

Envisaging a close-ended mutual fund model for Islamic financial intermediation beyond banking – Innovation, prospects and opportunities

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Abstract

In the present day world the mutual funds asset penetration highly resonates with the country's development. Islamizing Mutual Funds for the underdeveloped Muslim World has the potential, not only, to stimulate economic development but also to push the level of financial inclusion. Note that over half of the population of the Muslim developing world is under 25 years of age, which affirms a greater aggregate risk appetite on the supply side as well. On the basis of closed-ended-funds ability to capitalize the relatively illiquid, long term and growth projects, we assert on its potential towards the addressing sustainable economic and financial development for Muslim countries. This paper seeks to present an alternative financial innovation based on Islamic closed ended funds malleable across shared income, appreciation and equity. We present financial model delineating asset profile, structure and risk-return dynamics of the proposed investment vehicle. We also posit additional design consideration, and market mechanisms to mitigate the risk of: (i) debt overhand, (ii) financial fragility, and (iii) expropriation of wealth/ asset substitution. We argue that the proposed investment vehicle adds to the market completeness and financial development for its ability to package investment products to meet the risk-reward profile of economic agents across the continuum of life-cycle. Additionally, it complements the overall financial ecosystem by easing the pressure of credit grant process and the expensive capital of banks, encouraging the flow of surplus funds towards long term infrastructure development. The financial innovation in terms of Islamic close ended funds malleable across shared appreciation, income, and equity dimensions posited in this paper – can potentially alleviate

Keywords: Mutual Funds, Islamic Finance, Muslim World, Economic Devrlopmrnt

Introduction

Over a century ago, Mutual Funds (MF) were posited as a modern institutionalization of collective savings and investments in the United States of America. It was the decade of 1990’s that saw an expansive acceptance and demand of the MFs, wherein MF assets exceeded over 20% of GDP in over 16 countries (mostly developed countries). In the contemporary world, wide-scale penetration of MF assets is deemed as a predictor and determinant of economic development in a country.

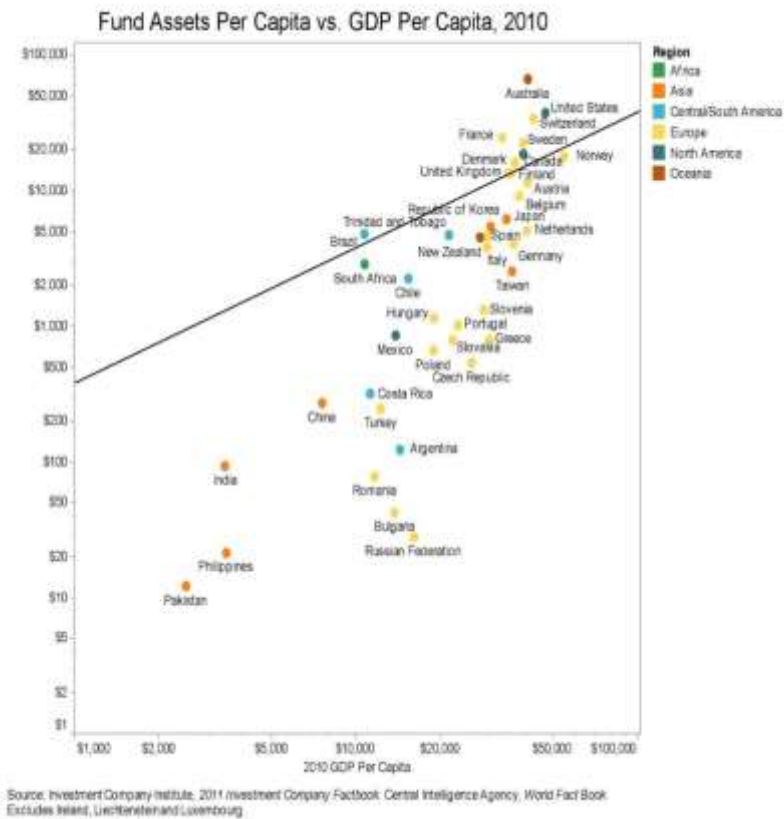


Figure 1- Asset under mutual fund per capita versus GDP per capita (Source: Investment company facebook)

