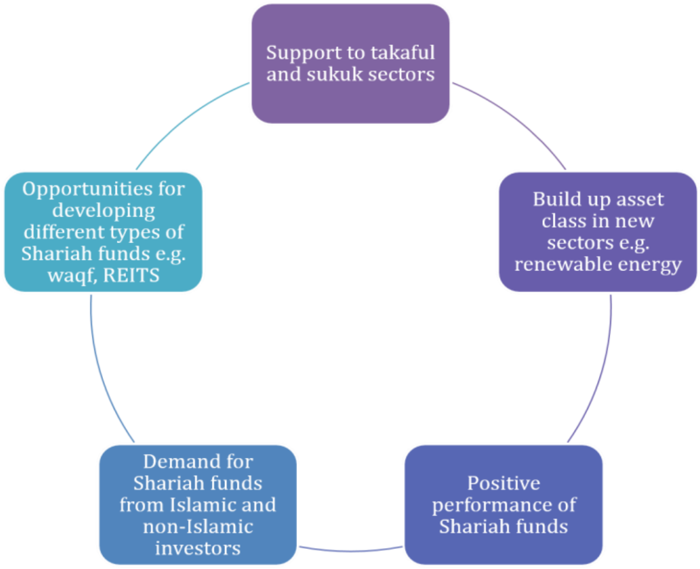
Morocco's Islamic finance industry is poised for growth. The country has the necessary economic, financial and political fundamentals to position itself as an international financial centre and a regional financial hub, incorporating the entire gamut of Islamic financial products and services. Investment funds are among the key products that Morocco can tap.

Among the investment and commercial considerations for the development of Islamic funds in Morocco is for the industry to build up the asset side of the market, by creating liquidity and thus supporting the sukuk and *takaful* sectors. The case of Wafa Gestion, expounded in **Box 4.6**, lends support to the positive performance of Shariah-compliant funds and their demand by investors, both Muslim and non-Muslim. The fund invests in equities listed on the Casablanca Stock Exchange. If the stock exchange comes up with an official list of Shariah-compliant equities which it publishes and updates regularly (as in the case of Malaysia, for example), it will certainly promote the creation of more Islamic equity funds. The development of an Islamic index over time will promote the creation of even more ETFs.

There is also significant potential for the development of new asset classes in Morocco, such as renewable energy, green finance, healthcare, real estate (e.g. student accommodations, retirement homes), and innovation and technology. Morocco has particularly clear and ambitious renewable-energy goals, to produce more than half of its energy needs through renewable sources by 2030. The move represents part of a national push to curb greenhouse gas emissions, reduce pollution, and improve Morocco's energy security. The promulgation of a renewable energy legal framework has propelled the nation to becoming a stable destination for renewable energy investments.

Furthermore, opportunities exist for the development of a whole range of Islamic funds, from Islamic UCITS to Islamic REITs and from commodity funds to *waqf* funds. There are already several UCITS in Morocco, which have gained appeal among international investors because they provide a certain level of investor protection and meet international regulatory standards. Developing Islamic UCITS can attract funds from international Islamic investors. On the other hand, currency convertibility and capital repatriation are likely issues, as with the other countries in the case studies. There is also the potential for the development of *waqf* funds by encouraging public-private-philanthropic partnerships to develop *waqf* assets and invest in social objectives. **Figure 4.18** summarises some of the investment and commercial considerations for the development of the Islamic fund management sector in Morocco.

Figure 4.18: Investment and Commercial Considerations in Developing Morocco's Islamic Funds



Source: ISRA

Morocco is currently working on the launch of REITs. The legal structure of REITs in Morocco is based on the Organismes de placement collectif en immobilier (OPCI) (or collective undertaking for real estate investment), the laws of which were passed in August 2016. The authorities are currently working on regulations/circulars, which are expected to be released in 2018 following the approval of the Ministry of Economy and Finance. Investments in real estate are one of the important asset classes in the Islamic finance industry; the OPCI Law is a significant opportunity to align Shariah compliance with investments in real estate. They will allow financial institutions in the participation finance sector to mobilise new resources by transferring their real assets to REITs.

The OPCI Law allows REITs to issue sukuk, shares and other securities. A Shariah-compliant REIT modelled on the *ijarah* contract only invests in real estate meet Shariah requirements (representing at least 60% of investments), limits the extent of debt, avoids speculative activities and specific Shariah non-compliant sectors. It is expected that REITs units can be sold for as low as 100 dirhams so that it is accessible to retail investors and generate annual returns of 6%-7%. REITs are expected to have a potential AuM of at least 200 billion dirhams, according to the Moroccan Ministry of Economy and Finance.

One of the first REIT market players, AjarInvest, is getting ready to launch its operations once the regulatory framework is finalised. **Box 4.7** discusses the case of AjarInvest.

Box 4.7: The Case of AjarInvest – A REIT in the Making

AjarInvest is set to become one of the first companies in Morocco to be authorised by the regulator to launch a REIT management company under the legal structure of OPCI in Morocco. AjarInvest is a subsidiary of CDG and CIH Bank, and has been leveraging the experience of the group in fund management and real-estate investments to venture into structuring REITs. Its management has been one of the contributors to the regulators' efforts in developing the legislation of REITs in Morocco.

Source: AjarInvest

4.4.4 Key Factors Underpinning the Development of Morocco's Islamic Fund Management Industry

Morocco seeks to establish a comprehensive Shariah-compliant financial system, with each segment of the Islamic finance industry integrated within the sectorial strategy of the respective components of the financial system, i.e. Islamic banking within the banking sector, *takaful* within the insurance sector, and the ICM within the capital markets. The authorities have thus put in place the necessary building blocks for the proper functioning of the industry, as explained below. The Islamic fund management industry, when established in the Moroccan market, would thus operate within the same infrastructural set-up that oversees the entire Islamic finance industry.

Legal and Regulatory Framework

Morocco has adapted its legal and regulatory framework to meet the requirements of Islamic financial institutions. Instead of issuing dedicated laws, it has amended its existing laws to provide a suitable legal and regulatory structure for the development of Islamic finance, for example:

- Participative banks and windows: Banking Law no. 103-12
- *Takaful* operators: Law no. 59-13
- Sukuk issuances: Law no. 5-14
- Shariah governance: Dahir no. 1-15-02
- Tax law: General tax code CGI

The aim is to ensure neutrality between Islamic and conventional financial institutions in terms of requirements.

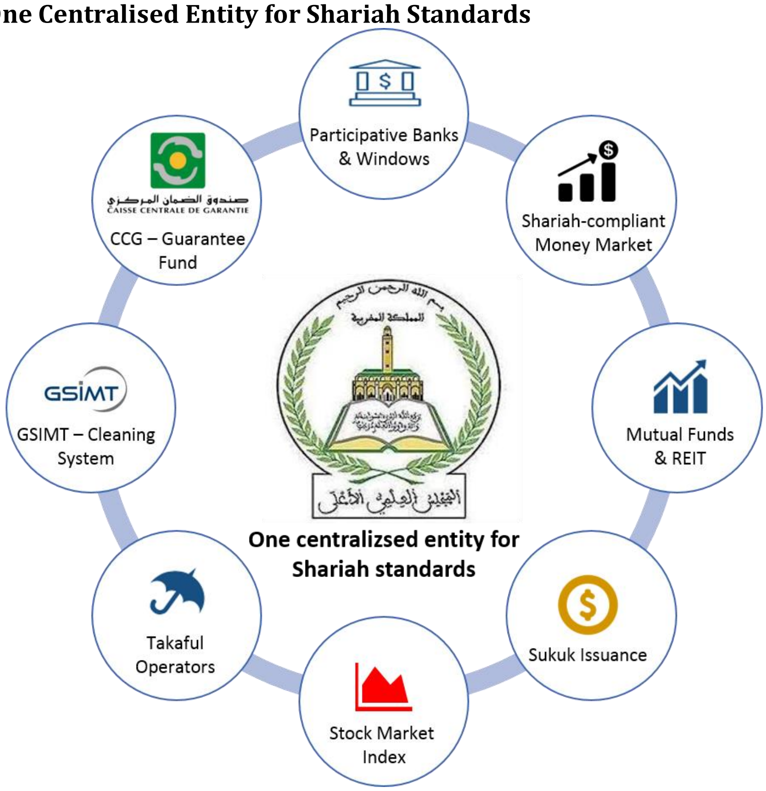
Regulatory texts are mainly inspired by Maliki laws in Morocco. However, they should be drafted with an openness to other schools of thought and inspired by banking practices (Jouti, 2017). The market is currently awaiting these regulations (e.g. technical notes, circulars) for the launch of *takaful* operations and a legal framework for the Islamic fund management market.

Centralised Shariah Governance

Morocco has adopted a centralised Shariah governance system to issue Shariah standards for the entire Islamic financial sector. The Higher Council of Ulamas is appointed by the King and is the only entity in the country authorised to issue *fatwas* on different matters. The Higher Council of Ulamas has set up a specialised committee on Islamic finance, i.e. the Conseil Supérieur des Oulémas (CSO or Council of Scholars), that oversees and approves all aspects of Shariah compliance for the overall Islamic finance ecosystem in Morocco, as shown **Figure 4.19.** The CSO is composed of nine members and one coordinator, and can add five experts who will assist the committee in its decisions and orientations (Jouti, 2017). The CSO works independently of Islamic financial institutions, to ensure credibility and neutrality in terms of *fatwas* and opinions. The CSO has to date approved investment deposit products and three *murabahah* financing products for Islamic banks.

Since Shariah approval and compliance issues are tackled by only one authority, i.e. the CSO, there are inevitably many issues that require approval and the process of approval takes longer. The development of the Islamic fund management market, Islamic stock screening and Islamic indices are currently in the queue as the existing priority areas are Islamic banking, *takaful* and sukuk. Furthermore, the Shariah standards approved are at present only applicable to the products of Islamic banks (e.g. *murabahah* for vehicles, real estate and houses). This means that the *fatwas* are shared by all the market players. As such, the system currently does not provide much room for product innovation. This element is expected to come as the market develops further.

