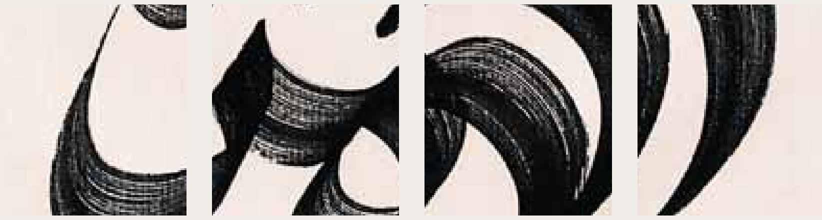
SARASIN

Islamic Wealth Management Report

2012

Sustainable Swiss Private Banking since 1841.

Bank Sarasin
Islamic Wealth Management Report 2012



Foreword

We are pleased to present Bank Sarasin's Islamic Wealth Management Report 2012. This is the third edition of our Islamic Wealth Management report and is based around the topic – "The Path to Corporate Transformation – Converting a Company to Islam". Our previous reports have focused on Islamic Financial Planning and Estate & Succession Planning, respectively.

The choice of the topic for this year's report is related to an interesting incident. At Bank Sarasin's Islamic Wealth Management forum in Muscat, an Oman-based businessman posed excellent questions: "How do I make my company Islamic? What does this mean? What are the implications, and what are the requirements?". This question led us to research this area further and we soon realized the dearth of information on this subject. We decided to compile the different perspectives about converting a conventional business to Islam and made it the theme of our 2012 report.

"Converting a business to Islam"

Throughout the world, Muslims are becoming increasingly active as investors, manufacturers, bankers, traders, competitors and suppliers. They are becoming partners in the global economic system, and increasingly represent a major growth opportunity for business around the world.

Operating in a conventional business environment, Muslim businessmen are faced with the challenge of making their businesses compliant with Islamic principles. Banking with an Islamic bank and arranging one's finances according to Islamic principles is the first thing that comes to mind but there are several other areas to be reviewed. Full Sharia compliance means that not only are production and logistics in compliance, but the business' finances, marketing policies and advertisements, safety and hygiene standards as well. The potential impact on the value chain is immense.

Our Islamic Wealth Management Report 2012 focuses on several aspects when converting a business into an Islamic one, including market factors, governance and legal procedures as well as financial implications. In addition to considering the processes, we also review the various asset classes. The legal firm Al Tamimi & Company has contributed an article on the legal implications of Sharia compliance.

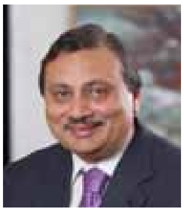
Islamic Wealth Management and Bank Sarasin

The Sarasin Group, which has its roots as a Swiss private bank, launched its full spectrum of Sharia-compliant private banking products and services in 2009. Bank Sarasin's Islamic Wealth Management includes services such as estate and succession planning, financing and asset management with money market and structured products such as Wakala, Murabaha and Maraya. Bank Sarasin has also established a Sharia Advisory Board that is responsible for continuous monitoring of implemented solutions. The Islamic finance team is fully equipped to assist in meeting the investment goals of clients in a Sharia-compliant manner and analyse clients' needs with a holistic approach.

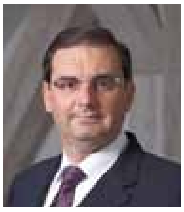
Our Islamic finance team has challenged the status quo and always argued that Islamic Portfolio Management should be treated in a just manner that reflects its identity and fulfils clients' expectations. As a result, we have a unique Portfolio Management and Investment process concept that begins with the Sharia. The investment universe is then screened for compliance before the best possible asset allocation for each client is determined. This also ensures that the investor is adequately compensated for investment risks. Bank Sarasin extends its Islamic Wealth Management offering to its valued clients throughout its network of branches and subsidiaries.

We hope that you enjoy reading our Islamic Wealth Management Report for 2012 and thank you for your continued trust in Bank Sarasin.

Fidelis Goetz
Head of Private Banking, Bank Sarasin & Co. Ltd, Switzerland

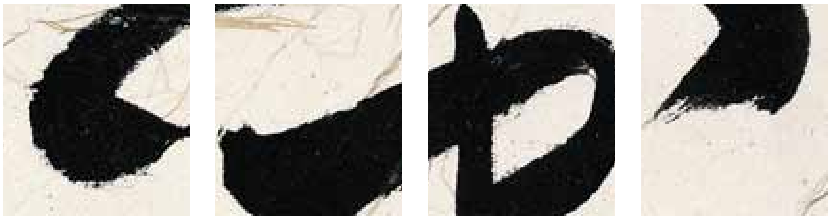


Rohit Walia
Executive Vice Chairman & CEO, Bank Sarasin-Alpen Group



Fares Mourad
Head of Islamic Finance, Bank Sarasin & Co. Ltd, Switzerland

Foreword from the Sharia Advisory Board of Bank Sarasin, Switzerland



The Islamic Finance team at Bank Sarasin has, under our guidance and supervision, developed a full range of Islamic Wealth Management services. The Bank's management has continuously shown enormous commitment and has not shied away from the costs involved in establishing and developing this business.

The previous two reports touched upon topics that are largely neglected in the Islamic Finance world. In 2010 Sarasin reviewed Islamic Estate and Succession Planning and, in 2011, Islamic Financial Planning. This year's topic addresses an issue that is rarely written about - "The Path to Corporate Transformation – Converting a Company to Islam". The topic touches upon each and every activity in which a business is involved, be it management, production, banking relations or marketing strategies and activities. Once again, the chosen topic demonstrates the commitment Bank Sarasin has taken to be a leader, not only in words, but in deeds in Islamic Finance.

We, as the Sharia Board, are satisfied with the approach and the manner in which the Islamic Finance division of Bank Sarasin is handling and pursuing its Wealth Management offering. We would like to express our best wishes to Bank Sarasin and its dedicated Islamic Finance team and hope that they achieve sustainable success with Allah's blessing.

Wallahu Waliuu Al-Tawfiq

Sheikh Dr Mohammed Ali Elgari
Member

Sheikh Dr Mohammed Imran Usmani
Member

Sheikh Dr Monzer Kahf
Member

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The path to corporate transformation – converting a company to Islam

One of the defining trends of this century is the public surge in awareness of Islam, as its practitioners assert their identities and values. In the last 30 to 40 years, Muslims have become increasingly active in every area – from business to education to politics – making an indelible footprint across various societies. They are now recognized as a considerable global force, not only religiously and politically, but economically. The Muslim world is now a distinct – and extremely attractive – market segment.

The numbers speak for themselves. In 2010, about 23% of the world's population was Muslim. In practical terms, that means a market of 1.9 billion across 112 countries, hungry for halal food (www.elhalal.org July 2011). Some dub it the "third billion", with China and India. Demographics also make marketers salivate – of that 1.9 billion, 43 percent are under the age of 25. That's equal to about 10% of the world's total population.

And there's more to come. The Muslim population is expected to increase by 26% to 2030 to approximately 2.2 billion. In numerical terms, the 1.9 billion Muslims of 2010 will beget a further 300 million, the equivalent of today's US population, by the end of this decade (representing a 19% increase). Muslims currently have a 7.7% share of global GDP which is expected to grow to 8.7% by end-2016.