Mutual funds are fundamentally categorized in terms of various dimensions such as their objectives, asset classification, risk profile, and their investment model i.e. open-ended funds (OEF) and close-ended funds (CEF). The key defining differentiation between OEF and CEF is delineated by the CEF's (i) process of liquidity management i.e. its ability to trade in the secondary markets; and (ii) and its size capping defined at the time of initial public offering. This technically isolates the CEF from its investor base and thus from the pressure of liquidity management, as the CEF investor can invest in or redeem their investment in the secondary market (stock exchange). It is worth noting here that the pricing of CEF thereby is determined by the supply and demand; and investor expectation, instead of the net asset value (NAV) (Lee et. all, 1991). The so-called isolation of the CEF from the investor-base, exonerates the fund managers from liquidity management pressures arising out of idiosyncratic and at times irrational buy-sell behaviour of the investors that usually leads to an unfavourable market timing. Moreover, fund managers can therefore have the luxury of deploying funds into long term, rewarding and growth-oriented asset classes e.g. REITS, Small cap stocks, long-term infrastructure projects, Venture Capital, and project finance etc. (Elton, E., et al, 2013)

Further sophistication is added to CEF by under-writing bank debts, preferred stocks, and sub-ordinated debt instruments. On the other hand, the OEFs are somewhat modest in their structure, wherein the issuer is responsible to redeem or issue investment units at the prevailing price based on their NAVs. The fund manager manages an uncapped size portfolio of investment, mostly in liquid and low-risk assets to ensure amicable returns and efficient management of asset-liability mismatches. This paper seeks to present a financial innovation based on Islamic closed ended funds based on shared income, appreciation and equity to address the economic development and financial development related challenges in the developing Muslim countries.

The Case of Mutual Funds for the Muslim World

Islamizing Mutual Funds for the underdeveloped or the so called emerging Muslim World, not only, has the potential to stimulate economic development but also to push the level of financial inclusion (Kaminsky et. al,2001). On the basis of CEF's ability to capitalize the relatively illiquid, long term and growth projects, we can safely assert its suitability towards the sustainable development goals of the Muslim countries. Moreover, its ability to package investment products to meet the risk-reward profile of

economic agents across the continuum of life-cycle adds turns in its favour (Tin et al,2000). It is pertinent to mention here that over half of the population, of the Muslim developing world, is under 25 years of age, which affirms a greater aggregate risk appetite on the supply side as well.

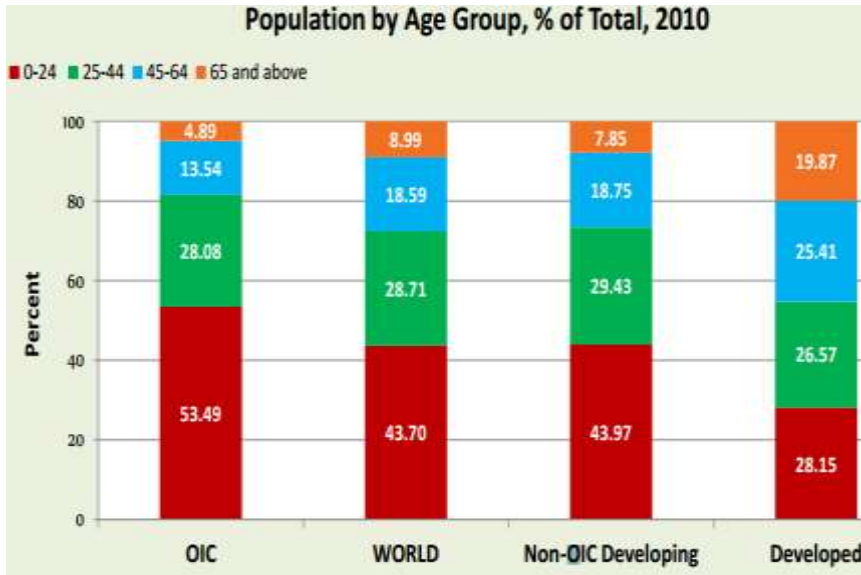


Figure 2- Population distribution across developing and developed country classification