Figure 4.19: One Centralised Entity for Shariah Standards



Source: Jouti (2017)

Regarding Shariah review and audit, a Shariah compliance function has been instituted at the level of each financial institution - to ensure that Shariah standards issued by the CSO comply with and procedures and operations in consonance with the guidelines of the CSO. This function works like an internal review process that provides oversight on Shariah compliance. However, the issue of external audit has yet to be addressed by the CSO and the regulators. They have yet to decide whether external audits will be conducted by external audit firms or other parties.

Infrastructure Institutions

Morocco has different regulators for the banking, insurance and capital markets:

- Banking: Bank Al Maghrib
- Insurance: Autorité de Contrôle des Assurances et de la Prévoyance Sociale (ACAPS)
- Capital markets: Autorité Marocaine du Marché des Capitaux (AMMC)
- Tax and Financial policies: Ministry of Economy and Finance

Each regulator is in charge of its respective Islamic finance segment of the industry. The regulators have been working closely with market players to address their needs and meet international best practices in the development of Islamic finance. Similar expectations prevail for the development of the Islamic fund management industry.

Tax Framework

The tax framework has been amended to accommodate Islamic finance operations in Morocco, including double taxation that arises under *murabahah*, registration tax for real-estate transactions, and tax changes for sukuk to set a level playing field. The principle adopted is to ensure neutrality between conventional and Islamic products.

Demand Side

Investor base: Market surveys have indicated that a large segment of the 99% Muslim-majority population of Morocco is interested in living their faith through access to Shariah-compliant finance. The offer of Shariah-compliant funds will give an opportunity to retail investors to receive attractive returns while benefiting from professional management of their funds. Based on the performance of the Shariah-compliant fund offered by Wafa Gestion, the prospects for competitive returns on Shariah-compliant funds appear positive. An attractive return of 6%-7% is even expected to be generated by prospective REITs. Shariah funds will also represent an alternative investment avenue for those who have previously been over-dependant on bank deposits. The investor base for Islamic funds will also constitute institutional investors, especially the newly developed participative banking institutions as well as prospective *takaful* operators and institutional sukuk holders. The majority of investors in conventional funds are institutional (above 90% as per AMMC annual report 2016) and it may be the same scenario with Islamic funds. Furthermore, as the Islamic finance market develops over time, Islamic UCITS can draw the interest of international investors from regional countries and also Europe.

SMEs: SMEs play a significant role in Morocco. They account for about 95% of the country's operating businesses, contribute 30% to GDP and 48% to employment (Thomson Reuters, 2013). Access to finance at competitive rates is a common issue for SMEs. The development of Shariah funds, especially PE and VC funds, will provide a boost to the SME sector by injecting both capital and know-how.

Supply Side

New financial instruments in the making: At the level of the capital markets, several financial instruments are under way, including collective undertakings for real-estate investment (REIT/OPCI), sukuk, crowdfunding, green finance (including green bonds, which have been issued by three issuers). Additional products could be included in the list under consideration by the capital market authority (AMMC), such as SRI-Shariah funds, SRI sukuk, listing of sukuk on the Casablanca Stock Exchange, listing of Shariah-compliant securities, and an Islamic stock market index. These products could be considered under the country's Financial Sector Roadmap for Sustainable Finance and Development. The AMMC is taking several measures to promote the integration of sustainable dimensions into the governance model of issuers and asset managers and within their decision-making processes. The development of Shariah funds fall within the scope of these initiatives, notably the development of sustainable financial instruments and products, the promotion of financial inclusion, market transparency and discipline, among others.

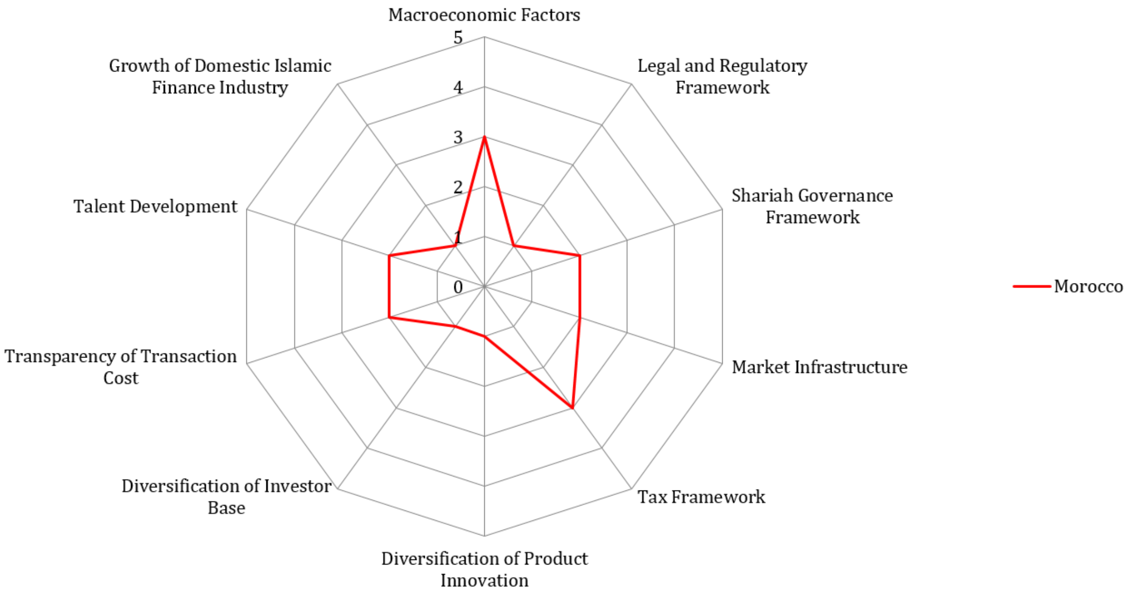
Availability of quality Islamic assets and opportunities to promote new funds: Morocco has several levels of quality for assets that underpin the development of the Islamic fund management industry, i.e. renewable energy, real estate, logistics, infrastructure, industry/agriculture, *waqf*. The scope for developing Shariah funds can thus be extended to include different types of funds, including:

- Pension funds
- *Waqf* funds
- Shariah-compliant SRI funds
- Technology and science funds
- Infrastructure funds

4.4.5 Country-Specific Recommendations

Morocco can be categorised as a market with a low level of development for conventional and Islamic funds. Based on the principal factors underpinning the development of the Islamic finance market as well as the critical success factors outlined in the stage-of-development matrix (outlined earlier), **Chart 4.20** summarises the country's current position in the development of Islamic funds.

Chart 4.20: Factors Influencing the Development of Morocco's Islamic Fund Management Industry



Sources: RAM, ISRA

There are several recommendations to improve the demand and supply sides of Islamic fund management in light of the issues and challenges faced by the industry. These are discussed in **Table 4.18** and **Table 4.19**.

Table 4.18: Recommendations on Improving Demand (Buy Side)

Issues and Challenges	Demand (Buy Side) Opportunities
1. Market education and awareness	▪ Building market awareness is important to increase customer buy-in and for the successful implementation of participation finance. Awareness is required at the level of customers, investors, lawyers, employees, market players and other stakeholders such as the general population. ▪ In this context, regulators, universities, training institutions and the marketing campaigns of banks and financial institutions can play an important role. ▪ Market education and awareness require continuous efforts and investment, to create a shift in mindset from conventional to Islamic finance. ▪ There is a need for more financial literacy at all levels in Morocco. According to the EMNES Financial Development and Inclusion Study (2018), knowledge of financial concepts is very low in the country, e.g. only 40% understand how inflation affects their savings. To promote Islamic finance, awareness of Islamic finance terms, principles and how the system works also need to be developed.
2. Fintech	▪ Efficient utilisation of fintech can be leveraged to increase market traction, e.g. by reducing costs, expanding online services, and extending customer outreach. The marketing of Shariah funds can also be improved through fintech.

Issues and Challenges	Demand (Buy Side) Opportunities
3. Develop a national savings strategy	▪ To heighten the appeal of Islamic funds, the government can launch a national savings and investment strategy, with incentives that encourage people to invest through responsible investments that create a social impact. This will in turn expand demand for SRI Shariah funds while boosting the impact on society and the environment. ▪ Islamic funds can also be promoted as an alternative avenue of investment, with better risk-adjusted returns than bank accounts.

Source: ISRA

Table 4.19: Recommendations on Improving Supply (Sell Side)

Issues and Challenges	Supply (Sell-Side) Opportunities
1. Shariah approval	▪ At present, it takes time to obtain *fatwas* from the CSO as the CSO has to deal with many issues arising from the various market segments. A possible strategy could be to create two sub-committees: (i) one that works on Islamic banking and *takaful* issues; and (ii) another that works on Islamic capital market issues (i.e. sukuk, Islamic fund management, REITs, equity market). ▪ This will help to reduce the time taken to secure Shariah approval and Shariah advice on issues. A similar approach is adopted by jurisdictions such as Malaysia, which has two SACs (at the levels of the central bank and the SC).
2. Shariah governance	▪ While internal Shariah compliance has been instituted at the level of participative banks, there is currently no guidance on external Shariah audits and reviews. The roles of the parties involved in Shariah audits and reviews within the different components of the Islamic finance market (e.g. for sukuk, *takaful*, Islamic funds) need to be properly defined to ensure effective Shariah governance of products and procedures.
3. Developing industry standards on Shariah screening approaches, income purification and *zakah* processes	▪ To develop the Islamic fund management industry, there is a need to develop industry standards by the CSO on Shariah screening of stocks, income purification and *zakah* payment. This will enable the creation of a list of Shariah-compliant securities, the publication of such a list on a regular basis, and the development of an Islamic index as the list of Shariah-compliant securities grows over time. This approach was followed by Malaysia when it first issued its list of Shariah-compliant securities in June 1997. The number of Shariah-compliant securities had been small initially, before rising to 686 as at 24 November 2017 (Securities Commission Malaysia, 2017).
4. Roadmap for the development of the Islamic finance industry	▪ With a number of regulators involved in the financial sector, there is a need to establish a coordination committee to oversee the development of the entire sector. One of the responsibilities of such a committee would be to develop a blueprint that maps the development of a harmonised Islamic finance ecosystem in Morocco and defines its vision, objectives, implementation targets and timeline for the development of the various components of the ecosystem. This will enhance transparency and strengthen the coordination efforts of the different stakeholders in the industry. ▪ There is also a role in developing new institutions within the industry to promote the further progress of the Islamic finance industry. Examples:

	rating agencies, research institutions. ▪ Research institutions specialising in the field of Islamic finance, for example, will conduct industry-based research to address implementation issues when applying Islamic finance in practice.
5. Innovative products	▪ Currently, the market is not innovative in terms of product development. Standard products using the contract of *murabahah* have been approved by the CSO and used by all participative banks. ▪ The market can, however, be innovative in terms of the development of various types of Shariah-compliant funds, such as *waqf* funds, equity funds, i-REITs and SRI Islamic funds, once the infrastructure for Islamic funds has been established by the authorities.
6. Human capacity	▪ Trained personnel are a necessity for the efficient and effective implementation of Islamic finance policies. Training is required in the aspects of Shariah compliance, product development, accounting and tax, Islamic stock screening approaches, risk management and many other areas. ▪ Collaborative efforts are required between market players and regulators to build up human capacity for the industry.
7. Competition from conventional finance	▪ While the conventional finance industry is well established, Islamic finance is a recent initiative. Islamic financial institutions should ensure high standards of service to broaden their customer bases. Islamic funds will also be successful if they offer competitive risk-adjusted returns.

