The phenomenon of Shariah compliant funds

Much of the focus in recent years in the Islamic finance space has been on the explosion in the issuance of Sukuk (or so-called Islamic bonds), the use of Islamic finance or tranches in financing large infrastructure projects and the equally notable growth in the retail market. However, another industry has also been quietly and very successfully developing – the phenomenon of the Shariah compliant fund and with it, the creation of a complementary Islamic fund and asset management market. NEALE DOWNES writes.

PRIVATE EQUITY

By Neale A Downes

In many ways, this is not at all surprising, as Islamic finance structures are, at their heart, far more akin to equity than to debt. Musharakah (joint venture) and Mudarabah (a limited partnership) – perhaps the purest of Islamic finance contracts – are arrangements whose very nature is in the sharing, between the partners therein, of risk and reward or, put another way, of profits and losses.

Structure

Shariah compliant private equity funds are normally structured as a limited partnership which, as explained previously, to all intents, is the same as a Mudarabah arrangement. As a general rule, Shariah prohibits investments in preference shares, as they go against the principle that all investors or stakeholders should bear losses equally or, at the very least, pro rata to the level of their equity participation. Hence, investing in or through a company which issues different participating classes of shares is generally not allowed, although the use of management shares (for control) is not uncommon.

One alternative is a closed-ended unit trust structure, whereby a fund company issues units to investors and then delegates management and administration to a third party – usually the fund sponsor or one of its affiliates. For example, this contractual structure is the norm for Middle East-sponsored funds domiciled in Bahrain. Shariah compliant private equity funds with international investors are, however, typically domiciled in traditional offshore jurisdictions familiar to such international investors.

The flat, opening or annual management fee is categorized as an agency arrangement (where the fee is a fixed amount or a percentage of capital commitments or the net asset value) and the carried interest or performance fee is viewed as a Mudarabah agreement (a silent partnership where certain parties (the Rab Al Maal) provide capital and the other party (the Mudarib) manages and deploys that capital toward an agreed investment policy or within investment guidelines and provides expertise in return for a share of the profit). Payment of the carry or performance is, as is usual in the conventional fund sector, dependent upon the investors first achieving a certain rate or return and/or on the returns exceeding a high water mark.

While the basic documentation for a Shariah compliant fund is similar to that of a conventional fund – ie analogous to a limited partnership agreement – certain terms, such as the equalization mechanism for investors admitted after the first closing and the charging of default or penalty interest on amounts due from limited partners which is not contributed (ie using a typical commitment model), must be adjusted in the context of Shariah.

As a result of their unique operating and investment restrictions, fund managers often set up the Shariah compliant fund as a parallel fund which invests proportionately in portfolio investments on substantially the same terms and at the same time as a separate conventional fund. While the parallel fund will have the same fund manager and investment focus as the conventional fund, such a structure allows the fund manager to provide a Shariah compliant investment vehicle to investors without restricting the operations of the conventional fund and burdening its investors with any additional costs.

Shariah supervisory board

A Shariah compliant fund must appoint a Shariah supervisory board that reviews proposed investments and issues opinions (Fatwa) as to their compliance or otherwise with Shariah. Most private equity funds from the Middle East simply engage an already existing Shariah board (typically the Shariah supervisory board of the fund’s sponsor or anchor investor). Alternatively, a fund may hire a Shariah consultant or establish its own Shariah supervisory board comprised of various Islamic scholars. There are also certain service providers with their own Shariah boards which may be engaged on a contractual basis to advise a fund.

The Shariah consultant or supervisory board is required to review and approve the private placement memorandum or other offering documentation and all other fund documents.

Shariah prohibits investments in preference shares, as they go against the principle that all investors or stakeholders should bear losses equally or, at the very least, pro rata to the level of their equity participation.

The Shariah consultant or supervisory board routinely audits the fund’s activities and produces an annual report regarding ongoing Shariah compliance. Such a review may involve, among other things, visiting portfolio companies and the examination of documentation pertaining to investments. Details of investments proposed by a fund manager

© Islamic Finance News
involving structures or securities not previously approved by a Shariah consultant or supervisory board are usually presented to the consultant or board for review and approval prior to investment.

Permissible investment areas

In order to qualify as Shariah compliant, a fund’s investment policy must contain restrictions that prohibit investment in industries or asset classes considered to be forbidden or Haram. These restrictions thus prohibit investment in companies active in the following industries and activities:

(a) conventional financial services (including conventional banks and insurance companies)
(b) tobacco
(c) gambling
(d) alcohol or pork products
(e) certain entertainment, such as pornography (but often including cinemas, music and publications)
(f) weapons or military equipment, and
(g) any other immoral or unethical activities identified by the Shariah consultant or supervisory board.

The application of these investment restrictions is subject to differing interpretations. For instance, some Shariah scholars argue that an investment by a fund in a hotel or restaurant that serves alcohol and/or pork is prohibited, whereas other scholars argue that if the alcohol sales are less than a certain percentage of the total revenue of the hotel or restaurant, the investment by the fund may still qualify as Shariah compliant. Alternatively, funds or other investments are often structured so that any revenues from any activities considered to be Haram are segregated and not distributed to the Shariah compliant investors – they are typically donated to a charity – or that such revenues are applied or reinvested in permissible activities or assets, so that any further ensuing revenues are ‘purified’.

Cash held by a fund may only be invested in Shariah compliant, short-term investment products, such as Islamic money market instruments (eg Sukuk)

While a Shariah compliant fund may engage in leverage through the use of Islamic financing instruments (such as Murabahah), it may not obtain or provide conventional loans or otherwise invest in conventional interest-bearing instruments, including convertible debt securities. Cash held by a fund may only be invested in Shariah compliant, short-term investment products, such as Islamic money market instruments (eg Sukuk).

Similarly, a Shariah compliant fund is subject to restrictions on the amount of conventional leverage permitted at the portfolio company level. This often takes the form of financial parameters in relation to the debt-to-equity ratios and interest income of its investments. The generally accepted standard is that the ratio of total conventional debt to total assets should be less than 33%. Additionally, the ratio of interest income (plus income from any incidental Haram or unidentifiable activity) to total revenue typically must be less than 5%. The ratio of liquid assets (cash plus accounts receivable) to total assets should be less than 45%. Finally, any conventional debt of a portfolio company must be restructured in a Shariah compliant manner generally within three years after acquisition.

Conclusion

As we can see, therefore, the inherent nature of a fund as a partnership between providers of capital and one or more expert and experienced managers of that capital and the requirement that all such parties should bear the risk and enjoy the rewards of their investment on an even or proportionate footing fits very comfortably into the ethos of Islamic finance.

The creation of screening services and widely accepted and trusted Islamic indices by a number of market participants – perhaps most notably Dow Jones – has further facilitated and hastened the growth of this exciting market.

Notwithstanding the continuing era of low interest rates and inflation, signs of tightening liquidity in the traditional debt markets would suggest that further opportunities will open up for the well-advised and fleet-footed equity investor, including those requiring Shariah compliance.

Neale A Downes is a partner at Watson Farley & Williams. He can be contacted at ndownes@wfw.com.