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Shari'a Compliance –Impediment or Reinforcement?

The Islamic economic doctrine carefully distinguishes between the functions of the real sector of the economy and the financial sector and its institutions. In an Islamic framework, the financial markets are designed to facilitate the functioning and promotion of the real, wealth generating sectors of the economy. The Islamic financial industry possesses the characteristics of an intermediary between finance and economic activity. In other words, it is designed primarily for the purposes of another sector, the real sector, and its existence bears little meaning had it not carried these functions. This is emphasized by the holy Quran, where it strongly prohibits the piling of gold and silver, and imposes annual taxes on non-utilized wealth in order to encourage the utilization of wealth in the form of real activity, and to avoid wealth being 'a commodity between the rich among you'.

The Shari'a is considered to be the laws that are designed to carry out the economic objectives set out by Islam. The realm of Shari'a itself is wider than some contemporary thinkers tend to believe. The viewpoint of Shari'a is to set out the rules and leave open the space for the design of different products, modes of finance or financial schemes. As a starting point, Shari'a with this respect is not different from a modern jurisdiction that sets out a set of rules, compatible to its philosophical and theoretical underpinnings, and leaves open the liberty of designing products and schemes subject to following the rules. The question that could be imposed is whether the type and quantity of Shari'a rules imposed by the Shari'a, if observed by an investor, and compared to conventional markets, act to hold back an investor from optimizing his portfolio of holdings or the opposite, act to reinforce his investment aspirations.

This question requires a closer examination of Shari'a compliance and the likely influence of compliance elements on the investment and on the issuer. The fundamental characteristics of a Shari'a compliant product are found in the prohibition of Riba, the elimination of Gharar, Jahala and Gambling, the implementation of profit sharing, the consideration of moral values, and the obligatory share of the poor in the wealth of the rich (Zakat). An investor would like to realize economic gains from compliance for it to act as reinforcement.

There is one area requiring attention, that is, the prevalent tradeoff between risk and reward. In the case of charging interest, for example, the optimal implementation of interest from the lender's point of view is attempting to reduce the ratio of risk to reward, to the best extent possible subject to market conditions, in favor of the lender. The lower

the risk compared to reward the more attractive an investment becomes for an investor. This can either be done by increasing the premium on the risk (interest) or by the reduction of the risk factor due to some exogenous and endogenous elements.

The fundamental premise behind the aforementioned question, relative to our theme here, is to consider the extent to which Islamic finance is able to optimize this simple formula from the point of view of the investor as compared to conventional finance. We assume the position of an investor is the same position as of an issuer, since all factors that will influence the risk/reward relationship for an issuer will be assumed to be fully reflected in the investors' decisions. Yet, the confidence of investors per se is not confined to their confidence in the soundness of an entity's financials and the ability of the management. In addition to the desire for Shari'a compliance, which has special value to Muslim investors, the overall regulatory, political and economic environment could be overriding factors to the entity's success. Thus, economic stability is another element we expect to have a great influence on the aforementioned formula. So the question here becomes, does compliance contribute to a more stable system?

Consider the concept of profit sharing in the Islamic doctrine. The reality of profit sharing is the realization of the fundamental concept in Islam that money cannot act as an end means in itself as though money was part of the real sector of the economy. The concept applicable to Islamic modes of finance can be described as based on profit sharing as opposed to interest or Riba. Profit represents value added and creates additional welfare and is a sign of an economic value that has been created. Such modes of finance are always backed by assets by the nature of the transaction. A key point to be considered is the impartiality between Islamic modes of financing and conventional modes in terms of the risk associated with changes in value of collateral; or the business risks associated with the utilization of money by the borrower. On the other hand, Islamic modes of financing by their nature act as deterrent to default risk since the financier exercises more prudence in identifying the most appropriate designation of funds since it also bears part of the risk of the overall transaction.

Consider also the ethical considerations held by Islam. These considerations play a role in the possibility of diversification of an investor's portfolio. This could limit the ability of an investor to sustain returns adequate in comparison to standard indexes by limiting the choices of securities into his portfolio. It is essential here to understand to what extent ethical considerations have an influence on an investor's universe. The Islamic doctrine doesn't intervene to spell out the fine details of the methods of carrying out business activity. It merely identifies areas that are considered adverse to the physical and psychological wellbeing of the society and prohibits the utilization of these methods. Otherwise, the universe is as wide as entrepreneurs are able and willing to innovate. Unfortunately, there is a lack of empirical evidence on the influence of ethical considerations on the economic value of investments. It is, however, evident that there is a significant number of industries that engage in Islamically acceptable activity to the extent that the prohibition of the trade of certain non-compliant securities, in itself, does not adversely influence an investor's ability to optimize or improve the risk-reward relationship in his own portfolio.

Some of the creative methods in conventional markets observed as financial markets develop include speculation, short selling, margin trading, equity futures and options. The underlying principles of the founding of these practices developed as an aversion to information asymmetry in stock markets and as means of controlling the risks prevalent in the modern day financial markets. Since money is practically given intrinsic value in conventional finance, the clearest example being the outright charge of interest, such practices are not seen to obstruct economic welfare although in most circumstances, no genuine economic benefit is being generated from such activity. We have repeatedly observed in news headlines that oil shortages are causing concern in world markets and leading to higher prices. The rise of demand for production and consumption has also been a driving factor leading to higher prices. But there has also been speculation in world commodity markets leading to additional demand and additionally higher prices, with no genuine contribution to the welfare of society.

