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January 2009: The way forward for Islamic structured products

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Ahmad Chaudry explained the current status of the Islamic structured products industry and suggested that the way forward for these instruments would be in offering unique, bespoke solutions matching investors' requirements with consideration not only to Shari'ah-compliant contracts, but also underlying assets, strategy and wrappers.

Chaudry is a dynamic strategies structurer with the equities division at RBS Global Banking & Markets. His primary responsibility involves the development of conventional and Shari'ah-compliant trading algorithms for retail, private and institutional clients. An aerospace engineer by academic background, Ahmad has also worked at HSBC Global Markets and HSBC Amanah.

The lecture was chaired by Iqbal Asaria from Afkar Consulting Ltd.

Structured finance has no particular definition. Generally, it involves the combination of various legal structures to achieve a certain solution or products matching investors' requirements. Normally, the starting point is to analyse the commercial objectives of the investors. Once those are known and clearly set out, then it becomes a question of looking at the possible Shari'ah-compliant financing techniques and undertaking any necessary due diligence, which may extend to matters such as legal research, tax analysis and a review of underlying assets that are to be employed in Islamic financing or investments structures.

After describing the structured products, Chaudry mentioned that for centuries, Muslims all over the world have conducted commodity-based trades, financed ambitious projects and managed their physical/cash wealth in methods consistent with Islamic law. As a result, they have gained a highly sophisticated understanding of transactions, based on a prescribed set of Shariah-compliant contracts.

Islamic financial institutions employ a board of Shari'ah scholars with the primary aim of reconciling the Shari'ah requirements and the law of the land in the business transactions. He pointed out that enormous development has been made in innovation of various Shari'ah-compliant contracts used in Islamic structured products in the last 25-30 years, for which credit goes to Shari'ah scholars, lawyers and practitioners. However, to achieve the true potential of Islamic structured products, there is a need to focus on the underlying assets and strategy for investment which received little or no consideration so far. In 1999, the Dow Jones Islamic Index was launched which employs various sectorial and financial criteria for the screening of stocks for Shari'ah-compliant investments. While it was a good start to facilitate Shari'ah-compliant investment transactions, for Islamic product structurers it really did not meet the objectives of their clients, especially those who wanted to invest in particular sectors or wanted to take a specific (either bullish or bearish) view on the stock. The problem is that after business and financial screening, the available universe of stocks becomes very limited and difficult to invest in due to liquidity (and sometimes foreign ownership issues) and it does not meet the requirements for big investments. On top of this, hedging the investment becomes a real problem due to lack of active secondary market and wide bid-offer spreads on such stocks.

Chaudry then proposed that the true potential of Islamic structured products can only be realised if there is a shift from Shari'ah-compliant to Shari'ah-based structuring which is possible by employing 'dynamic structuring strategies'. He pointed out that such strategies meet very well the investors' investment objectives and are gaining more popularity. These strategies change the allocation (and weighting) of investment in various stocks over time. Then, he went on to explain the concept of dynamic weighting and risk allocation in such structured products with the help of an example of three stocks. If an Islamic investor has \$1million for investment and based on his requirements there are three Shari'ah-compliant stocks available to invest in, the weighting of investment in each stock will be monitored and adjusted continuously, either on a weekly or monthly basis, after looking at the pattern (upside as well as down side) in the respective stock movements. If in the portfolio of three stocks, A, B and C, a weighting of 50 per cent was assigned to stock A, and 25 per cent to stock B and C respectively, and the value of stock C appreciates in a week's time, then weighting of stock C and A will be adjusted after one week to match the investor's requirements. He emphasised that it is the shift in selection of underlying assets, strategy of investments and wrapper used for such products that will bring credibility to Islamic structured products and make them different from conventional ones.

After the presentation, participations raised various questions about the costs of employing dynamic strategies, why bid-offer spreads are so wide in Shari'ah-compliant stocks and the risk management techniques which may be used in dynamic structuring strategies.

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