Source: ISRA

4.5 South Africa

Africa has untapped potential in Islamic finance, ranging from Islamic banking, *takaful*, sukuk for infrastructure development and Shariah funds. Home to more than 250 million Muslims and with the presence of Islamic finance in more than 21 African countries, the African continent is well poised to become a strong contender in the development of Islamic finance. The region's positive trends that include a rapidly expanding population, rising consumer spending, economic needs and a modest rebound in GDP growth support this ambition.

South Africa had been the first Sub-Saharan African country to establish itself as a potential hub for Islamic finance. Despite its relatively small Muslim population (1.5% of total population), South Africa is ranked among the top 10 countries in terms of contribution to the global Islamic fund management industry.

This case study on South Africa aims to examine the present environment and development of its Islamic finance industry, with a specific focus on the Islamic fund management segment. The issues and challenges faced by the country will be analysed and recommendations proposed. South Africa has been chosen as a case study for the following reasons:

- Its unique value proposition is envisaged to encourage other non-Muslim countries to consider the benefits of encouraging the development of their own Islamic finance markets.
- Given the level of development of its conventional financial system, South Africa has a competitive edge over most African countries in actively capturing and promoting the Islamic finance industry.

4.5.1 Overview of South Africa's Islamic Finance and Islamic Fund Management Industries

A Snapshot of South Africa's Islamic Financial Market Landscape

South Africa has one full-fledged Islamic bank, four Islamic banking windows offered by conventional banks, one *takaful* company and seven Islamic AMCs. **Table 4.20** compares the Islamic finance products offered by Sub-Saharan African countries:

Table 4.20: Islamic Finance Activity in Sub-Saharan Africa

Country	Issued sukuk	Planning sukuk	Islamic banks	Islamic windows	Foreign Islamic banks	Islamic micro-finance	Other Islamic products	Islamic funds	Islamic regulation
Nigeria	√	√	√	√			√	√	√
South Africa	√		√	√	√			√	√
Sudan	√		√		√	√	√		√
Senegal	√		√				√		
Gambia	√		√				√		√
Kenya		√	√	√	√		√		√
Tanzania			√	√					
Mauritius			√	√					√
Zambia				√	√				√
Uganda			√						√
Niger		√	√						
Ethiopia				√		√			

Country	Issued sukuk	Planning sukuk	Islamic banks	Islamic windows	Foreign Islamic banks	Islamic micro-finance	Other Islamic products	Islamic funds	Islamic regulation
Botswana				√					
Ghana				√		√			
Guinea			√						
Cameroon				√					
Chad				√					
Djibouti			√						√
Mozambique					√				
Mauritania			√				√		
Cote d'Ivoire		√							

Source: The Economist (2015)

On 1 April 2018, a new regulatory model known as Twin Peaks was implemented in South Africa. The entire South African financial market is supervised by the Financial Sector Regulation (FSR) Act, which was signed in August 2017 and came into effect on 1 April 2018. The legislation will bring about a major transformation of the South African financial services regulatory and risk management frameworks, including the move to a Twin Peaks approach to regulation.

The Twin Peaks model regulates prudential and risks under two separate bodies, the Prudential Authority (PA)—contained within the South African Reserve Bank (SARB)—and the Financial Sector Conduct Authority (FSCA) (formerly known as Financial Services Board (FSB)). Both the PA of SARB and the FSCA become the resolution authorities responsible for the protection, maintenance and enhancement of financial stability. **Table 4.21** lists the regulators' roles and responsibilities within South Africa's financial markets.

Table 4.21: Regulators of South Africa's Financial Market

Regulator	Roles
National Treasury	▪ Increase investment in infrastructure and industrial capital. ▪ Improve education and skill development to raise productivity. ▪ Improve the regulation of markets and public entities. ▪ Fight poverty and inequality through efficient public service delivery, higher employment levels, income support and empowerment.
FSCA (formerly known as the FSB)	▪ Regulate and supervise the conduct of financial institutions. ▪ Ensure consumer protection and market conduct.
SARB	▪ Responsible for the prudential aspect of Twin Peaks. Therefore, this responsibility includes both micro and macro prudential aspects. ▪ The SARB has been mandated to protect and enhance financial stability.

Source: National Treasury's website, Financial Sector Regulation Act: Implementing Twin Peaks and the Impact on the Industry, The Banking Association of South Africa: Regulations for a Safer Financial Sector

Banking Sector

South Africa has a well-developed and efficiently regulated banking system consisting of a central bank (the SARB), a few financially strong banks and investment institutions, and many smaller banks. Based on Lafferty's 2017 Global Bank Quality benchmarking study, which analyses the quality of 100 banks across 32 countries, South African banks remained the world's most robust for a second year, despite a downgrade of its credit ratings.

As at end-2016, the South African banking sector constituted 17 registered banks, 3 mutual banks, 15 local branches of foreign banks, 2 co-operative banks and 36 foreign banks with approved local representative offices (South Africa Reserve Bank, 2016). As a result of being consistently rated as one of the world's most advanced and well-functioning banking systems, the South African banking sector has been able to elicit solid interest from abroad, with a portion of foreign banks establishing offices there and others acquiring stakes in major South African banks (The Banking Association South Africa (2014).

On the Islamic banking side, there is at present only one full-fledged Islamic Bank, i.e. Al Baraka Bank, which was established in 1989 and marked the beginning of Islamic finance in South Africa. Other banks have also launched Islamic windows alongside their conventional operations. There are currently four banks offering Shariah-compliant products through Islamic windows, i.e. First National Bank (FNB), Absa Bank, HBZ Bank and Standard Bank. In 2014, Islamic banking assets only accounted for 1%-2% of the total banking assets in South Africa.

Bond Market

In contrast to many emerging markets, South Africa's domestic bond market is very well developed based on the structural and regulatory perspectives. The existence of an established base of local institutional investors has been the key to the market's success. Other than that, a wide variety of instruments and ample liquidity have also driven the domestic bond market to become one of the world's most sophisticated bond markets, which in turn provides essential support to its broader economy. This is also partly attributable to historical reasons and government preferences.

In the 1970s and 1980s, economic sanctions were enforced on South Africa. The country was effectively denied access to international financial markets; this was aimed pressuring the South African government to end apartheid (racial segregation) (Levy, 1999). This had forced the government to fund its swelling deficit through the domestic bond market, which had then contributed to the development of the industry (Mboweni, 2006). Interestingly, although there was flexibility to invest offshore, most South African institutional investors and asset managers lacked foreign appetite and preferred to invest in local markets, which led to high levels of domestic investments.

To raise funds for sizeable capital projects such as roads, power stations and hospitals, government entities had issued bonds and listed them on the Johannesburg Stock Exchange (JSE) Debt Board. More than half of the debts listed on the JSE had been placed by the South African government. The JSE regulates the largest listed debt market in Africa, both by market capitalisation and liquidity. Currently, more than R1 trillion of government bonds are listed on the JSE's Debt Board; these instruments account for 90% of all liquidity reported to the JSE.

The first corporate bond was issued in 1992. Since then, more than 1,500 corporate debt instruments have been listed on the JSE Debt Market. Over the years, corporate debt issuance has increased but the liquidity of corporate debts remains relatively poor compared to government debts.

Following legislative reforms in 2011, South Africa issued a USD500 million sukuk in September 2014. It became the third non-Muslim country to issue sukuk after the UK and Hong Kong. The sukuk had been four times oversubscribed and one half of the subscription allocation had been given to investors from the GCC. The issuance of the sukuk represented part of efforts by the National Treasury to diversify its funding and investor bases. Plans are afoot to issue South Africa's first domestic rand-dominated sukuk, with the aim of expanding Islamic finance beyond the banking sector (The Economist, 2015).

Fund Market

South African funds are regulated by the FSCA under the Collective Investment Schemes Control Act (CISCA), 2002. The assets of a CIS are managed by a manager registered with the FSB. CIS includes foreign CIS, which must be approved by and registered with the Registrar of CIS at the FSB and comply with the Collective Investment Schemes Control Act (CISCA) (Act 45 of 2002) (The Financial Services Board, nd).

In South Africa, there are five types of CIS that an investor can choose:

1. **CIS in securities:** the portfolio mainly consists of securities and includes local funds registered with the FSB. Most CIS fall in this category.
2. **CIS in properties:** the portfolio mostly consists of property shares or direct ownership of property.
3. **CIS in participatory bonds:** the scheme principally comprises participatory bonds.
4. **Declared CIS:** this is a scheme declared by the Minister of Finance as a CIS.
5. **Foreign CIS:** these are foreign schemes which solicit investments from South Africans.

The Islamic fund management market in South Africa currently houses seven AMCs offering six types of Islamic products comprising equity, balanced, global, property, income and ETF funds. As at end-2017, Islamic AuM accounted for only 0.7% of total AuM in South Africa. The next section will provide further analysis of the asset allocation.

