ISLAMIC STRUCTURED PRODUCTS

BY

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Objectives

- To create a **significant new revenue** stream for Islamic banking business
- To expand the **fee-based** income of Islamic banking
- To **convert high-cost on-balance** sheet funds into off-balance sheet items
- To offer opportunities for clients to obtain **higher returns** compared with that offered by normal deposit products.
- To **galvanize competency centres** within the Group into manufacturing and originating islamic wealth management ideas
Wealth Managers

Islamic wealth management

Investors

Conventional

“Non-screened” investments

Shariah-compliant investments *

✓ Ethical based
✓ Socially responsible

* In global investment terminology – similarities can be found with “Socially Responsible Investment – SRI”

However, the Islamic wealth management has a wider social agenda…
To develop a neglected segment of the Islamic Wealth Management business

**Investment products**
- ✓ Islamic Structured Product – growth area
- ✓ Islamic unit trust – well developed
- ✓ Investment linked takaful – well developed
- ✓ Islamic managed private portfolio – in existence
- ✓ Islamic ETF / closed end funds – slow & lethargic
- ❌ Islamic private equity fund – not popular
- ❌ Islamic hedge funds – non existent

**Non-Investment products**
- ✓ Islamic wealth redistribution & purification – developed
- ✓ Islamic Estate Planning & Administration – growing
- ❌ Islamic Retirement Planning – undeveloped
• The IWM team will work with various manufacturers within the Group to manufacture / source for Shariah-compliant products
<table>
<thead>
<tr>
<th>PRODUCT PLATFORMS</th>
<th>Manufacturing &amp; Distribution Infrastructure *</th>
<th>INTENSITY OF ACTIVITY / STAGE OF DEVELOPMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Nil</td>
</tr>
<tr>
<td>Structured Deposits</td>
<td>Established</td>
<td>○</td>
</tr>
<tr>
<td>Islamic unit trusts</td>
<td>Established (only distribution)</td>
<td>○</td>
</tr>
<tr>
<td>Investment-Linked Takaful</td>
<td>Established</td>
<td>○</td>
</tr>
<tr>
<td>Managed Portfolio</td>
<td>Established</td>
<td>○</td>
</tr>
<tr>
<td>Restricted Investment Schemes</td>
<td>Established</td>
<td>●</td>
</tr>
<tr>
<td>Exchange Traded Funds / Listed Closed End Fund</td>
<td>To be developed</td>
<td>●</td>
</tr>
<tr>
<td>Private Equity</td>
<td>Established</td>
<td>●</td>
</tr>
<tr>
<td>Private Funds</td>
<td>Established</td>
<td>●</td>
</tr>
</tbody>
</table>

* Established means either a Shariah or a similar conventional product in the product class has been launched
# ISLAMIC INVESTMENT PRODUCTS LAUNCHED BY ISLAMIC BANKS

<table>
<thead>
<tr>
<th>Originator/ Name of product</th>
<th>Month</th>
<th>Product type</th>
<th>Features / Tenure</th>
<th>Islamic concepts</th>
<th>Indicative Returns</th>
<th>Investment size</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC Amanah Islamic Dual Currency Structured Investment</td>
<td>April 2006</td>
<td>Liquidity management product that allows investors to earn a profit return on short-term surplus funds</td>
<td>Min 1 month NOT Capital protected</td>
<td>Commodity Murabaha-i and the Unilateral Promise to Exchange currencies (Waad)</td>
<td>Up to 9%</td>
<td>Min RM250,000</td>
</tr>
<tr>
<td>ABN AMRO Islamic Foreign Currency Private Investor</td>
<td>March 2007</td>
<td>Customised Structured Product (Multi asset) &quot;Islamic Alternative Index Tracking Certificate&quot;</td>
<td>Options of leverage, guaranteed return &amp; capital protection</td>
<td>n.a. (depends on the choice of assets)</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>CIMB Islamic - The Islamic All-Stars Global</td>
<td>Jan 2007</td>
<td>Equity-linked structured product (20 global MNCs)</td>
<td>Principal protected</td>
<td>Restricted Mudharabah</td>
<td>Indicative 1st year = 8% + variable rate thereafter capped at 10%</td>
<td>Min RM250,000</td>
</tr>
<tr>
<td>Maybank STRIDE-i</td>
<td>Oct 2007</td>
<td>Commodity-linked structured deposit (NIDC)</td>
<td>Principal protected 4 years</td>
<td>BBA-Murabaha &amp; Waad</td>
<td>Min 9.8% Max 39.8%</td>
<td>RM50,000</td>
</tr>
</tbody>
</table>

