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Developing Financial Products in Islamic Finance

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Abstract

For much of the last decade, Middle East banks and investment companies have tended to opt for in-house managed, proprietary products under the assumption that their domestic customer base prefers mutual funds developed and managed "in-house." These banks have struggled to provide quality mutual fund sales, marketing, asset management, shareholder record keeping, fund administration, and compliance, all within an organizational framework and culture that often misunderstands the product. Conventional wisdom would suggest that Web-enabled technologies tilt the balance toward the "buy" as opposed to the "build" option. Any financial services company seeking to offer Islamic funds should still consider three fundamental issues. First, what are the attitudes and habits of customers toward Islamic investment and to the institution offering Islamic funds? Second, how important is brand to the Islamic customer? Third, what skills or competencies can differentiate one from one's competitors? Innovative Islamic products that rigorously comply with Islamic investment principles are the threshold standard, but success will come to those institutions that first recognize and serve the fundamental needs of the customer. Build rather than buy decisions, taken in this context, stand a greater chance of success.

I. Introduction

Successfully growing the Islamic mutual fund market hinges on a "buy and build" approach that pays particular attention to giving the Islamic investor "equal value" (no "conscience penalty") and avoids propping the product on the ethical leg alone. Eighteen months ago, the National Commercial Bank engaged in a healthy debate with a local competitor in the Islamic funds market. "The problem with you banks," he complained, "is that you tell your customers too much." While NCB[i] strongly endorses moves toward greater transparency and disclosure in Islamic investing,[ii] there is a nugget of truth in our worthy competitor's comments.

There is an art to finding the right balance between detailed disclosure and clarity in customer communications, particularly in respect to Islamic investment. Inundating the investor with reams of detail on the subtleties of *sharīᶜa* investing is, in our experience, insufficient to attract a critical mass of new investors to these funds.

II. The Saudi Arabian Mutual Fund Industry

In the Middle East, mutual fund awareness and household usage, while relatively low by European and North American standards, is gathering momentum as investors increasingly turn to funds to meet their financial goals. The largest market, Saudi Arabia, witnessed solid 40+% growth in 1999, fueled by a rise in the number of higher quality and innovative Islamic funds.[iii] We have observed many institutions increase their marketing spending, seeking to raise their "share of voice" to achieve greater product awareness that would stimulate trial and ownership. With more viable choices available, Islamic fund investors no longer have to sacrifice performance or transparency when opting for *sharīᶜa*-compliant products.

For much of the last decade, many Saudi and other Middle East banks and investment companies have opted to produce their own-brand proprietary funds under the (often mistaken) assumption that their domestic customer base would not buy their Islamic mutual funds unless they were developed and managed exclusively "in-house." Traditionally, in the Arab world, financial institutions expanding into mutual funds have, for the most part, attempted to develop in-house some or all of the requisite mutual fund components.

However, few of these institutions have achieved the critical mass required to make this business a viable stand-alone economic proposition. Often, institutions can manage only a limited range of funds that is unlikely to meet the full scope of their customers' needs or compete on a world scale. Compounding the problem is that many banks and financial service organizations, and even some regulators, lack the organization, culture, or core competencies required for success.

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Saudi Arabia's National Commercial Bank has achieved a leadership position in both Islamic and conventional mutual funds in Saudi Arabia and captured a 55% share of the Saudi market through a strategy of "build and buy." Although Saudi Arabia's first mutual fund, in 1979, was a conventional U.S. dollar-denominated money market fund (offered by NCB to the expatriate market), eight years later, NCB launched the first Islamic fund. This was the Al-Ahli International Trade Fund, a low-risk, short-term U.S.-dollar *murāba®a*-based money market fund, which was to be the first Islamic fund in NCB's family of 28 funds. NCB now has 14 Islamic funds, which, with combined assets approaching $4 billion, have a leading global position among Islamic mutual funds.

III. OUTSOURCING

Today the interconnectivity of financial markets and delivery systems has begun to tilt the balance toward the *buy* as opposed to the *build* option. But are Islamic products or the customers that buy them any different? What does it take to succeed in this business? A financial services company seeking to offer Islamic mutual fund products to its market should consider three fundamental issues:

1. The Customer: What are the attitudes and habits of the target market with regard to Islamic investment?
2. The Institution: What values do Islamic customers seek in an institution from which they buy Islamic funds? What skills or competencies do they value that can help differentiate the Islamic funds offering? Can any of these be outsourced?
3. The Product and Brand: How important are product features and brand to the Islamic customer?