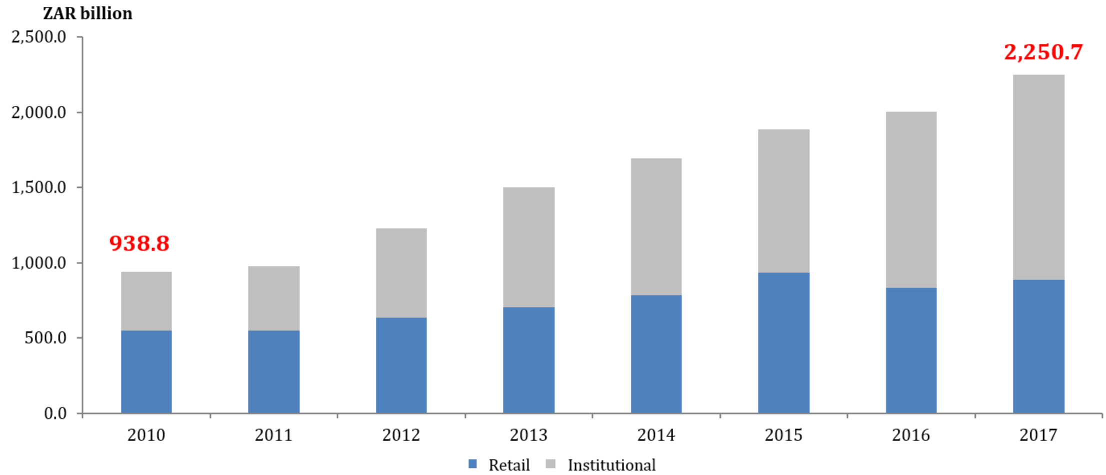
Insurance Market

The regulatory body of the insurance sector is the FSCA, which supervises the solvency reporting requirements and regulation of insurers and reinsurers under the Short-term Insurance Act 1998 (STIA) and Long-Term Insurance Act 1998 (LTIA) (Thomson Reuters Practical Law, nd). As of 2013, the country had 97 short-term insurers and 74 long-term insurers. The sector is already highly concentrated, with almost 90% of the long-term market in the hands of major players such as Old Mutual, Santam, Liberty Group, Outsurance and Sanlam. In the short-term market, the figure stands at about 44%. The South African Insurance Association (SAIA), which represents the interests of short-term insurers, reported 61 members as of June 2015 (Oxford Business Group, 2016). On the other hand, the *takaful* market in South Africa has been rather sluggish, with only one *takaful* company. *Takaful* was launched in 2003 by Takaful South Africa, the only firm offering Islamic insurance in Africa's biggest economy. In 2011, it was acquired by Absa Group.

Share of Domestic Islamic Funds against Total Funds Managed

As at end-2017, South Africa accounted for 2.4% of global AuM (IFSB, 2018) under 22 Islamic funds, including 1 ETF. The dominance of South Africa in this segment is not surprising given the high level of financial sector development and the conducive environment it offers to investors. As depicted in **Chart 4.21**, the total AuM of CIS has achieved a CAGR of 13.3% since 2010, amounting to ZAR 2.25 trillion as at end-2017.

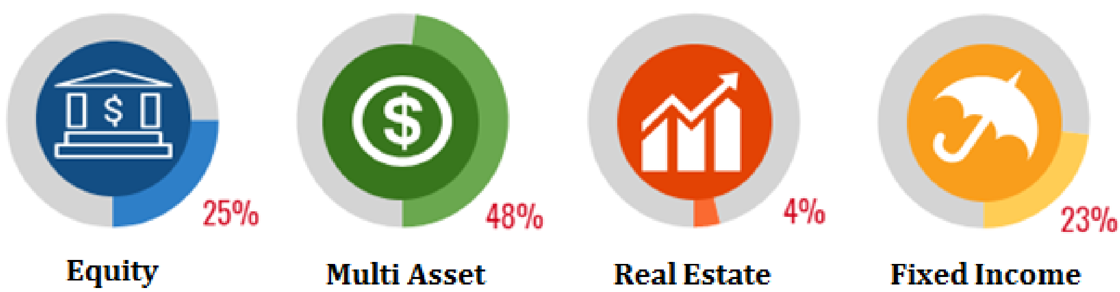
Chart 4.21: South Africa's AuM of CIS (2010-2017)



Source: ASISA

As illustrated in **Chart 4.22**, the AuM of CIS is further divided into asset allocations, where the biggest share is taken up by multi assets (48%). This is followed by equity, fixed income and real estate.

Chart 4.22: Asset Allocation of CIS (end- 2017)

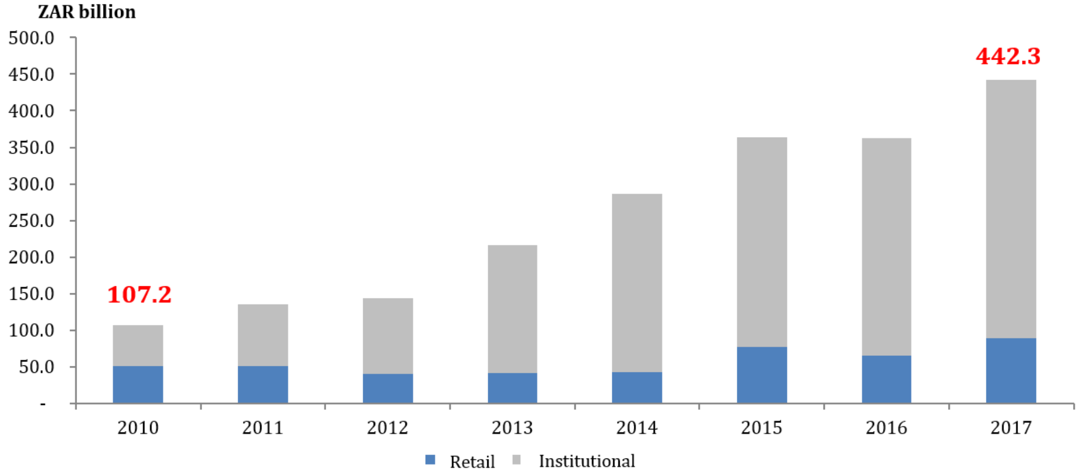


Source: ASISA

In 2014, South Africa registered 49 asset managers of CIS, many of which were also registered to manage funds in other African countries. Not surprisingly, for a market with such large players, the institutional sector is somewhat concentrated; the top ten asset managers handle more than half of its AuM and the top three manage a quarter. In contrast, the retail market is quite fragmented; the top ten asset managers handle just a fifth of its AuM.

Foreign Collective Investment Schemes (FCIS) are off-shore schemes regulated by the FSB and authorised for distribution in South Africa. The assets of FCIS amounted to ZAR442.3 billion in 2017, as illustrated in **Chart 4.23**, having increased annually between 2010 and 2017, with a CAGR of 22.4%. The majority of these FCIS were domiciled in Luxembourg, with Jersey and Ireland also popular domiciles.

Chart 4.23: South Africa's AuM of Foreign CIS (2010-2017)

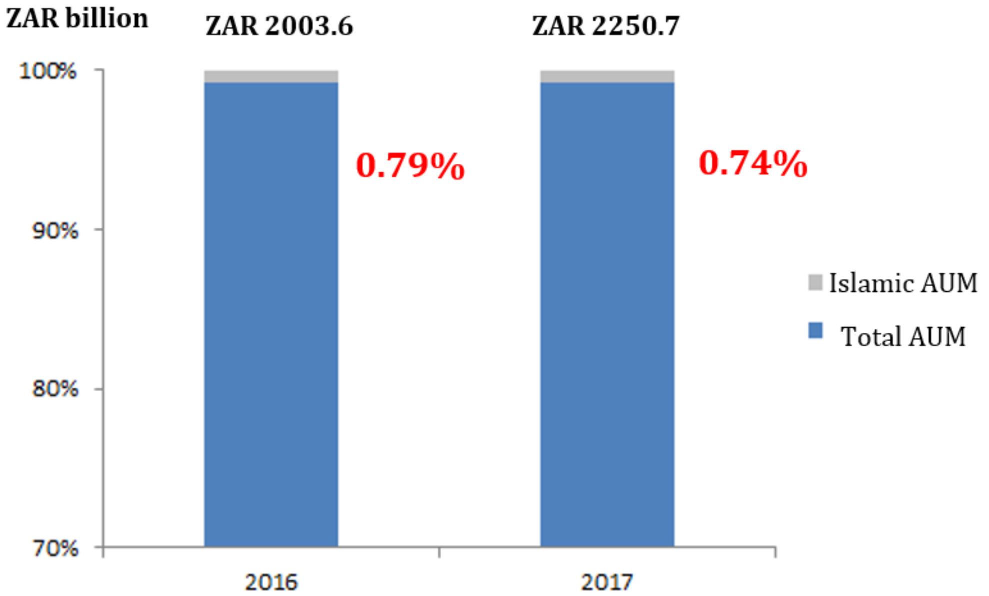


Source: ASISA

The manager of the FCIS must be approved by the registrar, and the country where the FCIS is based must have a regulatory environment of at least the same standing as that of South Africa. Local investors who wish to invest in these funds must comply with the Reserve Bank's regulations and use their foreign capital allowances as FCIS portfolios are denominated in foreign currencies, typically USD, GBP, EUR and JPY.

Similarly, the AuM of Islamic funds has been trending upwards, standing at ZAR18.3 billion as at end-April 2018. **Chart 4.24** shows Islamic AuM as a percentage of total AuM. Despite a marginal drop in market share for Islamic AuM from 0.79% in 2016 to 0.74% in 2017, the nominal value of Islamic AuM had increased to ZAR16.7 billion in 2017 (2016: ZAR15.9 billion). This indicates a high possibility or potential for South Africa to become the hub of Islamic finance in the African region, especially in Islamic funds. A slight contrast to the asset allocation of total CIS, local equity holds the largest percentage of assets allocated under Islamic AuM, followed by foreign equity, local cash and sukuk, and others—as presented in **Chart 4.25**.

Chart 4.24: South Africa's Islamic AuM as a Percentage of Total AuM



Source: Kagiso Asset Management

Chart 4.25: Allocation of Islamic Funds' Assets (April-2018)

Source: Kagiso Asset Management

4.5.2 Evolution of South Africa's Islamic Finance and Islamic Fund Management Industries

South Africa's regulators have taken several measures to develop and promote its Islamic finance industry, including amending tax laws to create an equitable and level playing field for Islamic finance. Proposed tax amendments were announced in May 2010, which provided tax parity treatment between Islamic finance products and conventional banking products in terms of diminishing *musharakah*, *mudarabah*, *murabahah* and sukuk.