Yet to offer islamic structured product:
Affin Islamic, RHB Islamic, HLeong Islamic, EonIslamic, AmlIslamic, KFH, Al Rajhi
<table>
<thead>
<tr>
<th>Originator/ Name of product</th>
<th>Month</th>
<th>Product type</th>
<th>Features / Tenure</th>
<th>Underlying</th>
<th>Indicative Returns</th>
<th>Investment size</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIMB Principal – CIMB Islamic Structured Growth Fund</td>
<td>June 2007</td>
<td>Closed-end unit trust investing in CIMB’s Structured Product</td>
<td>Variable price unit trust (No capital protection)</td>
<td>Best performing combo of equity, commodity &amp; property</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>CIMB Principal - Global Income Fund</td>
<td>April 2007</td>
<td>Closed-end unit trust</td>
<td>Principal protected 3 years</td>
<td></td>
<td>-</td>
<td>RM10,000</td>
</tr>
<tr>
<td>Public Mutual – Islamic Asia Balanced Fund</td>
<td>Aug 2007</td>
<td>Unit trust. Free Takaful up to RM100k.</td>
<td>Variable price unit trust (No capital protection)</td>
<td>Equity and Fixed Income</td>
<td>-</td>
<td>RM1,000</td>
</tr>
<tr>
<td>Public Mutual – Asia Strategic Sector Fund</td>
<td>Sep 2007</td>
<td>Unit trust. Regional sector allocation.</td>
<td>Variable price unit trust (No capital protection)</td>
<td>Equity</td>
<td>-</td>
<td>RM1,000</td>
</tr>
</tbody>
</table>
Some misunderstandings about Wealth Management (WM) products

<table>
<thead>
<tr>
<th>What they say .....</th>
<th>What we should tell them .....</th>
</tr>
</thead>
<tbody>
<tr>
<td>WM products are only for the high net-worth individuals</td>
<td>The biggest component of wealth management business is unit trust/mutual fund, which is targeted at the masses.</td>
</tr>
<tr>
<td>WM products are risky</td>
<td>There are risky WM products (variable price equity fund) and conservative WM products (capital-protected funds). The trick is to match the product with the risk profile of clients.</td>
</tr>
<tr>
<td>WM is all about investment</td>
<td>There are non-investment products and services, such as in the areas of advisory, wasiat, inheritance, hibah, wakaf etc (all these to be developed)</td>
</tr>
<tr>
<td>WM products are not halal because they invest in derivatives</td>
<td>BNM has issued a “Guidelines on the Offering of Islamic Investments Linked to Derivatives” 8 June 2006. The SC also has a Guideline on structured products.</td>
</tr>
</tbody>
</table>
Currently, there is a great discussion among Shariah scholars on the matter, and the prevailing impression one gets is the inconsistency in arguments and opinion from the learned scholars regarding these instruments.

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

"we should realize that even in the modern degenerated form of futures trading, some of the underlying basics concepts as well as some of the conditions for such trading are exactly the same as were laid down by the Prophet (PBUH) for forward trading. For example, there are clear sayings of the Prophet (PBUH) that he who makes a Salaf (forward trade) should do that for a specific quantity, specific weight and for a specified period of time. This is something that contemporary futures trading pays particular attention to."

Fahim Khan (Islamic Futures and their Markets, Research Paper No.32, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia)

"Firstly, it is a well recognized principle of the Shariah that purchase or sale cannot be effected for a future date. Therefore, all forward and futures contracts are invalid in Shariah; secondly, because in most futures transactions delivery of the commodities or their possession is not intended. In most cases the transactions end up with the settlement of the difference in price only, which is not allowed in the Shariah."