The global halal products market is already estimated at more than USD 2 trillion (including food and beverage at 67%, pharmaceuticals at 22%, personal care and fashion at 10%). In terms of services, the assets of Islamic banks and financial institutions worldwide are predicted to reach USD $1 trillion by next year and USD $1.8 trillion by 2016, according to Deutsche Bank. With markets beckoning, Ogilvy Noor, the first Islamic branding agency, was launched in 2010. Its report, "Brands, Islam and the New Muslim Consumer", retails at over USD 9,000. Demand for the report reflects interest in the sector.

Muslim markets create Muslim opportunity

The Sultanate of Oman recently joined the world of Islamic finance. To mark the occasion, Bank Sarasin, one of the only Swiss private banks offering the full range of Islamic private banking services, organised an event presenting Islamic financial planning. At the end of the seminar in Muscat, an Oman-based businessman posed an excellent question: "How do I make my company Islamic?" In this report, we ask, what does this mean? What are the implications, and what are the requirements?.

This report does not claim to be a guide, nor is that its aim. Rather, it addresses various issues that need to be considered when converting a business to Islam. This report simply cannot offer a comprehensive approach because the different business activities of each company will determine the aspects to be addressed, just as a private banker considers each client's individual needs and goals before a solution is proposed. Sarasin could not find a single reference book or document that provided complete guidance, although a few articles address some issues. As the market leading Swiss private bank providing Islamic Wealth Management services, we also share the practical experience we have gained as an advisor.

The rationale for transformation

Prior to addressing what must and must not be done, it is important to understand the motives and rationale behind the conversion of a business to Islam. Why would a businessman, such as our enquirer in Oman, want his company to be Sharia-compliant, particularly when his business is already successful? In our experience, the main reasons are:

Identity and faith

A person who lives following the guidelines of the Sharia, which regulates his inheritance and civil status, and who pays Zakat dues, would naturally ask himself why he does not conclude his financial and business activities in conformity with the Sharia as well. This may be a small step when the core business is halal and situated in a Muslim-majority country in which Islamic banking services are offered, although not all Muslim countries have Islamic banks. The person might take a further step and make the Sharia-compliant operation of his company public since there may be a marketing benefit.

Economic considerations

Many businessmen, in particular in the Arabian Gulf, know that converting a business to Islam could increase the value of their company by a remarkable 18-25%, even though the cost of changing the business may be minimal and bearable. It should be noted that the scarcity of genuine Islamic investments is the main driver behind these favourable valuations. Beyond valuations, the Islamic consumer market is very attractive and growing.

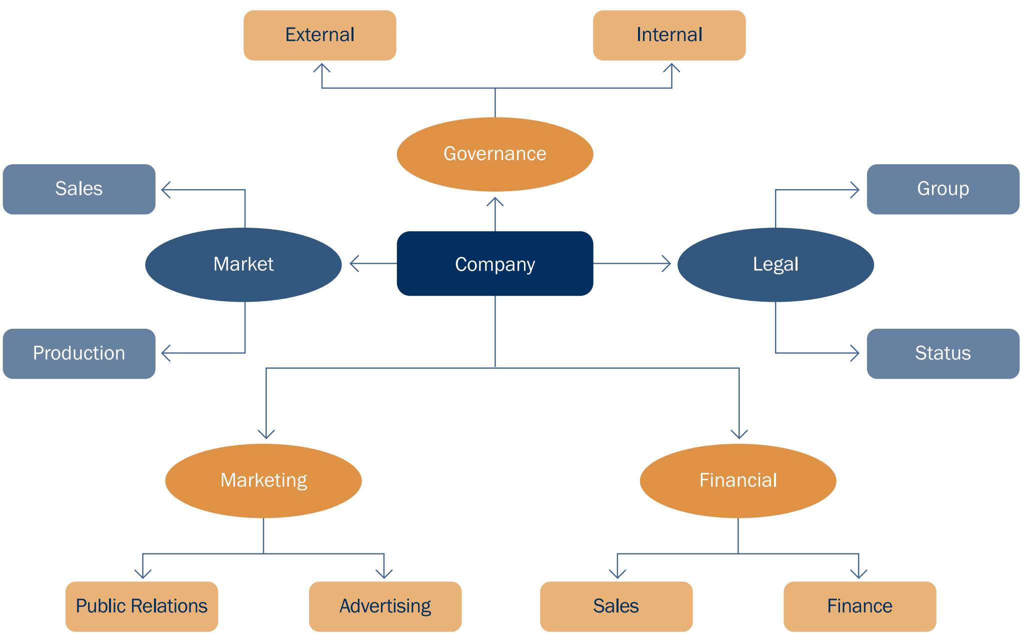
Converting a company to Islam would touch upon a number of issues, which can be summarised as relating to:

- Market
- Governance
- Legal
- Financial
- Marketing

Although there are clear requirements regarding the conversion of a financial institution and the handling of financial transactions to ensure compliance with Sharia law, largely documented in the standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the question becomes much more complex when commercial enterprises are concerned. Such companies target various markets and offer a vast range of products or services for which there are few written references or documented standards.

In reality, transforming a company to Islam would demand examining every aspect of the business. The degree

Aspects to be considered when converting a company to Islam



Source: Bank Sarasin

of transformation would depend on many issues and aspects related to the type of business the company undertakes, how it conducts its business and finances, and where it is located. To be Islamic it must reflect a complete understanding of Islamic culture and values throughout the organisation, including but not limited to management, procurement and production processes, working environments, sales and marketing, packaging, distribution channels and retailing.

The complexity of conversion

The complexity of conversion depends to a large degree on the business' location. A company based in Saudi Arabia can assume that its inputs and products are largely Islamic, with finance being the common exception. But a butcher in Germany who might wish to be publicly declared halal to attract new or different types of customers would need to address many issues. This affects the consumer as well. A consumer in Turkey would never doubt that the meat he is buying has been obtained in conformity with Islam, while one in France must do so.

How drastically does a company need to change to be Islamic? This depends on the degree the company deviates from the guidelines required by Islam. How is the company managed? What and how are materials sourced? How are products produced? What would it cost to achieve halal certification? How would that affect profitability? What would happen to the supply chain? How would this "new and improved" product affect the company's existing brand and loyal customers? For this product, is the Muslim consumer the most attractive now and in the future? What risks are being taken and can they be addressed?

Who is the Muslim consumer?

The question of who the Muslim consumer is itself poses a question – What does Muslim mean? How strictly observant are the majority of Muslims in the target market? Since Islam is a religion and a culture, observance is expressed differently across the world. The question "What is the Muslim market?" is not trivial. As a common market, the concept is nebulous, so there is no one-size-fits-all approach. Instead, clients must be targeted on the basis not only of geography but of context, requiring deep cultural comprehension and a specifically tailored approach.

Muslim consumers are far from homogeneous. First, they do not speak a single unifying language. They dress differently. They are educated differently. And they eat differently. While the Muslims of the Arab world may have many similarities, what of the Muslims of Turkey and Indonesia, Russia and Oman, Iraq and India, Germany and China, Malaysia and France, Egypt and Bosnia, Britain and Brunei? While the distinctions immediately become apparent, a stark contradiction remains – for while Muslims are more integrated globally, more and more they see themselves as distinctly Muslim. They are known as Ummah, the global Islamic community.

