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GROWING INTEREST

When Hedge Funds Meet Islamic Finance

**U.S. Firms Hire Scholars
To Help Design Products;
The 'Rent-a-Sheik' Issue**

By JOANNA SLATER

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HAYMARKET, Va. -- One recent afternoon, New York money manager James Rickards presented Sheik Yusuf Talal DeLorenzo with a dilemma: Could his hedge fund be Islamic-friendly?

Islam prohibits all kinds of speculative behavior that is embedded in Wall Street's DNA. But Mr. DeLorenzo, a Massachusetts-born convert to Islam, is on a mission to meld centuries-old Islamic law with modern finance in the U.S.

Mr. Rickards's fund couldn't bet on currency futures or some of the shares in the Standard & Poor's 500 index, Mr. DeLorenzo said, if he wants observant Muslims to invest. But some alterations could earn the sheik's approval -- such as holding currencies instead of futures, and buying only S&P 500 companies that aren't debt-heavy or dependent on profit from interest payments. "Music to my ears," Mr. Rickards said. "It sounds like I can still get the effect I'm looking for."

With the Middle Eastern economy booming, partly thanks to soaring oil wealth, the Islamic financial industry has been expanding at a clip of about 15% a year, according to accounting firm KPMG, and is on pace to reach \$1 trillion in two years. The money is seeking new outlets and Western financial institutions are seeking new clients -- opening the door for more aggressive methods to reconcile two worlds that don't easily mesh.





**Sheikh Yusuf
Talal DeLorenzo**

The issue of what's permissible has opened fault lines within Islamic finance. Malaysian adaptations of Western-style bonds, for instance, have been condemned, then copied, in Muslim countries in the Middle East. Scholars consulting for Western financial institutions are criticized for bending religious laws to serve financial ends -- the "rent-a-sheik" argument, says one U.S. bank official. Vendors profit by "capitalizing on people's religious insecurities," says Mahmoud El-Gamal, a professor of economics who holds a chair in Islamic finance at Rice University. "Don't take my duck, sprinkle holy water on it, and say it's a chicken."

Islamic law, or Shariah, stems from the Quran and subsequent interpretations by scholars. In the economic realm, commerce receives divine approval but several verses speak of a prohibition on interest, a practice viewed as exploiting the borrower.

An association in Bahrain is the informal authority on Shariah compliance for Islamic financial institutions. But its standards aren't mandatory and don't govern the offerings of Western firms, which retain their own Shariah boards to advise them and issue their own rulings, or *fatwas*. Top scholars can serve on dozens of boards, earning retainers of up to \$20,000 to \$40,000 a year per client. Scholars who give their seal of approval sometimes receive a percentage of assets invested.

Mr. DeLorenzo says it's rare to get a percentage of assets, but that one time he accepted such compensation. Among his other clients is **Dow Jones & Co.**, parent company of The Wall Street Journal, which retains him and five other scholars to consult on its indexes of Shariah-compliant companies. Mr. DeLorenzo receives an annual retainer of \$5,000 plus stipends for attending two to three meetings a year.

Pledging Collateral

Western banks say they make more than cosmetic changes to create shariah-compliant financial products. London-based Barclays Bank PLC, which worked with Mr. DeLorenzo and a firm called Shariah Capital Inc. on a platform for hedge funds to trade without violating Islamic requirements, had to rewrite a 20-odd-page brokerage contract. The concept of short-selling -- using borrowed shares to bet on a stock's decline -- was replaced with an Islamic down-payment structure known as an *arboon*. Any reference to a "guarantee" was replaced, for instance by a pledge of collateral, because Islamic rules require shared risk by all parties.

NEW OPTIONS

- **The Issue:** Hedge funds and financial-services companies are seeking to create new products that can meet Islamic religious requirements.
- **The Incentive:** The Middle East's economy is booming, creating demand for new investment

"There were definitely a few firsts," says Kieran McCann, a director in Barclays Capital's prime-brokerage group.

The gap between Wall Street and Islamic financial law can be uncomfortably wide, especially amid lingering distrust on both sides after the 2001 terrorist attacks on the U.S. But

options, and Western firms are looking for new clients.

- **The Challenge:** Firms are adapting offerings to avoid prohibitions such as charging interest, while religious scholars decide how freely they can interpret Islamic law.

the U.S. also is home to several million middle-class Muslims, one of the largest markets in the West. A 2004 Zogby poll for Georgetown University found a majority have college educations and earn \$50,000 or more a year. Some early steps in providing Islamic alternatives have exposed pent-up demand.

