Towards Developing a Conceptual Framework for Islamic Unit Trust Funds

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Abstract
There is increasing interest among investors in one of the latest investment vehicles - unit trusts. Unit trusts have several advantages as investments in comparison to other investment vehicles, as they are managed by fund managers and tied down by a trust deed. These advantages can be traced back to the investment diversification, professional management of the unit trust and the liquidity flow that can be obtained through sale and purchase of the unit trust. This paper presents an argument towards the development of the conceptual framework for Islamic unit trust funds, explored using references to the regulations in Malaysia, reviewing the types of unit trust funds, their distinctive features, Shariah principles that operate in the management of unit trust industry in Malaysia and the contributions that can be generated from unit trust fund to society. Some of the essential features of Islamic unit trust funds depend on the prohibition of riba, gharar and maysir, strict stock screening processes and purification processes. The main challenges to the unit trust industry are also discussed.

Keywords: Islamic unit trust, fund management; Shariah funds; stock screening
1. Introduction

Islamic unit trusts are a growing sector in the Islamic capital market industry. In Malaysia, the Islamic unit trust industry is supported by the government, which is evidenced in several initiatives such as the establishment of Kuala Lumpur Shariah Index (Abdullah et al., 2007), tax exemption (Mohammed Kamil et al., 2018) and the liberalisation of overseas investment rules (Jamaludin, et al., 2012). Islamic fund management companies are allowed to be initiated with 100% foreign ownership which is an additional attraction to global investors (Jamaludin, et al., 2012). This can be seen as an effort by the Malaysian government in pushing Malaysia as the global Islamic Capital Market hub. The unit trust industry in Malaysia amounts to M426.18 billion, with RM83.45 billion in Islamic unit trusts, approximately 20% of the total unit trust industry (Securities Commission Malaysia, 2018).

This paper aims to develop the conceptual understanding of the framework of unit trusts in Malaysia, with close identification of Shariah principles. The discussion examines the Islamic capital market and the distinctive features of Islamic unit trust funds, the relevant Shariah principles and traces the development of the growing unit trust industry in Malaysia.

2. An Overview of the Islamic Capital Market in Malaysia

The Islamic capital market in Malaysia is a growing market in the region. Operating in parallel to the conventional capital market, the Islamic capital market consists of stock-broking operations, including unit trusts, bonds and indices (Yusof and Majid, 2008); the main difference is that the operational activities of the Islamic capital market are in line with Shariah principles. The Islamic capital market is a capital market that follows secular law and religious law, where the listed securities and companies do not engage in prohibited elements such as usury (riba), gambling (maysir) and uncertainty (gharar). Firstly, the prohibition of riba implies that interest-based financing is not allowed. Secondly, the prohibition of gharar refers to restrictions on uncertainty, risk and moral hazard. Next, the prohibition of maysir means that gambling and business activities related to gambling are forbidden. Additionally, some activities that are contrary to the Islamic teachings are also banned.

The Malaysian Stock Exchange was formed in 1960 and separated into the Kuala Lumpur stock exchange (KLSE) and the Stock Exchange of Singapore (SES) in 1973 with the termination of currency interchangeability between Malaysia and Singapore. KLSE is now known as Bursa Malaysia, where financial assets are transacted. The Islamic capital market was introduced in 1992 (Yusof and Majid, 2008) and the Kuala Lumpur Shariah Index was introduced in 1999 (Abdullah et al., 2007). The Shariah Advisory Council (SAC) of the Securities Commission Malaysia (SC) screens and approves shares classified as Shariah compliant securities, which are then listed on Bursa Malaysia and updated every May and November (Bursa Malaysia, 2019).
Following the successful launch of Islamic indices, Bursa Malaysia further expanded the tradeable Islamic index (Yusof and Majid, 2008), namely FTSE Bursa Malaysia Hijrah Shariah Index, FTSE Bursa Malaysia EMAS Index, FTSE Bursa Malaysia Small Cap Index, FTSE Bursa Malaysia MidS Cap Index. As of 26 May 2017, there are 676 Shariah compliant securities, representing 75% of securities listed in Bursa Malaysia (Bursa Malaysia, 2019). This indicates a decrease in the number of Islamic securities compared to the data given by Yusof and Majid (2008) which reported that there were 816 Shariah compliant stocks in 31 May 2017; representing nearly 82.5 percent of the total listed companies in Bursa Malaysia. The reduced number of Shariah compliant securities in Malaysia is partly due to the rise of emerging markets in the region (Yusof and Majid, 2008) as well as the revised screening methodology for the Shariah-compliant status of public companies listed on Bursa Malaysia. The first Shariah screening methodology was introduced in 1995, while the revised Shariah screening methodology came into effect from November 2013. The revised screening methodology includes tighter financial ratio benchmarks which are intended to measure riba and riba-based elements in financial statements of companies (Bursa Malaysia, 2019). The Shariah screening methodology will be discussed in the next section.