The traditional Muslim world itself is experiencing dramatic changes. The world was mesmerised by the Arab Spring, as largely Muslim populations took to the streets to demand change. These historic events are only the most striking element of the changes sweeping the Ummah. In Muslim communities across the world debate rages about economic and social interaction with broader society, education, the role of women, and Islam's place in politics. In some places this has literally lifted the veil, while in others women remain completely covered by the burqa, the jilbab, hijab and niqab. In Taliban Afghanistan women are not allowed to be educated, while in Kuwait, Qatar and Oman, women are allowed to vote, and in Pakistan, Syria, Bahrain and the UAE, even hold ministerial positions. Recently a royal decree was issued in Saudi Arabia allowing a female minister, who sits with the King in the Council of Ministers, to vote.

The economic rise of Islam

The importance of Islam to the modern global economy dates from the 1970s, when rising oil prices earned the OPEC nations vast current account surpluses. These surpluses fueled the rise of Islamic financial institutions and centres such as Dubai, as some Arab governments channeled their funds into home-grown entities. In turn, their populations have become rich, with some noted for their extravagant spending. Malaysia, which has taken a leadership role in Islamic finance, has become a vibrant Asian economy. Yet other Muslim economies have languished.

As a result, personal income across the Muslim world varies substantially, as demonstrated in the following chart. With the Muslim world having as many disparate parts as a mosaic has tiles, market complexities present huge challenges. But many of these markets are simply too big to ignore. For example, there are an estimated 140 million Muslims in India, 40 million in China, 14-20 million in Russia, 10-13 million in the US and about 30 million in the European Union. How can these markets be approached?

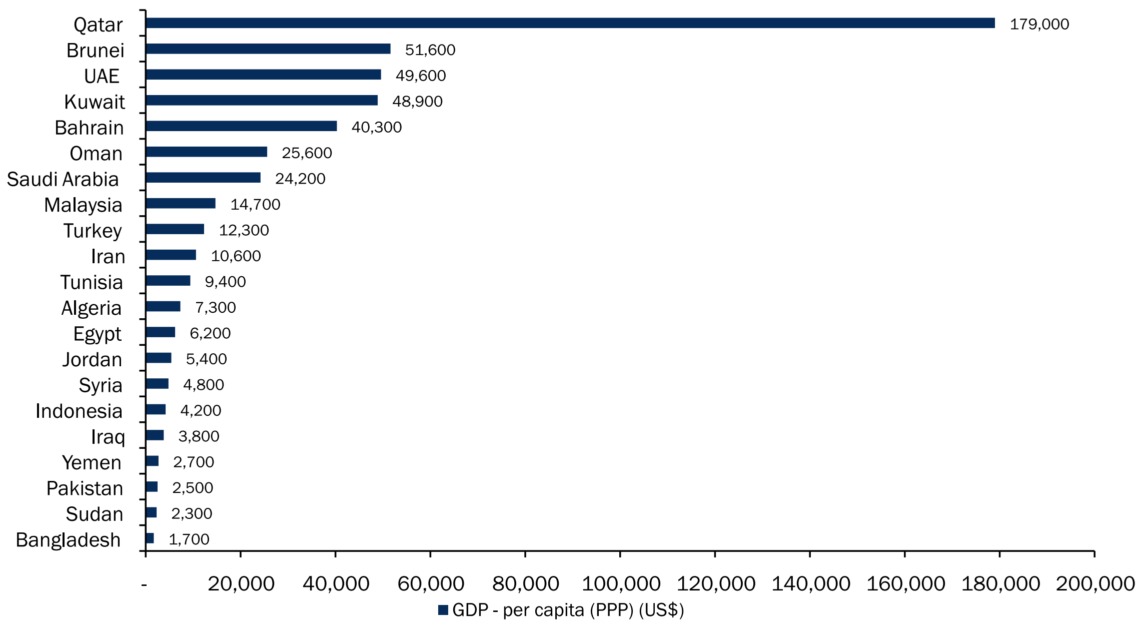
The Sharia effect

Sharia law has a considerably greater effect on some industries than others, in particular when their products are ingested or applied to the body (food and beverage, pharmaceuticals, personal care) or those that may contravene Islamic edicts (fashion, finance).

The definition of halal, or that which is clean, compared to haram, that which is not, is critical. For example, Islam prescribes specific rituals for the slaughter of animals, as well as completely banning the consumption of pork. Alcohol is strictly prohibited. Haram products and practices are not permitted within a company, from sourcing and supply chains to marketing and retailing.

This is complicated by the degree of observance common in different cultures. In terms of food, a Malaysian Muslim would only set foot in a pork-free restaurant. In nearby Indonesia, a Muslim would sit down to a pork-free dish at the same table with a non-Muslim eating pork ribs. Neither would enjoy a beer. In Sub-Saharan Africa, meat must be halal and pork avoided, but alcohol is widely accepted.

Personal income in the Muslim world



Source: www.indexmundi.com; July 2010

Expanding to Muslim markets may be a moving target, though it's not impossible to hit the mark. While not an Islamic company, Nestlé has been successfully serving these markets since the 1980s, and is now the world's largest manufacturer of halal foods. Halal food accounts for 5% of Nestlé's global food sales, with 85 of its 456 factories worldwide producing halal-certified food. Malaysia is home to Nestlé's Halal Excellence Centre, which is the biggest halal food producer within the Nestlé Group, exporting to more than 50 countries worldwide. Thailand, known as the Halal Kitchen, is the world's fifth largest producer of halal food and is renowned for its halal expertise in science and testing. In Singapore, global chains such as McDonald's, A&W, Taco Bell and KFC are 100% halal.

Supply chains can also be big business. The port of Rotterdam is developing a "HalalDistripark" to serve Europe's 30 million Muslims, while Wales has proposed a Super Halal Industrial Park that would be the largest in Europe.

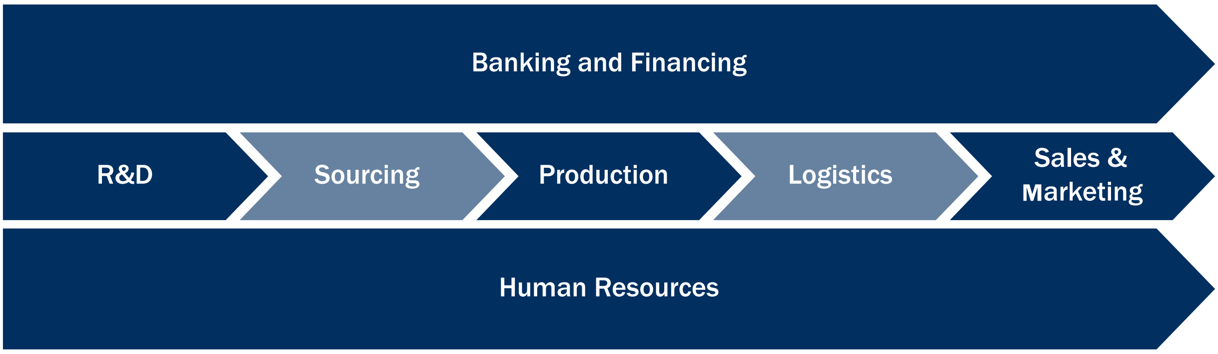
While the rewards of halal production can be considerable, implementation may be complex. For a corporation to be truly Islamic, its conversion must be comprehensive, as outlined in the chart below.

a cold storage firm, to allocate more than 1,000 pallets in the port of Rotterdam as storage space kept at the correct temperature for halal foods, with no other products sharing the same space.