Other than that, Regulation 28, which was promulgated in 1962, aims to protect the pension fund member by setting out prudent investment limits on certain asset classes in investment funds and this regulation is enforced on both conventional and Islamic pension funds. Regulation 28 was later amended in 1998 and 2011. The recent amendments were made in February 2018 where the allowed maximum exposures to certain asset classes have been revised to 75% for equities; 25% for property; 30% for foreign (offshore) and 10% African assets. **Table 4.22** shows the important milestones of Islamic finance in South Africa, followed by **Table 4.23**, which exhibits the regulatory timeline.

Table 4.22: Milestones of Islamic Finance in South Africa

Year	Islamic Finance Milestone
1989	▪ Al Baraka Bank was the first full-fledged Islamic bank granted a licence by the SARB.
2003	▪ *Takaful* was launched by Takaful South Africa.
2004	▪ WesBank launched an Islamic window, i.e.the WesBank Motor Vehicle and Asset Finance. ▪ First National Bank (FNB) launched an Islamic window offering Shariah-compliant financing.
2006	▪ Absa Islamic Bank was established.
2007	▪ FTSE/JSE Shariah All Share Index was launched.
2008	▪ FTSE/JSE Shariah Top 40 Index was launched.
2011	▪ FTSE/JSE Capped Shariah Top 40 Index was launched. ▪ Takaful South Africa was acquired by Absa Group.
2014	▪ Issued debut USD500.0 million sovereign sukuk.

Table 4.23: Regulatory Timeline of South Africa

Year	Description
1962	▪ Regulation 28 of Pension Fund Act was announced. It was amended in 1998, 2011 and February 2018.
2002	▪ Collective Investment Schemes Control Act (CISCA) ▪ Financial Advisory and Intermediary Services Act (FAIS)
2010	▪ Taxation Laws Amendment Act of 2010 (the Act), recognising arrangements such as diminishing *musharakah*, *murabahah* and *mudarabah*.
2011	▪ Amendment of Taxation Laws Amendment Act of 2010 (the Act), introducing sukuk as another form of Islamic finance limited to the government.
2016	▪ National Treasury proposed further amendments to tax laws to extend the current legislation in respect of *murabahah* and sukuk to cover all listed companies. ▪ Twin Peaks model of financial regulation.

Source: RAM

4.5.3 Investment and Commercial Considerations

Different countries have different methodologies or process flows on how a fund may be developed. **Figure 4.20** illustrates the processes of fund development from conceptualisation, planning, regulatory approval and implementation to monitoring of funds in South Africa.

Figure 4.20: Process Flow of Fund Development in South Africa

Stage 1: Feasibility Study	Stage 2: FSCA Queries Addressed	Stage 3: Fund Implementation & Investment	Stage 4: Fund Performance Analysis & Reporting
▪ Determine investment policies ▪ Determine mandate and profile of investors ▪ 3-year forecast and break-even analysis ▪ Complete and submit FSCA forms	▪ Proof of seed capital ▪ Registration of fund by the FSCA	▪ Screening of equities ▪ Fundamental analysis ▪ Risk evaluation ▪ Fair-value assessment ▪ Portfolio management	▪ Measuring performance against benchmarks ▪ Reporting back to clients

Source: Kagiso Asset Management

Value Propositions of Islamic Funds

It is fairly challenging in South Africa to construct balanced fund solutions for investors which comply with the prudential guidelines of Regulation 28 and Shariah parameters yet still offer good returns. Islamic funds tend to differ from conventional funds in terms of their underlying sector risk, stock risk and asset allocation.

1. Shariah Compliance and Shariah Screening

Demand for Islamic funds has been largely fuelled by increasing awareness, rising trade with the Middle East, growing demand by local Muslim populations for Shariah-compliant products, and an ever-increasing demand for more ethical risk sharing-based products given the recent global financial crisis.

The JSE collaborated with FTSE to come up with a Shariah screening methodology while FTSE formed a joint venture with Yasaar to create Shariah-compliant indices. The FTSE/JSE Shariah All Share, the FTSE/JSE Shariah Top 40 and the FTSE/JSE Capped Shariah Top 40 indices were launched in 2007, 2008 and 2011, respectively. Under these indices, Shariah credibility is determined through company screening at both the financial and business levels.

Based on the FTSE/JSE Shariah screening methodology, companies involved in any of the activities listed in **Table 4.24** will be filtered out as Shariah non-compliant. The remainder are then screened further from a financial perspective.

Table 4.24: FTSE/JSE Shariah Screening Methodology

Business Activity Screening	Financial Ratio Screening
• Conventional finance (e.g. non-Islamic banking, finance and insurance) • Alcohol • Pork-related products and non-*halal* food production, packaging and processing or any other activity related to pork and non-*halal* food • Entertainment (casinos, gambling and pornography) • Tobacco • Weapons, arms and defence manufacturing	• Debt is less than 33% of total assets • Cash and interest-bearing items are less than 33% of total assets • Accounts receivable and cash are less than 50% of total assets • Total interest and non-compliant income should not exceed 5% of total revenue

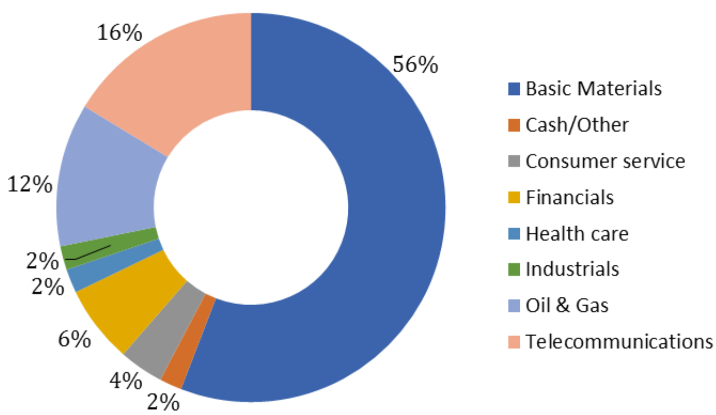
Source: Market Data FTSE/JSE Shariah Indices

2. Islamic ETF

Absa Capital launched South Africa's first Shariah-compliant, equity-linked ETF, i.e. New Funds Shariah Top 40 Index ETF, on 11 March 2009. The IPO for this new ETF opened on 23 February and it was listed on the JSE on 6 April 2009. The Shariah Top 40 Index ETF provides investors with a diversified exposure to the broad market by investing in one Shariah-compliant ETF and earning a market-related performance. The New Funds Shari'ah Top 40 Index ETF tracks the price performance of the FTSE/JSE Shari'ah Top 40 Index, which is jointly established by FTSE and the JSE.

The FTSE/JSE Shariah Top 40 Index comprises securities that represent the performance of the 40 largest and most liquid JSE-listed companies, the activities and financial ratios of which are Shariah-compliant. The index is rebalanced quarterly and all dividends will be paid out to the investors on a quarterly basis whenever declared. As shown in **Chart 4.26**, the sector that dominates the asset mix of the New Funds Shariah Top 40 Index ETF is basic materials (55.86%).

Chart 4.26: Sector Allocation of New Funds Shariah Top 40 Index ETF



Source: ABSA CIB

4.5.4 Key Factors Underpinning the Development of South Africa's Islamic Fund Management Industry

The development of South Africa's Islamic fund management industry will provide a competitive advantage to South Africa's Islamic finance market. The country has the potential to become the leading hub for Islamic finance in the African region. This is supported by its advanced financial landscape, which adopts strong regulatory and governance structures. The following section provides an explanation of the factors that have had an impact on South Africa's Islamic fund development.

Legal and Regulatory Framework

South Africa has an advanced legal and regulatory framework for the conventional market. The government has put in place various measures to ensure the market remains robust. In 2018, several new and revised regulations were unveiled:

- The Twin Peaks model was implemented in April 2018, bringing about a new regulatory system governed by the PA of SARB and the FSCA.
- Revised Regulation 28 in February 2018, which aims to protect pension fund members and facilitate economic development and growth.
- Proposed Regulatory Framework for Foreign Member Funds in South Africa was issued in March 2018. This aims to create a seamless gateway for foreign funds to invest in South Africa or any other African country.

To date, the FSCA has yet to release any specific guideline on Islamic funds. Instead, Islamic funds are governed by the CISCA 2002 and monitored by the FSCA.

Shariah Governance Framework

Regulators in South Africa have yet to adopt any Shariah governance framework. Rulings on Shariah matters are managed by the Shariah advisory committee of each fund management company. Due to the absence of a centralised or harmonised approach to Shariah governance, the market is exposed to inconsistencies in Shariah rulings.

Market Infrastructure

Financial market infrastructure (FMI) is central to the clearing and settlement of monetary and financial transactions in global and domestic financial systems. Examples of FMIs in South Africa are the systems operated by the SARB, as follows:

- The South African Multiple Option Settlement (SAMOS) system is the real-time gross settlement system.
- The continuous linked settlement (CLS) system settles foreign-exchange transactions in designated currencies, including the South African rand.
- The SADC Integrated Regional Electronic Settlement System (SIRESS) settles cross-border credit transfers that require immediate settlement (Goodspeed, n.d).

South Africa has one of the most sophisticated financial markets and has earned a reputation for its sound financial market development. This is also reflected through the JSE, which is the only licensed securities exchange in South Africa and has been ranked as the best regulated market in the world (out of 148 rated) for four consecutive years (Oxford Business Group, n.d).

Tax Framework

South Africa amended its tax laws to develop and facilitate its Islamic finance industry. Under the Taxation Laws Amendment Act, 2010, legislation on Islamic finance was added to recognise *mudarabah*, *murabahah* and diminishing *musharakah*. In 2011, another amendment was made to the Act to introduce sukuk, although confined to sovereign issues. In January 2016, a sukuk legislation was passed to accommodate listed companies. These concerted efforts highlight the support of the government and regulators in the development of Islamic finance even though South Africa is not a Muslim-majority country.