As a component of the overall financial ecosystem, it can optimize the financial intermediation by easing the pressure of credit grant process and the expensive capital of banks, encourage saving to channel the surplus towards long term infrastructure development and growth oriented projects (Iqbal Z.1997; Ong et al, 2000) as schematically represented in figure .

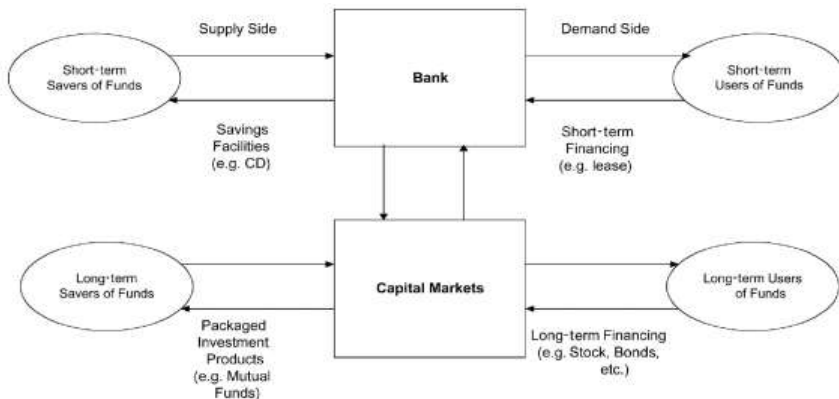


Figure 3- Schematic representation of financial intermediation system comparing the role of banks and capital markets Source: Ebrahim et. al 2010

Primarily, Islamization of MF Industry solicits deliberation across three axis, i.e. the Shariah consideration (weaved around the prohibition of Ribawi debt and the nature of business i.e. prohibition alcohol, porn, weapons sectors etc), the structure of the investments and the sources of funds, respectively on the Assets and Liability side of an MF. The literature provides guidance on the probable structures of Mutual Funds based on literalist or contemporary views, whereas others taking the maqasid approach insisting on the eradication of expropriation of wealth, financial fragility and financial exclusion (Ebrahim et al, 2014). However, both tend to converge on the single fact to uphold participatory and equity based arrangements. The table below summarizes the established consensus on the screening criteria for investments:

*Financial Screening Criteria Based on the Major Four Global Islamic Indices Providers and SAC of Malaysian SEC**

	Level of Debt	Cash and interest bearing securities	Liquidity	Impermissible Income
Dow Jones	Total Debt/ Market Cap (Aver.24month) less than 33%	Cash and interest bearing securities/ Market Cap (Aver.24month) less than 33%	Account Receivable/ Market Cap (Aver.24month) less than 33%	Should not exceed 5% of total revenue
FTSE	Total Debt/ Total Assets less than 33%	Cash and interest bearing securities/ total assets less than 33%	Account Receivable and cash/ total debt less than 50%	(Total interest and non compliant activities income) should not exceed 5% of total revenue
S&P	Total Debt/ Market Cap(Aver.36month) less than 33%	Cash and interest bearing securities/ Market Cap (Aver.36month) less than 33%	Account Receivable/ Market Cap (Aver.36month) less than 49%	(other than interest income) should not exceed 5% of total revenue
MSCI	Total Debt/ Total Assets less than 33.33%	Cash and interest bearing securities/ total asset less than 33.33%	Account Receivables and cash/ total asset less than 33.33%	Should not exceed 5% of total revenue
Malaysian SEC**	n/a	n/a	n/a	5% - 25% of total revenue

Source: Official Indices Websites, 2011

* Shariah Advisory Council (SAC) of the Malaysian Securities and Exchange Commission (SEC).