Mufti Taqi Usmani of the Fiqh Academy of Jeddah
It appears that most scholars agree that, in principle, futures and option contracts may be compatible with Shariah principles. What makes them worth objecting to, is the manner in which they have found application in the marketplace in certain instances, such as with speculation and exploitation of certain counterparties. The objections of the learned scholars differ in accordance with their individual interpretation of the Shariah and their understanding of the instruments under discussion.
As this deprives businesses from an array of benefits and advantages that, if understood and appreciated properly, appear to be halal in many instances, a concerted effort may be necessary to address the social disadvantages it is placing on such businesses in today's global economy – comments by Islamic-world.net
Islamic Structured Products

- Islamic Transaction
- Investment Mechanism
**Islamic Transaction**

**Underlying principle**
- **Spot**: Acceptable as is i.e. exchange of trade.
- **Forward**: Contract for future sale not allowed as per Shariah. However, one way promise or undertaking (one way Wa’ad) is allowed.

**Mechanism**
- Client unilaterally promises to purchase a commodity, say Copper for MYR at a future date at a fixed price. This is in the form of a Promise to Purchase given by Client to MIB. MIB will provide an acknowledgement.

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**Timeline**

1. **Step 1**
   - **Deal Done**

2. **Step 2**
   - **Promise to Purchase/Sell**
Islamic Transactions

Mechanism (.....Continued)

- At maturity, Client makes an offer to purchase the commodity i.e. Copper for MYR on a spot basis at the pre-agreed rate.

- MIB accepts Client’s offer and the trade are exchanged.
# Investment Mechanism

<table>
<thead>
<tr>
<th>Proposed Product</th>
<th>Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Type</td>
<td>Structured Investment</td>
</tr>
<tr>
<td>Product Mechanism</td>
<td>Lump sum investment is split between 1.NID-i to generate capital protection 2.Equity basket/ Index based derivative to generate upside returns</td>
</tr>
<tr>
<td>Payout/Return to Client</td>
<td>Payout at end of tenure only</td>
</tr>
<tr>
<td>Tenor of Investment</td>
<td>1 Year and above</td>
</tr>
<tr>
<td>Shariah Concept(s) used</td>
<td>Structured Product - Wa’ad/Murabahah</td>
</tr>
</tbody>
</table>

**Option Payoff**
- Option
- Fixed Income
- Guaranteed Payout
Client and Bank enter into a Commodity Sale and Purchase transaction for the investment Amount

- **Step 1:** Client Purchases Commodity (direct or through MIB as Agent)

- **Step 2:** Client sells Commodity to MIB for Principal plus agreed profit payable on deferred basis. The deferred period will be the same as tenor for the relevant index tranche. This will provide the principal protection to the Client.

- **Step 3:** MIB will issue a promise to purchase commodities post maturity of the initial Murabaha. The profit rate will be benchmarked to the final tranche value to be declared at the end of the initial Murabaha period. The Client will have the right to conduct the 2nd Murabaha at the declared Index value.

- **Note:** The profit for the initial Murabaha stage will be a nominal rate
Investment Mechanism - Process Phase 2

- Based on positive Tranche Value, Client and Bank will enter (at the option of Client) into a Commodity Sale and Purchase transaction for the investment Amount

- **Step 0**: The initial Murabaha will mature and the full amount (inclusive of profit) will be returned to the client.

- In case the final Tranche Value is positive, the Client may wish to enter into the 2nd Murabaha as per the initial promise given in Phase 1.

- **Step 1**: Client Purchases Commodity (direct or through MIB as Agent)

- **Step 2**: Client sells Commodity to MIB for Principal plus the agreed profit (as per final index value) payable on deferred basis.

- **Step 3**: On Maturity the client will receive the Murabaha amount based on the final index value.

- Note: The deferred period in this stage will be short.
All transactions are done on Spot basis.