Demand Side

Lack of market awareness and understanding of Islamic finance: Islamic finance started in 1989, with the establishment of one full-fledged Islamic bank, followed by Islamic windows operated by conventional banks and an increasing number of Islamic AMCs. However, awareness of Islamic finance is poor among its communities. Based on a study conducted in 2014 to examine awareness of Islamic banking products and services among consumers in South Africa, the results revealed that 48% of the respondents were not aware that Islamic banking was available for both non-Muslims and Muslims. The study also showed that 70% of the Muslim customers had accounts in non-Islamic banks, with few customers embracing Islamic banking (Cheteni, 2014).

Government and some private sector employees have no choice but to opt for conventional pension funds: The Government Employees Pension Fund (GEPF) manages pensions and related benefits on behalf of all South African government employees. It is also Africa's largest pension fund. It has more than 1.2 million active members, in excess of 400,000 pensioners and beneficiaries, and assets worth more than R1.6 trillion. Unfortunately, the GEPF has no specific allocation for Shariah-compliant funds. In the private sector, most companies would have their own private pension fund schemes, which are mostly invested in conventional funds. Therefore, both the government and private sector employees have no choice but to place their money in conventional pension fund schemes.

Lack of incentives to encourage Shariah-compliant savings and investment: Normally, Islamic funds attract higher costs than their conventional counterparts due to certain fees, charges and treatment of the transactions. Therefore, the top-down approach by the government in providing incentives plays a crucial role in creating a level playing field for Shariah-compliant investment/savings.

Supply Side

Inadequate Shariah-compliant assets: The number of Shariah-compliant companies available on the JSE is very limited. There are only 160 Shariah-compliant entities out of 400 as at end-2017. The number of sukuk available in the market is also scarce, prompting fund managers to invest in offshore assets. However, Regulation 28 limits pension funds' foreign exposure to only 20%.

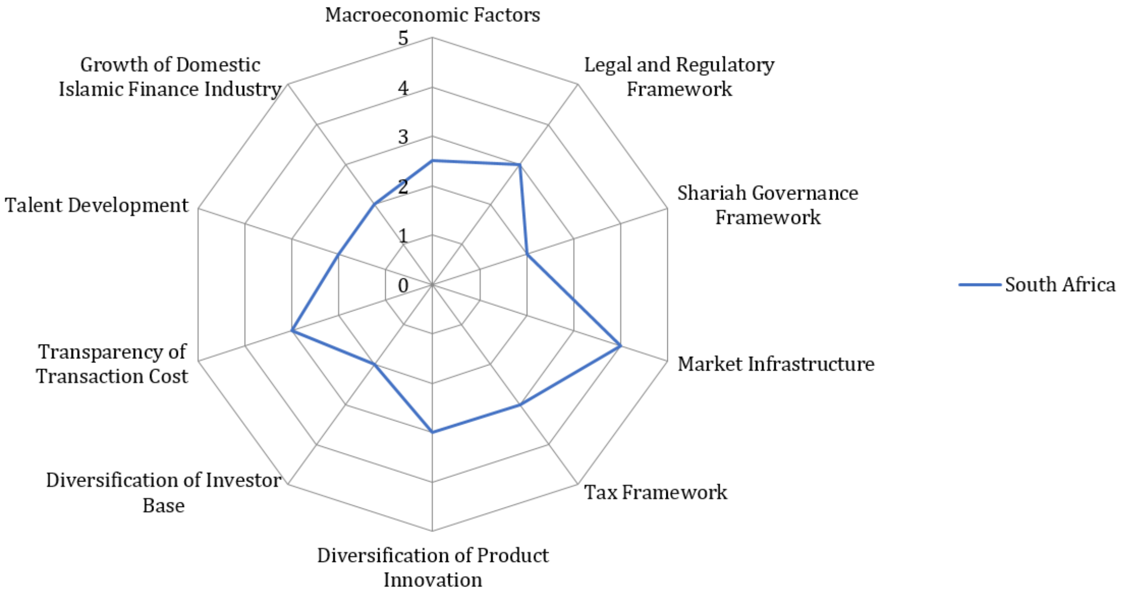
Absence of harmonised approach among the Shariah advisory committees: There is no central or harmonised Shariah governance body in South Africa. Each AMC adopts a different approach and methodology, as advised by their own Shariah advisor. This has led to inconsistencies in Shariah rulings.

Shortage of experts in Islamic finance: There is a talent deficit in the Islamic finance industry. As such, identifying domestic institutions that can assist to nurture local talent is crucial to sustaining the industry's long-term development (MIFC, 2016).

4.5.5 Country-Specific Recommendations

Chart 4.27 highlights the scores for all the major factors underpinning the development of South Africa's Islamic fund management industry.

Chart 4.27: Factors Influencing the Development of South Africa's Islamic Fund Management Industry



Sources: RAM, ISRA

Based on the issues and challenges faced, the following policy recommendations from the supply and demand sides are proposed to support the development of the Islamic fund industry, as outlined in **Table 4.25** and **Table 4.26**.

Table 4.25: Recommendations on Improving Demand (Buy Side)

Issues and Challenges	Demand (Buy Side) Opportunities
1. Lack of market awareness and understanding of Islamic finance	Concerted efforts by the Islamic finance community to build understanding, awareness and promote Islamic finance to Muslims and non-Muslims. The setting up of a viable proposition to attract corporate sector sponsorship may provide opportunities to host Islamic finance conferences/seminars/training.
2. Government and private sector employees are not given the flexibility to choose the type of pension funds to invest in	Encourage the government and private sector employers to allow employees to decide which funds to invest in. This will facilitate opportunities for Muslims or ethically-inclined employees the option of investing in Shariah-based funds.
3. Lack of incentives to encourage Shariah-compliant savings and investment	▪ Provide tax incentives to investors to invest in Shariah-compliant products and for AMCs to establish Islamic funds. ▪ Tap the potential wealth of *awqaf* funds, high-net-worth Muslim individuals, and other Islamic funds to create a base of Islamic institutional investors that will spur demand for Islamic fund products.

Source: RAM

Table 4.26: Recommendations on Improving Supply (Sell Side)

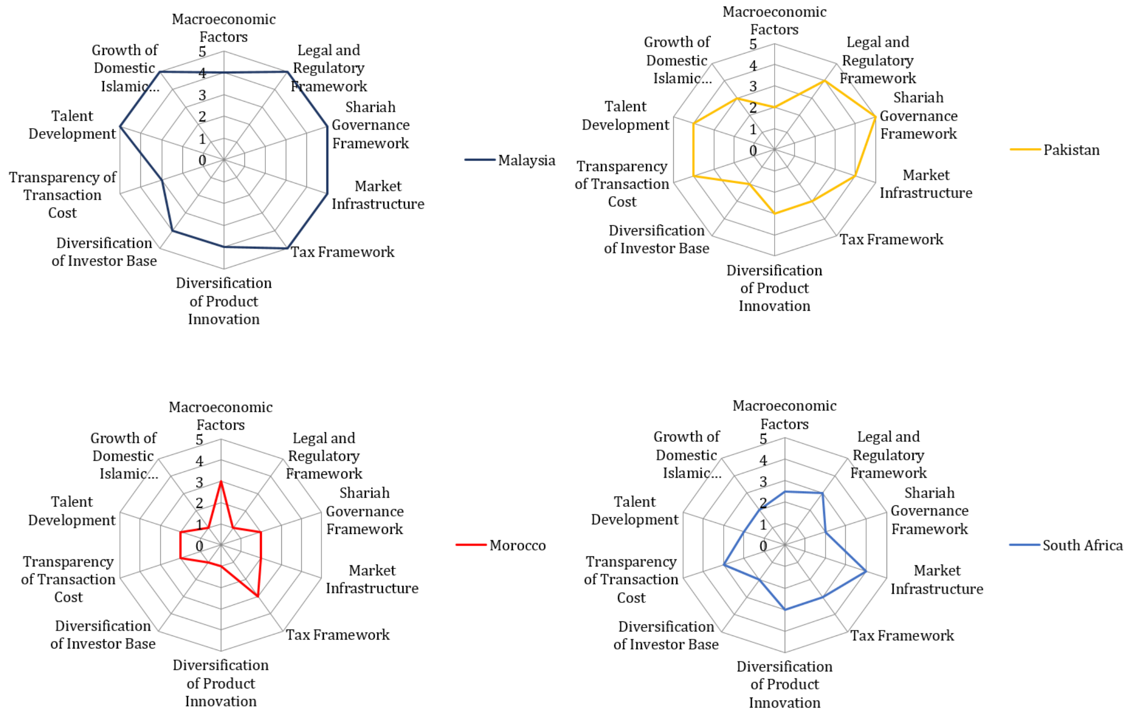
Issues and Challenges	Supply (Sell Side) Opportunities
Inadequate Shariah compliant asset	▪ In line with the government's efforts to increase the number of green companies, public awareness on the similarities of Islamic finance and ESG/green finance should be emphasised. This will encourage companies to be listed as both Shariah-compliant and ESG entities. ▪ Develop an ICM masterplan to spur the promote of Shariah-compliant assets.
Absence of a harmonised approach among the Shariah advisor committee.	▪ Create a task force that comprises industry players and regulators, with representatives from every company to develop a harmonised Shariah governance framework. This will help address disputes and promote transparency in Shariah rulings.
Shortage of experts in Islamic finance industry	▪ Establish accredited Islamic education institutions to offer Islamic finance training/ professional courses. Encourage local Islamic finance talent from the corporate sector to share their experience and knowledge.

Source: RAM

5. GENERAL POLICY RECOMMENDATIONS

Based on the lessons learned from the case studies, the factors which have had the most impact have been summarised under the Development-Stage Matrix. Subsequently, spider charts have been used to illustrate the areas which need to be further developed to facilitate the progress of the Islamic fund management industry. **Chart 5.1** provides an overview of the respective countries' spider charts when compared collectively.