** Adopted from Rahimie (2010).

Figure 4- Islamic/Shariah Screening criteria for Mutual funds investments.

2.1 Imperatives for Asset Mix and Capital Structure

The above table not only dictates the screening criteria for a security to be deemed acceptable, but also indirectly derives key imperatives for the leverage of a CEF, wherein a CEF can hold debt (dayn) not more than one-third of its total market capitalization/assets.

On the Asset mix, a CEF, to be tradable, has to have a preponderance (atleast 51%) of tangible assets based or beneficial claims, as set by Islamic Fiqh Academy Ruling.

2.2 Issue of Discount / Premium on NAV

CEF's issue of trading at a value different from that of its NAV, contradicts with the fairness principles of shariah – however can be rationalized on the basis of daroora (need) and public good. Other remedies proposed by (Ebrahim, 1993) includes allowing CEFS to trade only on NAV's within specified periodic time windows. One pragmatist solution which can be tabled for an ijtihadi review is to cap Z-Stat (relative variance of the CEF's market price), necessitating extra-market measures e.g 'management buy-back' to stabilize the market price.

2.3 Structuring CEFs on Islamic Principles

In the following section, we would be setting the boundary conditions for an MF structure to be deemed Islamic or Shariah Compliant (Ebrahim 2010)

- 1- **Avoidance of Debt Overhang** to subsequently protect the interest of financial claimants and deter the Under-Investment Form of Agency problem.
- 2- **Avoidance of Expropriation of Wealth** amongst the counterparties and across all financial claimants i.e.

$$\Pi \ll r_{sukuk} \leq r_{un leveraged equity}$$

Where, Π is the inflation rate

r_{sukuk} is the expected return on the sukuk securities underwritten by the MF

$r_{un leveraged Equity}$ is the expected return on the unleveraged equity i.e. the CEF's share.

Referring to the concept of inflation above, it is pertinent to mention here that, the risk free rate is substituted by the inflation rate (Π) which in turn enables the asset manager to price securities and evaluates projects on the basis of the CAPM.

$$E(r_s) = \Pi + \beta_{SM}[E(r_M) - \Pi]$$

Where, $[E(r_M) - \Pi] > 0$

- 3- Deter financial fragility by embedding options like that of equity kickers to set a floor for the prices.
- 4- Mitigate the risk of asset substitution, i.e. to dismiss the risk of an in-the-money put option that incentivize moral hazard and liquidation.

As we can see the above condition solicits intricate attention primarily to two issues:

- Optimizing the capital structure of the MF.
- Rigorous pricing of the various claimants.
- Investment portfolio optimization to meet the income/growth expectations financial claimants.

i.e. MF Investment Portfolio Payoff (P) = Sukuk payoff (Q) + Equity Payoff (E)

Wherein, $E > 0$ would only hold when

$P > Q$

We need to assure the following condition to hold even in the worst state of the economy

$E_{1, \text{worst}} = P_{1, \text{worst}} - Q_{1, \text{worst}} \geq 0$

2.4 Employing Participatory Debt for Resilient Gearing

To gear the CEF in accordance with the Islamic principles, it is preferable to employ participatory debt/ hybrid securities malleable across income and appreciation of the portfolio referred as Shared Equity, Shared Appreciation and Shared Income i.e. SID, SAD, SED (Ebrahim et al 1995). Given the PD's ability to tune the income sharing ratio, LTV and appreciation cultivate resilience to the overall CEF, even in bad state of economy (Ebrahim et al, 2010). This subsequently, enables effective matching of the risk profile of the investor to that of the investment. Another, suitable structure for the risk-averse investor segment looking for capital-protected investment is a combination of qard and an equity call option such that the payoff hedges the inflation (Ebrahim, 1996). On the asset side, the CEF manager can build a portfolio of growth (REITS, Infrastructure projects, Public Finance) and Income Security (value/mature equity, and Ijarah) to match their investor's risk profile.