- MIB as Agent
  - Client
    - $\text{P}$
    - Commodity A

- MIB
  - Trader
    - $\text{P}$
  - Commodity A
  - MYR
  - $\text{P}$
  - Commodity A
Prohibitive List

- Islamic finance uses principles of Shariah or Islamic Law and modern banking. Funds are banned from investing in companies associated with tobacco, alcohol, or gambling, and the system also bans the earning of interest.
- There may be local regulations applicable due to Shariah guidelines or similar public policy laws which may render these transactions unenforceable.

In addition, companies involved in the following prohibited businesses activities are to be excluded:

1. Alcohol
2. Gambling
3. Pornography
4. Tobacco and dangerous drugs
5. Entertainment
6. Pork
7. Prostitution
8. Interest-based lending
9. Conventional insurance and stock brokering
10. Terrorism
11. Hotel – in particular those suspected of condoning to haram activities, and etc

All transactions are for hedging purposes only and not for speculative purposes.
Prohibitive List

- The Shariah Advisory Committee may add or update the list from time to time.

- Supplementary to the above list, the list of Shariah compliant counters issued by the Securities Commission will be used as a guide for Malaysian public listed companies.

- Shariah Advisory Committee may grant exceptions to the list, depending on the case from time to time. Exception can be requested through the Secretary/Assistant Secretary of the committee.
Glossary Of Islamic Financial Terms

**Al Wakala / Wakalah**
Absolute power of attorney.

**Mudaraba / Modaraba (Trust Financing)**
The term refers to a form of business contract in which one party brings capital and the other personal effort. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. The financier is known as 'rab-al-maal' and the entrepreneur as 'mudarib'. Mudarib in a mudaraba contract, the person or party who acts as entrepreneur.

**Murabaha / Morabaha (Cost-Plus Financing)**
Lit: sale on profit. Technically a contract of sale in which the seller declares his cost and profit. This has been adopted as a mode of financing by a number of Islamic banks. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is agreed in advance. It has been estimated that 80 to 90 percent of financial operations of some Islamic banks belong to this category. There are a number of requirements for this transaction to meet the Islamic standards of a legal sale. The entire transaction is to be completed in two stages and as two separate contracts. In the first stage, the client requests the bank to undertake a Murabaha transaction and promises to buy the commodity specified by him, if the bank acquires the same commodity. In the second stage, the client purchases the good acquired by the bank on a deferred payments basis and agrees to a payment schedule. The Murabaha form of financing is being widely used by the Islamic banks to satisfy various kinds of financing requirements. It is used to provide finance in various and diverse sectors e.g. in consumer finance for purchase of consumer durable such as cars and household appliances, in real estate to provide housing finance, in the production sector to finance the purchase of machinery, equipment and raw material etc.

**Musawamah**
Negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated, they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabaha and Musawamah with all other rules as described in Murabaha remaining the same. Musawamah is the most common type of trading negotiation seen in Islamic commerce.

**Riba**
This term literally means an increase or addition. Technically it denotes any increase or advantage obtained by the lender as a condition of the loan. Any risk-free or “guaranteed” rate of return on a loan or investment is riba. Riba, in all forms, is prohibited in Islam. In conventional terms, riba and “interest” are used interchangeably.

**Shariah / Sharia / Shari’a**
Islamic canon law derived from 3 Primary sources: the Quran; the Hadith (sayings of the Prophet Muhammad); and the Sunnah (practice and traditions of the Prophet Muhammad), and three Secondary sources Qiyas (Analogical deductions and reasoning), Ijmá (Consensus of Islamic Scholars) and Ijtihad (Legal reasoning).

**Sukuk**
A certificate entitling the holder to the benefits of the income stream of the assets backing the certificate. Equivalent to a Fixed income bond.

**Wa’d**
A promise to pay and it gives a unilateral effect of binding promise upon the promisor (customer). Thus the promisor (customer) is obligated to fulfill the promise but not the promisee (bank)
Case Study 1

• Local Bank (Appendix 1)
Case Study 2

• Foreign Bank
THANK YOU