Islamic banking

The banking industry faces specific constraints. The key concerns are Sharia's three major prohibitions: usury (lending money for which interest is charged), trading in financial risk and investing in virtual assets such as indexes and options and in businesses that are considered haram. Islamic finance has developed several structures that are approved by Sharia scholars, including Murabaha, Ijara and Mudaraba. As we have seen in the food sector, standards vary. Saudi Arabia bans some products that are permitted in Malaysia, while some countries, such as Oman, have just opened up to Islamic banking. The many differences in accounting and taxation rules add further difficulties. Attempts are being made to reach common standards, with AAOIFI having done a tremendous job. However, since these are not obligatory in most countries, standardisation remains elusive and many issues remain subject to interpretation.

Conversion requires a holistic approach



Source: Bank Sarasin, A.T. Kearney

As mentioned earlier, reconfiguring a product will not only affect business-to-consumer companies but those further back along the supply chain. Muslims don't want meat that has been stored with pork. This prompted Eurofrigo,

Fashion and apparel

Modesty may be the key concern of fashionable Muslim women and men, but the opportunities they represent are far from modest. With demographics promising a booming market for Islamic fashion, the French Fashion University Esmood, Dubai has estimated the global Muslim apparel market at USD $96 billion. This compares to the UK fashion industry, estimated at USD $30 billion. While definitions of modesty vary, an interest in fashion is widespread. Islamic fashionistas have even won their own label – hijabistas – and their own verb – to hijabise – an activity practiced by those hijabistas who creatively make mainstream fashion comply with their ideas of modesty.

There are many non-Muslims who also prefer modest dress. One example, the Muslim swimming costume that has become known as the “burqini”, has been adopted by non-Muslims as modest, sun-safe swimwear, most famously by British celebrity chef Nigella Lawson. The issue of modesty also affects advertising. As an example, it would be most inappropriate to advertise a car using scantily-clad women.

Personal care and pharmaceuticals

The demand for pharmaceutical products that conform to Islamic principles is growing. For example while Muslims are allowed to consume haram products in life threatening situations, the use of animal derivatives and gelatins in pain killers, cough syrup, vitamin capsules and the like is a major issue. Again, standards vary, while Malaysia has issued standards and general guidelines (Standard MS 2424:2010) defining halal pharmaceuticals, certification in Iran is not required for medicines and pharmaceutical products that are used for health reasons.

According to the Institute of Personal Care Science of Australia, the halal cosmetics industry accounts for just USD 13 billion of the USD 334 billion global industry. The industry remains in its infancy, with very few companies addressing this consumer segment.

Again, Malaysia is taking the lead, having hosted the first International Conference on Halal Cosmetics and Toiletries in 2010. Muslim women want cosmetics prepared without pork products or alcohol, but they also want quality, colour options, and a scientific approach. Industry observers note that the eco-ethical emphasis for cosmetics also appeals to non-Muslims. Saaf Pure Skincare, the first halal cosmetics firm in Europe, estimates that 75% of its customers are non-Muslim Alternately, the Body Shop’s natural products and values attract Muslim consumers, supporting the retailer’s significant presence in the Middle East. Safety and hygiene are also a concern.

Winning Muslim customers

In many respects, marketing to Muslims is no different than marketing to other segments. Key markets need to be identified and understood, competitors evaluated and best practice established, profitability reviewed and a brand strategy determined. But beyond the basics of market entry, companies need to consider additional risks and organisational demands if they are to be declared Islamic. Although the areas of risk are the same, represented as social, political and financial, the nature of Islam creates fundamental issues that must be addressed when a company is converted to Islam.

Social risk

Consumers will shun those products that they think are not sincere, those which they judge to be making a token attempt at being Muslim. Brands’ core values must reflect an empathetic understanding of Islamic concerns. Sincerity is Muslim consumers’ greatest concern, according to Ogilvy Noor. In its ground breaking 2010 Noor Index, the first study benchmarking Islamic brands, Lipton, Nestlé and Nescafé – with many unaware that these global multinationals are major players in the halal market – finished in the top three in food and beverage while Emirates and Etihad Airways, both based in Muslim-majority countries, suffered low rankings. A brand’s behavior will be critically judged by Muslim consumers who have exacting standards because Islam defines who they are.

Brands may also be hit by discrimination. In 2011, the US health food chain Whole Foods faced criticism when it promoted a specific brand of halal food during Ramadan.

Whole Foods stood their ground and sales of the brand rose 300%, while Whole Foods gained the respect of a new market segment, as well as increased support from many existing customers.

Political risk

In Muslim countries, regulators have responded to the increasing awareness of Islam among their citizens. Malaysia is a shining example of politicians working to maximise the potential of the Muslim market. Beyond being a leader in the field of Islamic finance, Malaysia has also championed the standardisation of halal production. It is promoting "Halal Penang" (Penang is an island off the northwest coast) as a holistic halal hub that offers research and development, logistics, finance, manufacturing and support services as well as halal auditing and certification. As a result, its manufacturing sector has a distinct competitive advantage. It is also promoting tourism from other Muslim countries. Some western countries have also begun to adopt policies protecting Muslim consumption preferences. New Zealand, for example, enacted a halal meat law which is supervised by the government. In the US, several states have adopted halal food laws. These include California were a famous supermarket in Orange County was fined a handsome sum for violating the halal food laws in 2011.

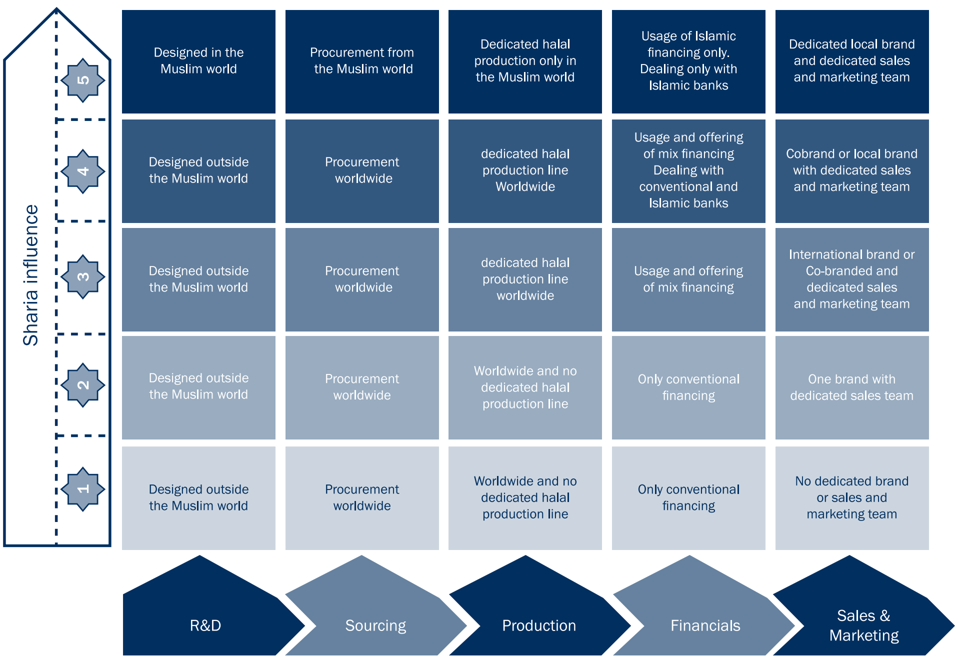
Financial risk

Clearly, a company may face losses beyond the Muslim segment if it erodes its brand's values by serving Muslims badly. A company, declared Islamic, would suffer a similar fate if it were to disappoint investors.