Graphical representation of SID/SAD

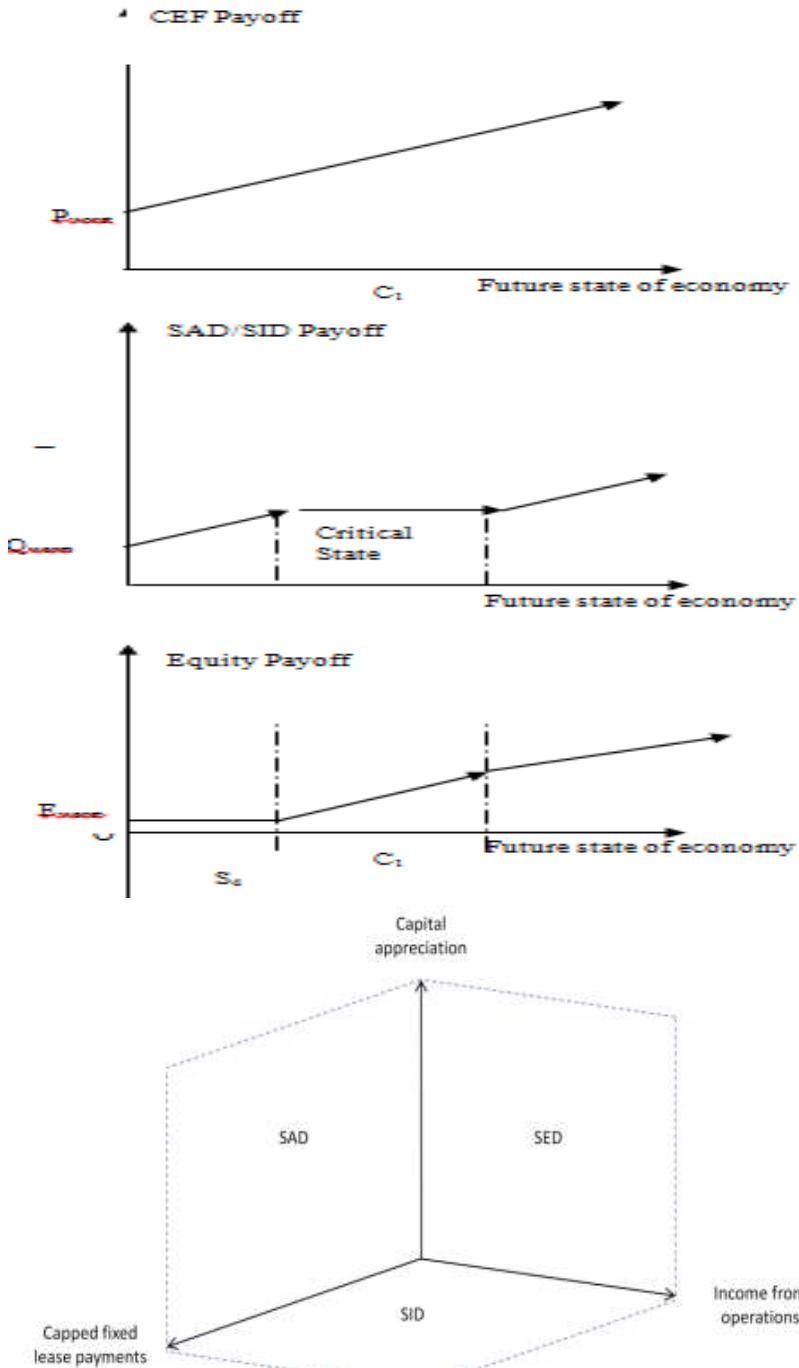


Figure 5-Graphical representation of Shared appreciation, income and equity sukuk payoffs

Other structural consideration may include structuring the portfolio to aim diversification not only to diversify the unique risk, but also to pull the portfolio to operate on the Markowitz efficient frontier. Portfolio selection and optimization may be achieved for a varied class of investor based on their risk averseness, age, security market line and efficient frontier. The capital allocation model may also guide the asset manager on optimizing its borrowing and lending frontiers across the capital allocation line.