Chart 5.1: Key Factors Influencing the Development of the Islamic Fund Management Industry

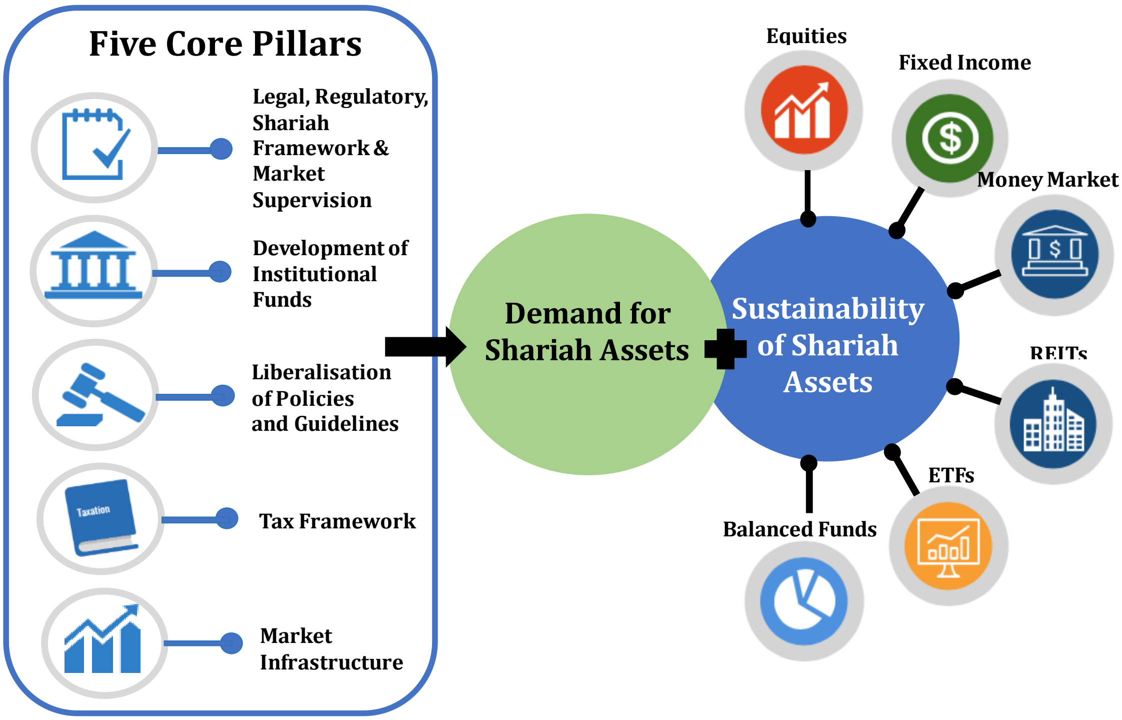


Sources: RAM, ISRA

5.1 Strategic Framework and Roadmap for Islamic Fund Management

Upon understanding the areas which affect a domestic Islamic fund management industry, we have then been able to illustrate its ecosystem. **Figure 5.1** depicts the congruence of the five core pillars that support the sustainability of Shariah-compliant assets. Without them, the industry will face challenges in developing domicile Islamic fund management markets, as seen in Pakistan and South Africa.

Figure 5.1: Ecosystem of the Islamic Fund Management Industry



Source: RAM

As mentioned earlier, the establishment of the necessary pillars to kick-start or support the development of the Islamic fund management industry is key to ensuring sustainable organic growth. However, a definitive structure must be established upfront to ensure the pillars are successfully incorporated. The framework should also highlight the roles and responsibilities of key stakeholders and identify actionable measures to promote accountability and monitoring of progress, in line with the proposed roadmap. The factors listed in **Table 5.1** should be taken into consideration in the development of the framework and roadmap for the Islamic fund management industry.

Table 5.1: Key Measures to Support a Viable Framework for Islamic Funds

Item 1 - Political Will and Cohesive Collaboration with Key Stakeholders	
Key National Measure	**Merits and Actionable Measures**
Establish an enabler or catalyst to produce a viable framework for the successful deployment of Islamic funds	▪ Government's presence in promoting the successful inclusion of Islamic funds within the financial landscape will boost and aid effective implementation of strategies. ▪ Key areas of review or development to support an enabling environment: 1. Establish a dedicated entity or agency that looks at streamlining Islamic finance activities (e.g. Malaysia established the Malaysia International Islamic Financial Centre (MIFC) under BNM to promote Islamic finance in the country). 2. The specialised centre has the responsibility of identifying gaps and market challenges, as well as engaging with market players to identify practical solutions.

	3. Grant incentives to market players who opt for Islamic finance solutions and the establishment of funds via taxation or fiscal incentives.
Item 2 – Robustness of Capital Market Activities	
Key National Measure	**Merits and Actionable Measures**
Development of essential building blocks to support the sustainability of ICM activities	▪ An integrated plan at the national level is vital to the development of a domestic ICM. ▪ The following building blocks constitute the essential pillars for ICM. Ultimately, the absence of a healthy pipeline of Shariah-compliant equities and sukuk will limit the ability to create a wide range of Islamic funds. 1. Legal and regulatory framework. 2. Shariah governance. 3. Tax framework. 4. Market infrastructure. 5. Diversified market players on supply (breadth and depth of products and services) and demand (broad investor-base) sides.
Formation of specific working groups/ associations to facilitate and moderate market issues	▪ Different markets operate differently. Some adopt the top-down approach while others require market forces to drive the development of guidelines and policies. ▪ The advent of working groups comprising fund managers, regulators and institutional investors will fuel market progression. However, it is important to identify the commercial interests of members upfront, to ensure the group's collective efforts will benefit the industry and not its specific interests or gain.
Item 3 – Creating a Captive Demand Base for Islamic Funds	
Key National Measure	**Merits and Actionable Measures**
Creation of market demand for Islamic funds will provide the necessary investor base	▪ Alignment of wealth creation via Shariah investments or ethical investing for government and corporate pension schemes will provide a solid base in building the Islamic fund management industry. ▪ Level of financial inclusion varies across different jurisdictions. The ability to penetrate retail investors with a solid value proposition will go a long way towards supporting the long-term growth of Islamic funds. ▪ Ultimately, the growth of a country's GDP per capita will have spill-over effects. As a person's income improves, so will his/her allocation when setting aside money for savings.
Item 4 – Awareness and Capacity Building	
Key National Measure	**Merits and Actionable Measures**
Awareness and technical understanding define the success story of any fund management industry	▪ Development of market awareness will provide the coverage required to support financial planning. This can be achieved through collaboration between regulators and market players via promotional activities, conferences, and seminars for public education. ▪ Penetration using digital interface should also be considered since mobile penetration is considered the fastest-growing tool in reaching out to the masses, irrespective of geographical location.

Sources: RAM, ISRA

5.2 General Recommendations for Improving Islamic Fund Management

A broad set of recommendations has been proposed to address the inherent challenges faced by each country. Depending on its stage of development, the recommendations are envisaged to accelerate or jump-start the country's developmental efforts.

Matured Market

Based on our analysis of Malaysia, its level of maturity is depicted by its well-developed architecture as defined through its robust legal, regulatory and Shariah frameworks, and strong ICM ecosystem that promotes the sustainability of Shariah assets. These factors facilitate the development of a stable Islamic fund management industry. Nonetheless, there is still room for further improvement, as defined by the SC's *Islamic Fund and Wealth Management Blueprint*. In accordance with the five core pillars, the recommendations in **Table 5.2** are proposed for consideration.

Table 5.2: General Recommendations for a Matured Market

Pillar 1 – Legal, Regulatory, Shariah Frameworks and Market Supervision		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Provide enabling frameworks to support fintech and attract international SRI investors.	The choice of which international SRI standard to adopt will have a bearing on market activities.	Adoption of an open architecture will facilitate business activities. Proactive engagement with market players on which route to adopt will help in the decision-making process.
Pillar 2 – Development of Institutional Funds		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Development of institutional investors with a focus on investing in Islamic funds.	Some institutions are concerned about the performance of Islamic funds.	Realign values with beneficiaries and manage the perception of market performance.
Streamline religious beliefs with investment behaviour.	Muslims are unaware of their responsibilities in money management.	The same values adopted by a Muslim in his or her way of life should restrict investors to only choosing Islamic funds.
Pillar 3 – Liberalisation of Policies and Guidelines		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Enhance market access and international connectivity.	Based on industry feedback, there are still gaps in the system which could lead to a slower turnaround in the launch of funds and insufficient market involvement.	Regulators to proactively engage with domestic and foreign fund managers to seek practical solutions to closing the gaps.
Enhance market position as an international fund centre.	Bilateral and multilateral regulatory cooperation arrangements with international jurisdictions exist, although more can be done to further expand market linkages and connectivity.	Cooperate with other jurisdictions to promote Malaysia as a passporting centre for global Islamic funds.

Pillar 4 – Tax Framework		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Implement measures to secure commitments from targeted segments (supply and demand sides) to sustain the long-term growth of Islamic funds.	Despite tax incentives, there are still more opportunities for investments to grow.	Apart from providing tax rebates, the government should also consider matching individual investments in Islamic funds (e.g. the government to match every USD1 saved in Islamic funds and to introduce tax incentives for SRI funds).
Pillar 5 – Market Infrastructure		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Facilitate new digital business models to promote seamless reach for Islamic funds.	Connectivity to the masses remains a challenge for regulators and fund managers.	Leverage the use of mobile phones to interface with applications such as robo-advisors, to improve ease of fund investment and market education.
Promote merit-based fees and transparency of costing structure.	High up-front transaction costs deter penetration of retail investors.	Regulators to engage with developed countries and implement transparent cost structures, with the aim of making transaction costs more effective.

Sources: RAM, ISRA

Developing Markets

The level of financial inclusion was a key concern during the review of Pakistan and South Africa. The creation of a broader base of captive investors is important for the development of the Islamic fund management industry, especially in developing markets. The sustainability of ICM performance is the backbone to facilitating organic growth. **Table 5.3** lists the common issues and proposed solutions.

Table 5.3: General Recommendations for a Developing Market

Pillar 1 – Legal, Regulatory and Shariah Framework		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Develop investors' trust and confidence in products and services.	Lack of trust in the feasibility of investments in Shariah funds.	Regulators and market players work together to improve the level of awareness and highlight the governing rules for investor protection.
Establish comprehensive legal, regulatory and Shariah frameworks.	Lack of effective implementation and enforcement of laws and regulations, giving rise to gaps in the system.	Review existing policies and guidelines and address the gaps.