Organising an Islamic Company

An Islamic company must take a holistic approach. The educated modern Muslim will ask how that company is organised, how its products are brought to market, and even how it spends its profits. To be able to answer these questions, a company's operations may need a drastic overhaul, most probably of the supply chain where alternate distribution and storage methods may be required. The issues are all encompassing, as noted in the chart below.

The impact of Sharia influence



Source: Bank Sarasin, A.T. Kearney

Governance-related issues

To be truly Islamic, a modern corporation needs to apply Islam's moral code to its governance. Islam is not anti-business, rather, it is anti-exploitation. The Qur'an itself acknowledges the temptations of business, noting, "O you who believe, when the call is proclaimed to prayer [Friday], hasten earnestly to the remembrance of Allah and leave off business". Trade and business have long been a part of Islam. The Islamic Empire was the world's greatest economic power from the 7th to 13th century, when Muslim traders traveled to much of Europe, Asia and Africa. Many of the business tools that are standard today, such as cheques, limited partnerships and trusts, originated from the Muslim world of the 13th century. It is not surprising that although joint stock companies as legal entities with limited liability are a western invention and contribution to mankind, they are very similar to Muslim limited partnerships, Al-Inan and Mudaraba.

Mudaraba, which is now a financial term, literally means to travel the earth for trade or business, and is mentioned in the Qur'an: "Others (making dharb on earth) traveling through the land, seeking of Allah's bounty" (Surah 74:20). For modern purposes, it is effectively a form of a joint stock company. Under Mudaraba, one partner (which may be a group of individuals) provides capital, while the other partner manages the investment, which is not a loan but a contribution to the partnership. Profit is shared as agreed by the partners. Modern corporations also utilise separate ownership and control, with investors and shareholders delegating the management of a company. As in Mudaraba, there can be many owners or investors and the company is not dissolved if there is change in equity ownership.

For a modern corporation to satisfy the scrutiny of sophisticated Muslim investors (and consumers) the company must be governed in compliance with Islamic law, and its profit making must be exercised in accordance with its moral and humanistic standards. The company should therefore adopt a specific company act, setting forth its commitments. In Islam, three dominant institutions dictate a company's internal laws and guidelines: the Shura, Hisba and religious audit.

The Shura defines how decisions will be reached. In a passage known as the Shura, the Qur'an calls for consensus among individuals making any decision as a group. Frank discussion is encouraged. Shuratic decision making ensures a greater degree of acceptance by all parties since no decision is being dictated by an individual. The process also ensures that the impact of any decision is considered broadly. Shuratic decision making also protects from selfishness, since one person cannot dominate others to get what he wants, or because he thinks he is superior. Both are considered intolerable under Islam.

Given Islam's emphasis on social responsibility, decisions taken by a group are a grave responsibility. A Muslim, who believes he is accountable to God for every act, consults others before taking action, and would not dare to act alone. Shura intends to foster collaborative decision making in which just decisions are made through honest, respectful deliberations among a group.

An Islamic code of conduct

Hisba, which means verification in Arabic, governs economic, commercial and social matters, providing a divine code of conduct. It applies in three ways. First, commerce and transactions must be conducted in compliance with Sharia law. Second, the moral principles and values of Islam must be observed. Finally, an appointed muhtasib enforces hisba. The first muhtasib in Islamic history was the Prophet himself, who began a tradition of regulation that has lasted for centuries. It is the muhtasib's role to ensure "al-Amr bil-Ma`ruf wa al-Nahiy `an al-Munkar" – enjoining what is good and forbidding what is evil.

In economic terms, the muhtasib should ensure fair trade and a free market; including monitoring competitive behavior; should police fraud and illegal transactions; and should ban price manipulation, such as hoarding necessities to drive up prices. For good governance, a corporation should adopt an internal muhtasib, who effectively acts as the Islamic conscience of the company.

A religious audit is required

Finally, good governance requires an independent religious audit. Companies expect internal and external audits to ensure that they are in compliance with rules and regulations; Islam is no different. To assure that a company is Sharia compliant, management needs to have a religious audit conducted to test its internal controls and performance. This is a requirement and a necessity. This highlights the fact that companies need specially trained staff across a number of disciplines, and specific IT systems, to assist with compliance, which can create higher cost structures.

An Islamic religious audit comprises three areas.

- Prior to the audit advice – The company's management and board of directors consult a specialised body which advises them on conformity.
- After the audit monitoring – At this stage, an auditor reviews whether the advice has been heeded and implemented, and whether the business is compliant. Shareholders and consumers are then informed of the results.
- Audit of the Zakat (Islamic tax for the poor) – This is not dissimilar to a tax audit, except that the regulations are Islamic. The audit ensures that Zakat is being properly calculated and distributed, as required by the Qur'an. Zakat funds require both financial and religious audits which should be reported in the company's annual report.

There are two types of religious audit reporting. These are:

- Direct – The religious auditor's report is published with the company's financial audit reports.
- Indirect – The religious auditor's report is submitted to a financial auditor, who then testifies to the company's compliance with Sharia law. He must also report any non-compliance during the audit period.

In the eyes of Allah

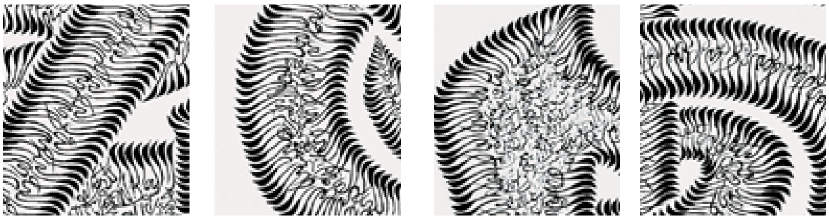
As this report has demonstrated, an Islamic audit extends far beyond the financials, back through procurement and production, distribution, sales and retailing, to the treatment of employees and the environment, and the corporate and social activities the company undertakes. But the Islamic audit looks further, into the future, and the impact of the company's activities on society.

If a company wishes to be Islamic, it cannot focus only on its business, but on making its business right in the eyes of Allah, and this includes issues related to fairness towards clients and employees as well as being honest in advertising for "To those who believe and do deeds of righteousness hath Allah promised forgiveness and a great reward." (Surah 5:9).


米廣江書

A legal perspective – corporate transformation to Islam

By Husam Hourani and Dena H. Elkhatib, Al Tamimi & Company



Islam is a way of life; it encompasses all aspects of an individual's life including social, economic and political. This phrase is often used when describing the broad scope of the religion. But this phrase fails to demystify the statement because a conventional view of life is not contrary to that of Islam. Rather in some instances a conventional model may be used to serve or further Islamic principles. Examples include the conversion of banks to Sharia compliant banking institutions, and the use of conventional banking services and products to provide Islamic wealth management. This article focuses on methods that a conventional business may apply in order to operate on an Islamic basis. However, it is important to note that, from a UAE legal perspective, there are no specific laws or regulations that govern corporate Shariah practices. Although there may be national laws that apply in some sectors, this article only provides general guidelines.