Vetting Services

Once word began to spread that Devon Bank in Chicago was exploring Islamic financial products in 2002, there was an immediate response from the local Muslim community, says bank vice president David Loundy. "People said, 'Can you do houses, cars, lines of credit, and how about my sister in Connecticut?'" Some customers went as far as calling scholars in Pakistan to vet the acceptability of Devon's services, he said.

One Devon customer, Ahmed Khan, a technology executive at Dutch-based bank ABN Amro Holding NV, says he owned a home in the late 1980s but was "very uncomfortable" paying conventional mortgage interest and went back to renting. In 2005 he took out a Devon "Shariah-compliant" mortgage using a method called *ijara*: The bank bought Mr. Khan's condominium and he pays a monthly sum to buy it from the bank over time, plus a lease payment for using the property.

In the first five years his cost of financing is about 7%, he says, and he paid some fees beyond normal closing costs for the specialized legal structure. Mr. Khan had to fill out a standard mortgage application, but says it's important for U.S. Muslims to accept such compromises to encourage banks' efforts. "If you don't show that demand, there will never be any supply," he says. The bank also converts the arrangement to a conventional mortgage for its regulators and the Internal Revenue Service, and advises customers to seek tax advice on whether it's deductible. Mr. Khan takes the deduction.

Cadre of Scholars

Mr. DeLorenzo, 58 years old, is at the center of the push to develop Islamic financial products in the U.S. He also serves on boards of Islamic scholars that rule on their acceptability, as do a cadre of less than 20 top scholars globally -- only a couple of them in North America -- who advise banks and financiers. Mr. DeLorenzo's clients have included Morgan Stanley, Brown Brothers Harriman & Co., Royal Bank of Scotland PLC, and France's Société Générale SA.

An Islamic mortgage that Mr. DeLorenzo helped develop here is serving as a blueprint for a venture in Saudi Arabia. He worked with a Lebanese investment bank to structure the first-ever Islamic bond from a U.S. company, issued last year by a small Texas energy firm. Mr. DeLorenzo acted as "a cultural bridge between us and the rest of the scholars," says Ibrahim Mardam-Bey of Bemo Securitisation, the Lebanese bank. He can read banks' term sheets as well as the Quran, and has another advantage, says Mr. Mardam-Bey: "Very few of the other scholars care to read their email."

Mr. DeLorenzo, named Anthony at birth, is a grandson of Sicilian immigrants whose family was half-Catholic, half-Methodist, and was raised in neither religion, he says. He uses the Islamic honorific "Sheik" that religious scholars are free to claim for themselves, but favors business suits and has a trimmed white beard. He was interested in finance from the age of 13, when he asked his mother to buy him shares in

Studebaker Motor Co., he says.

As a Cornell University student he hopped a trans-Atlantic freighter to study in Spain, but tired of the trip early and got off in Casablanca. There he became fascinated with Arabic and Arab culture and began to read the Quran. He never returned to Cornell, instead studying in Cairo and Karachi. He changed his name, married a Pakistani woman and in the 1980s became an adviser on education to the Pakistani government.

After attending a conference on Islamic economics held in Pakistan, he began collecting fatwas on Islamic banking issued by religious scholars across the Muslim world. In 1989, amid escalating violence in Karachi, armed men attempted to shoot their way into the home where Mr. DeLorenzo, his wife and their three children lived. One of the family's servants was shot in the head. The case was never solved, he says.

Mr. DeLorenzo quickly moved his family to Virginia, and his interests turned to the challenges faced by observant Muslims living in the U.S. The Islamic financing options here -- small-scale efforts by cooperatives, rather than financial heavyweights -- left him unimpressed. "They were charging people too much, making them stand in line for six months to a year, demanding down payments of 40% on a house, and didn't have very good Shariah advice, if any."

Banking Fatwas

He began to establish his reputation as an expert in the late 1990s, after publishing a collection of English translations of the Islamic banking fatwas. In 2000 he began working with what would become Guidance Financial Group, a company founded by Mohamad Hammour, a former economics professor at Columbia University. The goal: to offer U.S. Muslims a competitively priced Islamic mortgage.

It took a year and a half to hammer out a solution that they believed could not only comply with Shariah, but also clear the various home-finance regulations of individual states. It also needed to be eligible for financing by mortgage giant Freddie Mac. "We had to essentially reinvent the entire mortgage process -- from the day you talk to the consumer, to the day the mortgage gets sold on Wall Street," says Dr. Hammour.