Most firm(s) seeking to enter this market focus their efforts on producing innovative Islamic products that rigorously comply with *sharīᶜa* investment principles. But this is only one of several threshold standards that must be met. Success is more likely to come to those institutions that also recognize other fundamental customer needs. *Build* vs. *buy* decisions, taken in this broader context, stand a greater chance of leading to success in the Islamic mutual fund market.

Outsourcing fund accounting, pricing, custody, fund administration, and even shareholder services (shareholder communications, support services, marketing services, and distribution services) is increasingly commonplace in the global mutual fund industry. But among institutions that are considering offering Islamic mutual funds, outsourcing asset management (including *sharīᶜa* screening) may be overlooked. Why is this?

The U.S. financial services industry, and the mutual fund sector in particular, has recognized that it cannot be expert in all asset classes. In a recent report published by the Boston-based Financial Research Corporation (FRC), some $425 billion of assets in the U.S. mutual fund market was identified as managed under "sub-advisory" contracts—representing about 7% of the total industry.[iv] About $33 billion was raised in the sub-advised funds segment in 1999, roughly 10% of the industry's total net sales in 1999. The FRC report also noted that 704 of the country's 6700 mutual fund portfolios were managed under sub-advisory contracts.

The arguments outlined by the FRC for appointing sub-advisors are compelling:

1. Fund families cannot consistently add value and outperform across every investment category.
2. Performance in the categories of domestic equity, international equity, government, and money market portfolios outperformed that of internally managed counterparts over three to five year time horizons—even allowing for the incremental advisory fees.
3. The instant track records gained from sub-advisors can help boost sales.
4. Appointing a sub-advisor is often a cost-efficient alternative to hiring (or terminating) a full-time portfolio management and/or research unit.
5. In some markets, brand recognition is crucial, and can be more easily had by bringing a sub-advisor on board.

IV. CHARACTERISTICS OF THE SAUDI ARABIAN ISLAMIC INVESTOR

Is there something unique about Islamic investors (or perhaps the Saudi investor) that limits an organization's freedom to outsource? Not according to six years of customer research undertaken by NCB. Starting in 1994, NCB conducted extensive annual customer (tracking) surveys and analyzed responses to some 40-50 questions relating to all aspects of investing, including the customer's experience with mutual funds in general, the relationship between the customer and NCB (in the specific categories of general attributes, services, funds, communications, and employees), the customer's investment needs, and the customer's own background.

Over the past six years, NCB has measured a rising awareness of and preference for *sharīᶜa*-compliant investment. Beyond this, however, it has sought through its research to define a value proposition and identify detailed customer values that could be reflected in a range of new Islamic funds and services that differentiated NCB's Islamic funds from its conventional funds.

We divided the responses into two general categories: a) investors who said they preferred Islamic investments "every time they invested"; and b) investors who said they preferred Islamic investments either "sometimes, depending on their risk tolerance" or "I don't worry too much about this aspect of investing." The 1999 survey generated 3000 responses, representing 8.5% of NCB's fund customer base. Given NCB's 50% share of Saudi fund accounts, this translates to about 4% of the Kingdom's mutual fund customer base.

From the parameters we set, we could find virtually no clear-cut point of differentiation between NCB investors who prefer to invest exclusively in Islamic funds and those who are not predominantly governed by this specific condition. This comes as no major surprise, as the differences we have anecdotally observed seem to be based on the extent to which religious ethics are allowed to permeate personal finances rather than on fundamentally different social and financial goals. Further market research is underway to determine whether this applies to only NCB customers or to the broader market as well.