Although a conventional business and an Islamic business may be fairly similar, there will be a few key differences demanded by Sharia law. These include

- the structure of business arrangements (loan agreements, business-to-business contracts, etc.),
- the structure of investments and debts,
- business sectors in which the company is involved which may be banned under Sharia (alcohol, gambling, etc.),
- any licensing requirements,
- the appointment of a Sharia B/board or a consultant to assist with compliance, and
- Sharia-specific internal controls or constitutional documents.

Structuring business arrangements

First, the company should review and amend its business arrangements to ensure compliance with Sharia principles. Its liabilities must also comply with Sharia standards, which prohibit earning or paying interest. All the facility arrangements the company has undertaken with any financial institution must be Sharia compliant. For instance, conventional property financing will have a prevailing interest rate, a term, and non-payment penalties, while the company retains ownership of the property. Islamic financing for that property will commonly require an ijara model under which the property is owned by the bank and leased to the company. Business loans and arrangements also need to be assessed for Sharia compliance, and any conventional facilities converted. This review will not only include outstanding facility arrangements, third-party guarantees, and corporate credit cards, but business-to-business arrangements that impose penalties, fines or interest.

Compliant investments and debts

A company needs to ensure that its investments are in accordance with Sharia standards, which may be a fundamental change to its risk management. Many company assets (such as savings accounts, stocks, bonds, mutual funds, stock in trade, etc.) may have attributes inconsistent with Sharia principles. Investments and debts are not limited to the financial sector, but extend throughout the value chain. If a company owns grocery stores which sell alcohol or pork products, these products must be removed from the shelves and the entire stock discarded. Any profits or funds related to these products may not be accrued, and the funds may not be mingled with the company's receivables.

Reviewing business sectors

Taking a holistic approach, a company must ensure Sharia compliance within the various business sectors in which it operates or participates. Sharia prohibits engaging in any business that involves pork, alcohol, gambling, pornography, among other activities. A practical example is a company or a subsidiary which owns a restaurant.. The restaurant may not serve, own, or distribute any alcohol or pork products. In the event that the company sells the restaurant's alcohol stock, then the company may not be considered Sharia compliant until the products are discarded. Any resulting funds may not be utilized as working capital or create a benefit to the company. This becomes more intricate and complex as companies engage in multiple activities and projects that have underlying profit centers (for example, airlines sell alcoholic beverages). This may also be a concern for entities with shareholdings in other companies that may engage in prohibited activities. Even if the shareholding is minimal, the business must be Sharia compliant. This extends to a company's marketing practices. As an example, raffles and other marketing plans may be considered gambling under Sharia law.

Licensing under Sharia

The company must be compliant with all licensing and regulatory requirements within the jurisdictions in which it operates. The UAE Commercial Companies Law, Federal Law No. 1 of 2009 (Companies Law), does not specifically regulate Sharia compliance. Rather, the same Companies Law applies to both conventional and Sharia-compliant corporations. This is contrary to the regulation of financial institutions licensed by the UAE Central Bank which has specific requirements for Islamic institutions. The company needs to incorporate any additional or varied regulatory requirements within the new Sharia-compliant model and provide the necessary training for employees to ensure proper and adequate compliance. However, beyond Islamic financial institutions, the option to adopt Sharia compliance will often be an individual choice.

A Sharia Board or consultant

A company should consider the appointment of a Sharia board or a Sharia consultant to aid in the transition and review of the company and its activities. Although not compulsory, it is in the company's interests since a Sharia board will identify even minor elements of its internal operations or asset management that require modification. Currently there are no global or regional standards governing Sharia-compliant companies.

Codes for compliance

The company may elect to indoctrinate the Sharia policies in its corporate structure. This may include the development of internal policies that are drafted according to Sharia standards, or imposing guidelines and restrictions within its Memorandum and Articles of Association. For instance, the Memorandum and Articles of Association may restrict borrowing practices to ensure that all lending (including shareholder loans, guarantees, acquisition of subsidiaries, etc.) will be undertaken in accordance with Sharia principles and standards.

Succession and wealth planning

Finally, a business owner has Islamic wealth management options, even if the business is in a jurisdiction that does not support the division of inheritance in accordance with Sharia law. There are various mechanisms that may be used to divest wealth in accordance with Sharia law, as described in Bank Sarasin's previous reports, Islamic Financial Planning and Estate and Succession Planning, respectively. There are options pertaining exclusively to a corporate structure that provide the greatest flexibility for the distribution of wealth while at the same time preserving the daily operations of the company.

Shares in the business may be distributed in accordance to any desired percentage, including in accordance with Sharia principles. The business owner may maintain control over the new corporate entity through various mechanisms including statutory reserves, controlled voting, sale of stock restrictions, voting restrictions, and guidelines for the management of the company in the Articles of Association. Using a corporate structure, the business owner has the flexibility to retain control over the assets during his lifetime. Further, the corporate structure will continue to exist after the business owner dies, ensuring that his beneficiaries retains their respective inheritance.

The conversion of a conventional entity to a Sharia compliant entity requires great attention to detail. Business owners are advised to initiate the process with a Sharia consultant who is not only familiar with the business model, but with the relevant jurisdictions' laws and regulations. A Sharia consultant will assist in outlining specific procedures for the conversion and oversee the process, reducing risk.


戊子年冬月米廣江書

Overview – Islamic finance developments 2011

Despite a challenging market environment, Islamic finance made progress in 2011, supported by vigorous underlying trends. Volume, geographic reach and quality all increased last year as progress was made with regard to regulation and strong demographic growth saw the Muslim market increase in size. With increased media attention, even non-Muslim investors became more aware of Islamic finance.

In the face of market turbulence, it was astonishing to see many new economies joining the Islamic finance market, including central Asia with Afghanistan, Azerbaijan, Kazakhstan, Turkmenistan, Kyrgyzstan and Tajikistan; Africa with Egypt, Ethiopia, Kenya, Gabon, Malawi, Morocco, Nigeria, Tanzania and even South Africa and Somalia. The expansion stretched further, to Oman, India, Sri Lanka and even Switzerland, where plans for a new Islamic private bank were announced.

But the news was not all good, with some businesses hit by economic trends. In the Gulf and London, Islamic investment banks suffered substantially and one defaulted on its debt. Some of these firms now aim to copy the private banking business model, focusing on asset management and its more steady income streams. But the asset management business is not all smooth sailing. Fragmented regulations remain a major challenge.

The leadership role for the GCC

The GCC countries could take a leadership role by establishing standards for the registration of Islamic investment products with one regulator, which would then allow asset managers to market the product to clients across the region. Currently any offering needs to comply with different regulations in Bahrain, Kuwait, Saudi Arabia, Oman, Qatar and the UAE, resulting in a lengthy and expensive registration process. Reducing expenses and increasing the availability of investment products would increase competition, benefiting local investors and furthering the GCC's development as a centre of excellence for Islamic finance.

Another major observation is the constant criticism of certain Islamic finance structures such as the Tawarruq, which is purchasing a commodity with a deferred payment and selling it to a third party for cash, hence replicating the effect of a loan. Regulations need to be adjusted to allow financial institutions to engineer products that fit the spirit of Islam while meeting legal and regulatory requirements. While this debate has run for years, some progress is being made. One example is the recent cooperation between the halal industry (mostly foodstuffs) and Islamic finance – two sectors with similar goals that have had little contact. Thomson Reuters achieved considerable awareness when it created the SAMI (Socially Acceptable Market Investments) Halal Foods Index which comprises 200 companies listed in Muslim-majority countries. The Index represents a total market capitalisation of over USD 100 billion.