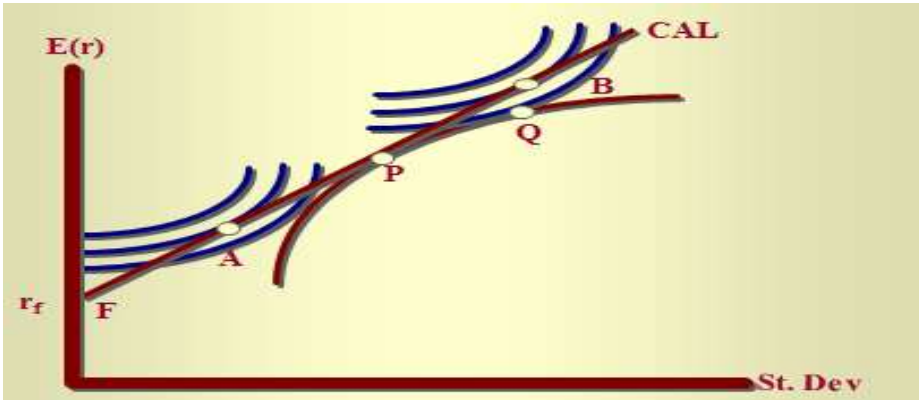


Figure 6- Asset class risk-return profiling

1- Concluding remarks, Opportunities and the Way Forward

Islamic Mutual Fund industry is presently scaled at around USD 56 Bn (out of a total Islamic Finance assets of USD 1.6 Tn), hugely dominated by OEF and retail customers, as against the conventional MF where 70% is contributed by the Institutional Investors.

Despite of stable double digit growth, there exists a potential to innovate and diversify across markets segments, asset classes and business models.



Figure 7- Distribution of Islamic mutual funds over the years

GLOBAL ISLAMIC FUNDS – ASSET TYPE (2013)

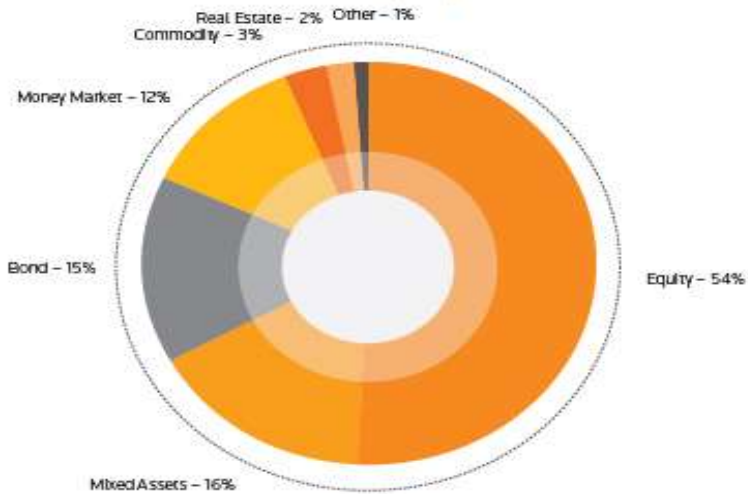


Figure 8- Asset class distribution of Islamic mutual funds world-wide

Pension Funds (PF) form around 29% of the world MF assets. The GCC's PF alone, is estimated around USD 180 Bn and can propel the Islamic MF industry struggling for scale and scope. Ethical, Impact and Sustainable sector valued around USD 20 Tn, offers humongous potential for Islamic MF sharing convergent principles. The financial innovation in terms of Islamic close ended funds malleable across shared appreciation, income, and equity dimensions posited in this paper – can potentially alleviate bank-centric and short-term oriented financial intermediation in the shariah finance industry to attend the economic development challenges in Islamic countries.

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