In the meantime, given this backdrop, we are led to believe that product/service providers that can meet the broad financial goals of the "strict *sharīᶜa* investor" without presenting him with an "inferior package" (e.g., no "conscience penalty") would find a receptive market. Again, this was not surprising. A Morningstar analyst, Emily Hall, recently labeled this "a marketing issue," when commenting on the low level ($45 million) of assets of the only two U.S.-registered Islamic mutual funds compared to the investable wealth of an estimated U.S. Muslim population of 6 million.[v]

This observation seems to give rise to the following hypothesis: The differences between a "strict Saudi *sharīᶜa* investor" and a "conventional Saudi investor" begin beyond such standard financial parameters as "advice," "liquidity," "capital preservation," "capital appreciation," and so forth. The personal sense of (commitment to) religious ethics appears to do little to color the investor's preference for and reaction to standard financial values such as these. However, it is unlikely that a strict Saudi *sharīᶜa* investor will compromise on value or accept a conscience penalty.

Our research has identified fifteen "essential and primary" customer values that we broadly categorize in four areas: staff professionalism, customer communications, institutional values, and fund performance. Only one of these values is specifically linked to *sharīᶜa* compliance.

V. Approaches to the Mutual Fund Business

Because the meaningful differences between a "strict Saudi *sharīᶜa* investor" and a "conventional Saudi investor" may be buried deep in the realm of personal ethics and morality, it is unlikely that a "formula approach" to investing would be successful in meeting the needs of the strict *sharīᶜa* investor. "Strict" probably carries as many different connotations as there are *sharīᶜa* investors. Hence, success may lie in establishing threshold standards and then building in sufficient flexibility that would allow for personal choice.

The above hypothesis would support the notion that in organizations that lack extensive manufacturing, asset managing, and/or *sharīᶜa*-compliance capabilities, buying and adapting might be the most cost-effective approach to forming a mutual fund. For example, the *sharīᶜa*-screening process employed by several Al-Ahli equity funds was developed jointly by NCB, our external *sharīᶜa* advisors, NMCC (The National Management Consulting Center, Jeddah), and Wellington Management Company, Boston. This is a "build *and* buy" partnership formula that has worked well for us and, more importantly, for our customers. It has also served as the cornerstone from which important strategic distribution alliances have been established with other institutions, including the National Bank of Kuwait and their successful Al Kowthar funds.

What about Islamic fund investors' attitude to risk? We had also hoped through our research to find material differences between the two customer groups; we did not. This has led us to develop Islamic funds that are not inherently riskier than the broader markets in which they invest.

NCB's Al-Ahli Global Trading Equity Fund, launched five and a half years ago, now exceeds $700 million in assets and is invested in a broadly diversified array of large-cap global equity securities in accordance with Islamic principles. The fund's annualized return of 23.51% (through June 30, 2000), has outperformed the MSCI World Index by almost 6% (5.78%), without subjecting investors to significant incremental risk. Using widely accepted risk measurements such as standard deviation or the Sharpe Ratio, we can confirm the observations of a number of recent articles and studies: Islamic fund investors do not necessarily have to "pay a conscience penalty" by accepting either lower returns or higher risks.[vi]

VI. Conclusion

If mutual funds can draw from an Islamically screened universe and, on a risk-adjusted basis, outperform broader secular indices, why have Islamic funds not been more widely embraced by the socially responsible investment community? Could it be that we are too narrowly preaching to the converted, or that we are focusing on only one essential customer value—*sharīᶜa* compliance—while ignoring some other essential and fundamental investor needs?

We have before us a challenge, as well as an opportunity, to demystify Islamic investing and broaden the appeal and ownership of Islamic funds. Success will come to those who recognize that meeting fundamental customer needs means looking well beyond *sharīᶜa* compliance. To succeed, most organizations entering the Islamic fund business must chose the *buy* option and *build* only where they can save time or cost, or create significant value to the customer. Recognizing this is, in our view, a fundamental "task ahead."

[i] In this paper, "NCB" and "we" are used interchangeably.

[ii] Accounting, Auditing and Governance Standards For Islamic Financial Institutions. 1420 A.H./1999 C.E.

[iii] Saudi Arabian Monetary Agency, Investment Products Committee (IPC).

[iv] Financial Research Corporation. The 2000 Sub-Advised Mutual Fund Report.

[v] Culloton, Dan. "Profiling According to the Words of the Prophet." http://www.morningstar.com: The Council on American-Islamic Relations. March 15, 2000.

[vi] Sahadi, Jeanne. "Serving God and Nest Egg: Banking on Your Religious Values Can (Sometimes) Bring Competitive Returns." http://cnnfn.com. March 6, 2000.