Additionally, with issues related to the environment and social practices, as well as corporate governance, getting more attention, there has been more reporting on corporate social responsibility, which is important to Islamic finance. There is still much room for improvement, with higher standards and a more strategic approach required at the state, company and private level. The Muslim countries face the greatest challenges.

Total family wealth – balancing asset classes

Family wealth in the Middle East typically originates from the family business so the company itself is the major asset. According to consultancy Booz & Co., family businesses represents about 40% of non-bankable assets. In recent years, Sarasin's Islamic Wealth Management Report has addressed the important role a family's governance plays in keeping this core asset in the hands of the family and the need for Islamic Estate Planning. This year's report reviews how to convert a family company into a truly Muslim company compliant with Islamic rules and ethics. But beyond the family business, what asset classes should families consider and why?

Non-bankable assets – a source of illiquidity

Family companies are typically non-liquid assets, which generally provide a good yield and a certain degree of security because of the family's expertise and experience. A more constant yield, which is perceived to be lower risk, is real estate. In the Middle East, real estate has a 30% share of non-bankable assets according to Booz & Co. Properties are among the most sought after investments by Middle Eastern investors, and local properties performed extremely well until 2008. Real estate provides limited liquidity, and its degree of security is challenged due to the high exposure of investors and banks to the sector, increasing downside risk. Other items, including collectibles, jewellery, cars and animals, such as race horses, account for about 30% of non-bankable assets.

Bankable assets – increasing liquidity

Bankable assets account for 30-40% of total family wealth, providing liquidity to balance the illiquid nature of the majority of wealth. Bankable assets should also reduce overall risk by being uncorrelated to the family business and real estate holdings. Excessive yield expectations for these assets reduce the positive impact of the asset class with regard to increased liquidity and reducing risk. Any long term investments should also be sufficient to serve as collateral for credit facilities, which may be necessary from time to time.

For an Islamic investor, choosing attractive bankable assets is challenging, although options are improving year by year. Holding cash with no returns is very common as demonstrated by the non-interest bearing deposits in the GCC to this day. The main task for the Islamic private banker is increasing the yield on these positions while controlling risk. Cross-regional placement of cash and short-term investments below one year, with some currency diversification, is easier said than done in the Islamic financial markets – and it is even more crucial that the family company stay liquid.

But investor's needs are still limited by a lack of standards and differing opinions about legal documentation among Sharia Boards. Further yield enhancement became more common in 2011, when private Muslim investors invested directly in Sukuk (Islamic bonds) (see page 23). Compared to the low-risk fixed-income sector, equity investments (see page 27) have become commonplace with families able to invest locally and internationally according to Islamic standards.

Commodities – limited access

The least developed asset class is alternative investments (see page 25). Islamic hedge funds exist, but they still represent equity-based risk, and are perceived as being against the spirit of Sharia law. As a result, demand for hedge funds is negligible. Muslim investors also have limited access to commodities, which needs to be solved in an ethical manner.

Family wealth needs to be reviewed from the perspective of non-bankable and bankable assets so that a secure and productive mix of assets is held by each family. The word "productive" may not refer to returns, but rather the purpose served by bankable assets in terms of a family's financial needs and goals.

The Sukuk market – recovered and back to normal, almost

In 2011, the Sukuk market finally recovered from its 2008 shock, when many investors withdrew funds to invest in the developed world. A huge rise in yields rewarded the investor who was loyal to this market. The major achievement was that Muslim investors now have halal alternatives to conventional bonds. A dedicated Sukuk portfolio can be constructed, not with the same efficiency as in the global bond markets, but enough to satisfy the needs of larger Islamic investors. About USD 80 billion of new Sukuk issuance in 2011 marked substantial progress, resulting in a global Sukuk market of USD 180 billion according to Zawya, an online news and networking company.

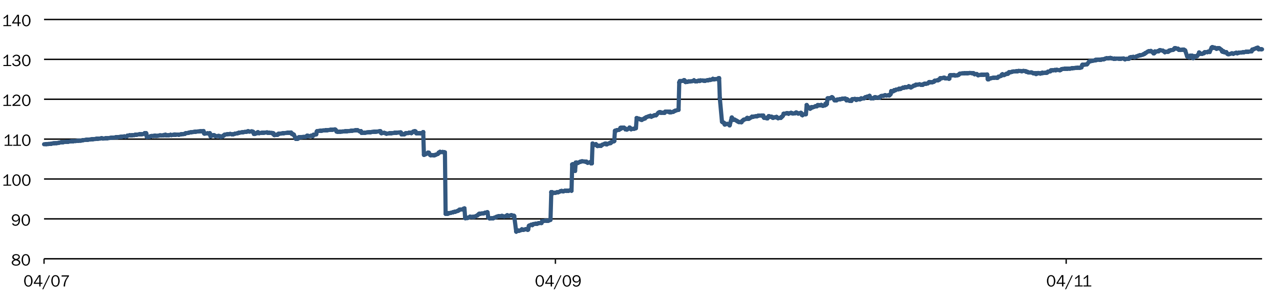
Strong growth forecast

The expectations of substantial Sukuk growth in 2012 is a positive sign that investors will have more opportunities than ever before. Depending on the global economy, the Sukuk market is forecast to grow by 10% or more. This forecast is supported by sovereign issuers such as Indonesia, Saudi Arabia, and even South Africa announcing that they are coming to the market. Interest in the Sukuk market from such conventional players as Goldman Sachs shows that the market has matured and become a very attractive niche.

Is the credit crisis an opportunity or a threat? Fixed-income markets are jittery but the Sukuk Indexes have recovered well. Although events in Europe are creating a challenging environment, the robust Sukuk market brought many issuers to the table. In November alone, the volume was about USD 4 billion; quite an achievement for a niche market. Market sentiment changed in December, experiencing what was called ‘indigestion’ due to the large number of issuers in November and rumours that Dubai government related entities might reschedule their debts. The rumours were quickly denied but still caused double-digit yields for Dubai Sukuk maturing in 2012.

Will investors again benefit from such high yields? Only time will tell. We can expect rising volume, less than 2011 but still substantial, with new issuers coming to the market and those which delayed their issuance from a difficult December 2011 to 2012. Postponement is not abandonment.

Dow Jones / Citigroup Sukuk Index

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Rare offerings – alternative investments

Islamic alternative investments have long been associated with private equity funds and real estate developments that have high yield expectations but typically low or no liquidity. Private Equity and real estate also provide little diversification since family wealth is generally already invested in family companies and properties. Nevertheless, alternative investments have been popular, but, similar to the conventional private equity market, dramatically less so since 2008, when many investors unexpectedly found themselves to be long-term rather than medium-term investors, with limited hope of good yields.

Commodities: An Islamic future without futures?

Conventional investors looking for alternatives to private equity have reallocated some of their assets to commodities, but very few offerings have reached Muslim investors. Commodities are globally traded at major exchanges such as the Chicago Board of Trade. The most common instrument used is a future, which is a standardised contract under which delivery and payment are completed at a future fixed date.