Let us consider option trading as an example. An issuer may wish to utilize the benefits of options to mitigate interest rate and/or exchange rate risk for the stability of the business. It is a fact that there will be cases where issuers will be worse off by foregoing the utilization of these tools. However, it is not a fact that investors will necessarily lose ground because they abstain from investment in non-compliant issuers. The universe of stocks available has been demonstrated to achieve a high level of performance despite not all conditions of a complete Islamic financial and economic system being in place, which is the ideal environment for Shari'a compliant businesses to subsist.

The Dow Jones Indexes has created a portfolio of indexes designed to capture those securities that fulfill the Shari'a compliance requirement as set by scholars. The family includes regional, country, industry and market capital based indexes, all of which are subsets of the Dow Jones Islamic Market World (DJIM World) Index. The index excludes companies whose total debt compared to a trailing 12 month average market capitalization equals or exceeds 33% and companies whose accounts receivable divided by 12 month average market capitalization equals or exceeds 33%. This is in addition to stocks of companies who exercise unacceptable activity from the point of view of Islam.

The index has performed very well over the past five years, on par with leading market indexes in the U.S. and abroad. It has outperformed the S&P 500 Index on a five years annualized totaling as well as the Russel 3000 Growth Index over the same period of time.

the Dow JonesSM Islamic Fund

Performance Review as of October 31, 2007

	Three Months	Year-to-Date	One Year	Annualized Three Years	Annualized Five Years	Annualized Since Inception (June 30, 2000)
Dow Jones Islamic Fund	12.19%	20.42%	24.37%	14.74%	13.58%	-0.24%
Benchmark Performance						
Dow Jones Islamic Market USA Index*	8.61%	17.99%	20.73%	13.68%	13.03%	-1.25%
Dow Jones Islamic Market World Index*	9.19%	21.12%	25.64%	17.53%	16.07%	0.68%
S&P 500 Index	6.97%	10.87%	14.55%	13.12%	13.86%	2.56%
Russell 3000 Growth Index	9.52%	16.34%	19.03%	13.18%	11.83%*	-3.76%*

Performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance data quoted. Performance data shown is current to the most recent month end.

* The Dow Jones and certain Russell 3000 Growth Indices do not include dividends reinvested.

Source: The Dow Jones Islamic Fund (IMANX)

It can further be argued that the principles set out in the Islamic economic doctrine can play the role of a shield against market and cyclical fluctuations to the businesses investors wish to consider. For example, the debt level of Islamic institutions is subject to a maximum constraint level. The contained leverage reduces the risk to the Islamic institution during downturns of the economy. At the same time, the significant growth of the Islamic financial market in recent years and the proliferation of Islamic windows by conventional Eastern and Western financial institutions indicate the manageable and competitive risk-reward ratio offered to an investor by Islamic institutions.

We may also consider the positive effects of profit sharing and the prohibition of interest during cyclical fluctuations. Due to the synchronization between payments and revenues and the lack of correlation between interest rate and borrower obligations, an Islamic financial institution is less expected to suffer the default risk faced by conventional institutions during interest rate hikes. These two factors capture the fact that Islamic securities are able to perform alongside their conventional counterparts and have the added prospect of higher stability.

It remains to mention some of the disadvantages of not complying with Shari'a to the economic system at large and which 'socially responsible' portfolios ought to consider. Apart from the upsetting moral effects some activities may create, the charge of Riba has its own distributional and wealth creation drawbacks. The cash acquired through debt can be put into uses that may or may not result in wealth creation. This shows that debt creation in the conventional mode is an inefficient means of wealth creation and also inequitable since the funds go to the most credit worthy borrower, not to the most promising projects. This is in large contrast with the Islamic structure which institutionalizes the decision making process through profit and loss sharing and will not create interest bearing debt but will participate in the economy by adding a new economic, wealth creating activity. In other words, Islam restores money to its essential

functions that participate in the stability of the system instead of being the source of instability.

The level of compliance to Shari'a rules can be one of the most significant considerations borne by Muslim investors. We observed the need for measuring the element of Shari'a compliance in Islamic institutions and presenting this information to the market. This information creates competition among Shari'a compliant institutions, encourages transparency and reduces the information asymmetry available to market participants. This naturally enhances the investor decision making process and encourages potential Muslim capital, reluctant to be invested in questionable institutions, to participate in the market.

This is the background where the Islamic International Rating Agency (IIRA) was established to accommodate for this need. It specializes in catering for the credit ratings with a special focus on the unique characteristics of Islamic financial institutions. It has also introduced the Shari'a Quality Rating which measures the level of compliance of Islamic institutions with the Fatwas stipulated by an institution's own Shari'a board. The specialization of IIRA does not include looking into the validity of the Fatwa. It rather measures the compliance methods and procedures that are considered the cornerstone of Shari'a compliance applied in an institution.

The existence of IIRA creates a reference point where investors can seek information on the quality of compliance that is measured on a single comparable scale for all institutions. The comparable scale places all rated institutions on an independent, impartial framework that synthesizes a solid rating methodology prepared by a panel from among the most prominent Shari'a scholars in the Islamic world. The existence of a compliance measurement ultimately serves the issuers, enhances market efficiency and acts as a leading reference for investors.