Guidance offers a co-ownership agreement known as a *musharaka*, a slightly different strategy than that of Devon Bank. The customer and Guidance jointly form a new corporation to own the home. Part of the customer's monthly payment goes toward buying out Guidance's share and part is a "utility fee," which the home buyer pays in exchange for using the asset. Guidance says it keeps the fees roughly competitive with the market in 30-year mortgage interest rates, though there are added fees connected with the co-ownership venture. By the end of the term, the home buyer has completely bought out Guidance's stake and wholly owns the house. Guidance reports the transaction to the IRS as a conventional mortgage, like Devon Bank, and says its customers generally take a regular deduction.

Guidance says it reached \$1 billion in such financing in June, and is now operating in 21 states and Washington, D.C. The firm contends the market for Shariah-compliant mortgages in the U.S. could top \$10 billion a year.

Selling Point

Another member of Guidance's Shariah board is a former Pakistani judge, Muhammad Taqi Usmani, whose expertise is a major selling point for Guidance customer Ferzana Mir, a doctor from Pakistan who lives in

Plano, Texas. (Mr. Usmani also serves on the Dow Jones Shariah board.) Dr. Mir refuses interest on her U.S. bank accounts, and says some U.S. Muslims she knows are skeptical of a mortgage like hers because they view its substitutions for interest as "just a play on words." She disagrees: "As you delve into the finer points, you understand how this is different," she says.

Mr. DeLorenzo is pushing the envelope with an even more complex product, the Islamic trading system for hedge funds he helped develop with Barclays and Greenwich, Conn.-based Shariah Capital. In the summer of 2001, Shariah's CEO Eric Meyer was a hedge-fund manager looking for a new venture. He was impressed by Mr. DeLorenzo's writing on Islamic finance. He sought him out and the two men talked for more than five hours about how to create an Islamic hedge fund.

Mr. DeLorenzo had his doubts. Hedge funds' variety of complex investment strategies -- including "short selling" stocks by selling borrowed shares to bet their price will drop -- poses a problem. In Islamic finance, investors aren't allowed to sell what they don't own because it represents an unacceptable form of speculation.



Eric Meyer

There are other prohibitions, too. Because of the ban on interest payments, investors must avoid companies like banks that rely on interest for their income. For the same reason, they are required to steer clear of firms that carry high levels of debt -- defined in different rulings as around one-third of either market capitalization or assets -- and thus pay a significant amount of interest.

Those are obstacles that would stop some experts. Monzer Kahf, an economist and consultant in Islamic finance who lives near Los Angeles, says he generally supports Islamic finance efforts, but draws the line at trying to make hedge funds Shariah-compliant: "What are hedge funds other than advanced forms of speculation?"

'Excruciating Detail'

Mr. DeLorenzo and other well-known scholars began by breaking down the entire process of the traditional short sale "in excruciating detail," recalls Mr. Meyer. Some of the scholars' questions stumped even seasoned short-selling pros. One example: If an investor borrows shares in a company, and that company goes bankrupt, who has voting rights?

Questions like that were "just exasperating," Mr. Meyer says. "You're thinking, 'It's bankrupt, what does it matter?' But in Islamic finance, you always need to know ownership and control" to make sure the risk is shared among the parties. After months of meetings in London and New York, Mr. DeLorenzo and his fellow scholars adapted the arboon contract -- akin to a down payment that enables the short-seller to take ownership of the share, rather than just borrowing it.

To address avoiding companies with too much debt or other issues under Islamic law, Shariah Capital developed new screening software. It taps directly into the quarterly reports that companies file electronically to the Securities and Exchange Commission and weeds out businesses that carry high amounts of debt or reap significant income from interest payments.

Mr. DeLorenzo now holds the title of chief Shariah officer for the company, and can tap into the software and monitor what's being traded at any time. Two U.S. hedge fund firms have signed up to use the trading platform so far, and Mr. Rickards, the New York hedge-fund manager, is considering joining them.

Mr. DeLorenzo says he hopes adapting Islam to modern finance could eventually influence other areas of Islamic law. Shariah has "essentially been in a coma for several centuries," he contends. "It desperately needs reviving." He says he wants to expand his own small group of colleagues, but encounters cultural obstacles. He recalls a meeting earlier this year in Dubai where a scholar lectured a group of visiting executives from a multinational investment firm about the sinfulness of conventional finance. "It was worse than bad," Mr. DeLorenzo says.