According to the majority of Sharia scholars, futures are not allowed and are considered to be trading obligations (bay kali bi kali), which is why Muslim investors receive limited offerings in this asset class. A bespoke offering for institutional investors can be structured, but a general solution is not yet available for those Muslim trading and production companies which seek to fix prices in advance, as is allowed with a Salam contract under Islamic law. The difference between Salam and futures is that Salam requires paying the full amount upfront. The remaining alternative for Muslim investors is increasing their allocation to commodity-related stocks or choosing selected Islamic-structured products. To date, there is no level playing field for the Muslim investor in commodities.

Whether gold is considered a commodity or a currency can be discussed at length from an Islamic perspective. The high degree of liquidity, especially in a crisis situation, is a strong positive. Gold is considered an alternative investment because the majority of investors have no bills to pay in gold, since these are now paid in US Dollars or local currencies. Today gold is something other than what it has been in history; it is no longer a means of payment. Gold, which can be held either as a physical asset or via a physical-backed security, is therefore considered an alternative investment.

Islamic hedge funds which follow a long-short strategy are often discussed but not widespread among Muslim investors. Over many years speeches have been made and articles published but the Muslim investor continues to disdain hedge funds, whether structured in an Islamic way or not, despite approval by many scholars.

Alternative investments as an Islamic asset class, with liquidity, remain a rare offering.


戊子年冬米廣江書

Country and sector indexes suffer – Islamic equity markets in 2011

2011 has been a challenging year for equity investors, including Islamic-oriented investors, with most indexes having fallen during the year. As an example, the Dow Jones Islamic Market (DJIM) BRIC Index was down a sharp 27.50%. The BRIC countries, namely Brazil, Russia, India and China, continue to be attractive, but emerging markets typically have higher volatility. Dubai also disappointed with its Dow Jones DFM Titans 10 Index down by 15.92%. Indonesia followed closely, with the DJIM Indonesia Index down 10.93%, while the Dow Jones Islamic Market GCC Index fell by 5.35%. Sri Lanka, a smaller market, fell by 5.21% (DJIM Sri Lanka Index).

Industry sectors indexes also suffered. The DJI Basic Materials Index was down by 22.83% and the DJIM Industrials Index by 11.84% – possibly triggered by the ongoing credit crisis, deleveraging and fears of recession. The impact was comparatively modest for the DJIM Europe Titans 25 Index with a loss of 3.68% in euros and 6.80% in USD. Faring slightly better was the DJIM US Index which gained 1.53%.

Some markets managed to outperform. The DJIM Thailand Index went up 9.22% in USD and the DJIM Pakistan Index, slightly down by 1.06%, beat the conventional Dow Jones Pakistan Index by more than 16.8%.

The discrepancy between the conventional index (down by 17.86%) to the Islamic Pakistan Index is at first remarkable – what explains the divergence? Comparing the indexes, it becomes clear that the 27.74% weighting of financials in the conventional index, compared with 1.15% financials in the Islamic index, had a tremendous impact.

How does Islamic criteria impact performance?

So how is performance impacted by Islamic criteria? Only a few academic studies have been published. The studies find that, although in theory a reduction of the investable universe by non-profit-oriented criteria should lower returns, there is no empirical proof of this. The opposite occurs, according to the following studies:

- Hakim/Rashidian (Risk & Return of Islamic Stock Market Indexes, Economic Research Forum Annual Meetings, Hakim, Sam and Rashidian, Manochehr, Sharjah, UAE, 2002) suggest that outperformance is a given (even in bear markets), but additionally suggest a substantially lower risk profile: The standard deviation was slightly better for the DJIM World Index SM than for the much more broadly constituted Dow Jones Wilshire 5000SM (22% and 24%, respectively). The difference in the Sharpe Ratio, which measures risk-adjusted performance, was even more astounding: 118% compared to 194%. According to the study, the diversification value is further enhanced because the Islamic index is influenced by factors other than the broader market or interest rates.

- Walkshäusl/Lobe (Islamic Index Investing: The International Evidence, University of Regensburg, Center of Finance, Draft November 2011), analyzed whether Islamic indexes exhibit a different performance to conventional benchmarks and concluded that there was no compelling evidence of performance differences over an international sample of 35 developed and emerging markets. On the contrary, outperformance was identified, mainly from the US, largely attributed to the exclusion of the financial sector, so this is not considered an argument for ongoing outperformance.

Muslim investment criteria may lower risk

Despite some positive signs in academic research, more studies need to be undertaken to decide the question of higher or lower returns in equity investing. However, the Muslim investor should face less risk (less company leverage) and may occasionally face positive and negative deviations due to the exclusion or low number of (Islamic) financial companies included in the universe. For this reason Islamic index benchmarks are preferred to measure the performance of the portfolio manager. It can also be concluded that there is no cost to being a Muslim by investing in a Sharia-compliant equity universe, and, as demonstrated last year in Pakistan and the US, a Sharia screen may actually prevent losses.

Description of calligraphy concepts

Alhamdulilah,
All thanks belong to Allah.
Cover

Mashallah,
Whatever God wills.
Page 6

Ya Rahim,
O Merciful.
Page 16

Al ilm nur,
Knowledge is light.
Page 20

Alhamdulilah,
All thanks belong to Allah.
Page 24

Alhamdulilah wa la ilaha Allah
Mohammad ar rasul Allah,
All Thanks Belongs to Allah.
There is no God but Allah and
Mohammad is the Messenger of Allah.
Page 26

A master of Arabic calligraphy – the art of Haji Noor Deen

Haji Noor Deen (米广江) is a renowned master of Arabic calligraphy who was born in 1963 in Yucheng, Shandong Province in China. In 1997, Haji Noor Deen was awarded the Certificate of Arabic Calligrapher in Egypt, becoming the first Chinese person to be honored with this prestigious award.

In 2000, Noor Deen initiated and taught the first regular and systemic Arabic Calligraphy course at the Zhengzhou Islamic College in China. In 2005, a piece named "The Ninety-nine Names of God" was acquired and displayed by The British Museum and will be displayed permanently in the gallery of Islamic Art. This is the first time that a piece of Arabic Calligraphy handwritten by a Chinese has been placed on permanent exhibit by The British Museum. Haji Noor Deen was included in the "Top 500 Most Influential Muslims" in 2009, 2010 and 2011 by the Royal Islamic Strategic Studies Centre in Amman, Jordan.

His work has been displayed in galleries and museums around the world, often as the first Chinese/Arabic artist, including The British Museum, San Francisco Asian Museum, National Museum of Scotland and Harvard University Art Museum.

Noor Deen's extraordinary mastery and genius along with his unique ability to present his craft spectacularly to an audience has brought him lecture and workshop invitations from some of the most renowned and prestigious institutions around the world, including The Zaytuna Institute (California), Harvard University, Cambridge University, University of California, Berkeley, Boston University and Qatar Islamic Cultural Centre (FANAR). He has also exhibited his work in a number of countries including the UK, Canada, Ireland, Australia, Singapore, UAE, Qatar, Mauritius, Kuwait, Algeria, Egypt, Turkey and Italy.

He brings immense knowledge of Islamic art and traditional thought to a modern audience. The focus of his work is a masterful calligraphic technique which uniquely fuses both the Chinese and Arabic arts. This edition of the Islamic Wealth Report features a selection from his calligraphic masterpieces.

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