Pillar 2 – Development of Institutional Funds		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Implement or enhance regulation of pension schemes.	If not regulated, pension schemes should be monitored to support wealth creation. Contributions are the most innate form of investment for any fund management industry.	Establish specific policies and guidelines to regulate investments and administration of funds.
Spur institutional participation in Islamic funds.	Lack of track record of Shariah funds poses certain challenges.	Regulators or institutional investors provide seed investment in Islamic funds to spur performance and build the necessary track record.
Pillar 3 – Liberalisation of Policies and Guidelines		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Attract foreign fund managers.	Domestic wealth may not be sufficient to spur industry growth. Market liberalisation offers ease of foreign fund flows, which can be deployed to fund domestic economic activities.	Government or quasi-government sector to allocate funds as incentive. In return, the foreign fund managers must bring a minimum level of foreign investments onshore. Rules on foreign ownership should also be liberalised.
Pillar 4 – Tax Framework		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Implement measures to secure strong commitments from retail investors to sustain long-term growth.	Tax incentives have helped attract retail investments.	Apart from providing tax rebates to retail investors, the government should also consider matching individual investments in Islamic funds (e.g. the government will match every USD1 saved in an Islamic fund).
Pillar 5 – Market Infrastructure		
Thrusts	**Issues and Challenges**	**Key Recommendations**
Strengthen administrative services to enhance the value chain of fund management.	Structuring of Islamic funds and monitoring of Shariah governance require specific skills, which need to be organically developed.	Development of human capital through government incentives to increase knowledge/talent in Islamic finance.

Sources: RAM, ISRA

Infant Market

Markets that fall under the 'infancy' stage have the advantage of learning from the experience of advanced markets, to determine their overarching framework and roadmap for the Islamic fund management industry. Each jurisdiction evolves differently, taking into account inherent market conditions and which route to adopt to facilitate successful inclusion. The recommendations in **Table 5.4** set preliminary proposals. Since it is a new market with very little experience, issues and challenges are not applicable.

Table 5.4: General Recommendations for an Infant Market

Pillar 1 – Legal, Regulatory and Shariah Framework	
Thrusts	**Key Recommendations**
Develop investors' trust and confidence in products and services.	Enforcement of governing rules and regulations to speed up market development, including the launch of guidelines on Islamic fund management and the setting up of policies for investor protection.
Establish comprehensive legal, regulatory and Shariah frameworks.	
Pillar 2 – Development of Institutional Funds	
Thrusts	**Key Recommendations**
Facilitate the involvement of institutional funds from the outset.	Identify institutions as catalysts in promoting investments in Shariah assets.
Pillar 3 – Liberalisation of Policies and Guidelines	
Thrusts	**Key Recommendations**
Promote the liberalisation of policies and guidelines.	Institute policy liberalisaton in the roadmap for the establishment of the Islamic fund management industry.
Pillar 4 – Tax Framework	
Thrusts	**Key Recommendations**
Inculcate fiscal stimulus to incentivise the involvement of market players (demand and supply) and accelerate growth.	▪ Amend tax regime to first create a level playing field. ▪ Tax rebates are the quickest route to attracting retail investments.
Pillar 5 – Market Infrastructure	
Thrusts	**Key Recommendations**
Establish a vibrant and effective ecosystem for the deployment of Islamic funds.	Develop market platforms and infrastructure to enable the efficient provision of products and services.
Promote free flow of capital.	Liberalisation of capital controls.

Sources: RAM, ISRA

6. CONCLUSION

In lieu of our assessment of the case countries, the comparison is made between the ecosystem for the Islamic fund management industry and the progress of a specific market in developing its core pillars (refer to **Figure 5.1**). Subsequently, policy recommendations have been proposed for the different types of markets. As a market grows in maturity, greater emphasis is given to strengthening the base of supply and demand as well as the overall development of the Islamic fund management industry's ecosystem. Compared to the developing stage, the focus is now on the review of existing policies and guidelines, identifying gaps in the framework and continuous expansion of products and services. For the infancy stage, the setting up of a viable framework and roadmap goes a long way towards detailing the measures that need to be taken. Ultimately, the level of cohesiveness between regulators and market players in reaching out to potential investors is critical for any market development, as well as enhancing market understanding of Shariah funds. **Table 6.1** summarises the policy recommendations for the development of the five core pillars.

Table 6.1: Summary of Policy Recommendations

Type of Market	PILLARS				
	Legal, Regulatory and Shariah Framework	Development of Institutional Funds	Liberalisation of Policies and Guidelines	Tax Framework	Market Infrastructure
Matured	▪ Adoption of an open architecture will facilitate business activities. Proactive engagement with market players on which route to adopt will help the decision-making process.	▪ Realign values with beneficiaries and manage the perception of market performance. ▪ The same values adopted by a Muslim in his or her way of life should restrict investors to only choosing Islamic funds.	▪ Regulators to proactively engage with domestic and foreign fund managers to find practical solutions to closing the gaps. ▪ Establish cooperation with other jurisdictions to promote Malaysia as a passporting centre for global Islamic funds.	▪ Apart from providing tax rebates to retail investors, the government should consider matching individuals' investments in Islamic funds (e.g. the government will match every USD1 saved in an Islamic fund).	▪ Leverage the use of mobile phones to interface with applications such as robo-advisors, to improve awareness and market education. ▪ Regulators to engage with developed countries to facilitate sharing of knowledge and explore the viability of a transparent cost structure, with the aim of making transaction costs more effective.

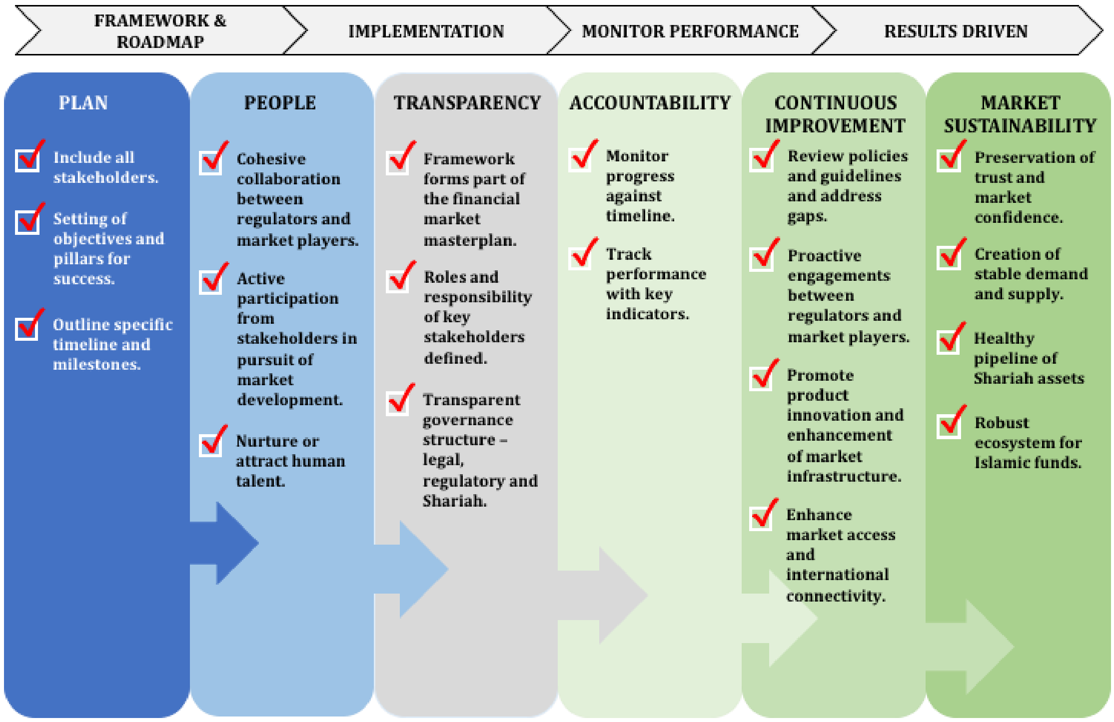
Type of Market	PILLARS				
	Legal, Regulatory and Shariah Framework	Development of Institutional Funds	Liberalisation of Policies and Guidelines	Tax Framework	Market Infrastructure
Developing	▪ Regulators and market players work together to improve the level of awareness and highlight governing rules for investor protection. ▪ Review of existing policies and guidelines and address the gaps.	▪ Establish specific policies and guidelines to regulate investments and administration of funds. ▪ Regulators or institutional investors provide seed investment in Islamic funds to spur performance and build the necessary track record.	▪ Government or quasi-government sector to allocate funds as an incentive. In return, the foreign fund managers must bring a minimum level of foreign investments onshore. Rules on foreign ownership should also be liberalised.	▪ Same as above.	▪ Development of human capital through government incentives to increase knowledge/talent in Islamic finance.
Infancy	▪ Enforcement of governing rules and regulations to speed up market development, including the launch of guidelines on Islamic fund management and the setting up of policies for investor protection.	▪ Identify institutions as catalysts in promoting investment in Shariah assets.	▪ Institute adoption of policy liberalisaton in the roadmap for the establishment of the Islamic fund management industry.	▪ Amend tax regime to first create a level playing field. ▪ Tax rebates are the quickest route to attracting retail investments.	▪ Develop market platforms and infrastructure to enable the efficient provision of products and services. ▪ Liberalisation of capital controls.

Sources: RAM, ISRA

Knowing which phase of development an Islamic fund management industry is in will facilitate the implementation of the right strategies. The Development-Stage Matrix has been designed for this purpose and any jurisdiction may deploy the matrix for the purpose of market identification. Factors influencing market development should also be monitored, with an emphasis on improving demand (buy side) and supply (sell side), as these will affect the sustainability of Shariah assets.

In conclusion, each country should adopt a viable framework and roadmap to progressively develop its domicile Islamic fund management industry. **Figure 6.1** provides a generic guide to the critical success factors and phases of development vis-à-vis supporting a sustainable roadmap. The systematic approach is envisaged to build trust and market confidence. Once achieved, it can lead to domestic wealth creation within its financial market, in turn resulting in the greater deployment of funds in spurring a country's economic activities.

Figure 6.1: Development Cycle of Islamic Fund Management



Source: RAM

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