2.1. Shariah Screening Methodology

The Islamic capital market co-exists with the global financial framework, which is not Shariah compliant. Most of the listed companies in the Islamic capital market are either involved in operational activities that are Shariah non-compliant or are a mix of compliant and non-compliant (Lewis, 2010). Mainly, these are for the following reasons. First, the Islamic capital market is underdeveloped or non-existent in many jurisdictions which adds barriers to making cross-border transactions in a Shariah compliant way. The limited number Islamic financial institutions are thus forced to obtain services from conventional sources (Hashim et al., 2017). Second, most trading companies are established and managed by non-Muslims who are not required to follow Islamic laws. Even though some practices are prohibited under Islamic laws, non-Muslims are not obliged to follow Shariah rules (Lewis, 2010). As such, exceptions or allowances are given to listed companies to be included in the Shariah-compliant list (Hashim et al., 2017).

Recognising the need to work in a dual-banking system in majority jurisdictions, Shariah scholars and regulatory bodies established a screening methodology to undertake Shariah screening for listed companies (Elfakhani et al., 2007). The rationale of having a Shariah stock-screening tool is to restrict Muslim investors and companies from engaging in Shariah non-compliant activities (Hashim et al., 2017). A comprehensive screening procedure is imposed on financial assets or potential investments in order to ensure that the financial assets meet the standards enforced by Shariah rules (Elfakhani et al., 2007). This screening procedure is known as Shariah screening. All Shariah screening methodologies have a two-tier approach: the first element covers qualitative measures, which involves sector and activity screening, whereas the second element covers quantitative measures, using financial ratios to
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determine riba and riba-based elements within the balance sheets of companies (Derigs and Marzban, 2008).

The first criterion of the Shariah screening methodology as outlined by Securities Commission Malaysia (Bursa Malaysia, 2019) is to exclude entities whose core business activities include involvement in impermissible activities. This criterion is consistent with other screening methodologies such as the Dow Jones indices (Lewis, 2010) and ISRA-Bloomberg screening (Hashim et al., 2017). Lewis (2010) commented that Securities Commission Malaysia has the most lenient approach in screening listed companies with mixed activities (a combination of Shariah compliant and non-compliant activities), as compared to the Dow Jones indices that use a more strict approach. Securities Commission Malaysia, for example, included companies involved in non-halal food and beverage, if the revenue generated from those business activities does not exceed 5 percent of the overall profit before tax (Securities Commission Malaysia, 2018).

After filtering out sectors that are impermissible under Shariah laws (e.g. gambling; sale and purchase of non-halal food and beverages), the next step is to screen out companies with unacceptable financial ratios (Lewis, 2010). This financial screening is to ensure that any impermissible secondary activities of the listed companies are within a tolerable benchmark (Hashim et al., 2017). The threshold of 5 percent or tolerable benchmark is important to indicate that Shariah non-compliant activities are negligible (Derigs and Marzban, 2008; Hashim et al., 2017) and thus acceptable from a Shariah-compliant viewpoint (Lewis, 2010). The Islamic financial ecosystem will be significantly smaller if all businesses with mixed activities are excluded; for example, airlines and hotels which sell alcohol would be considered Shariah non-compliant under stringent Shariah screening (Derigs and Marzban, 2008). Shariah scholars thus allow companies which keep haram activities at a minimum proportion or tolerable levels (Elfakhani et al., 2007). In cases where the income generated from interest-bearing activities exceeds the tolerable threshold, the proportion of such income must be given to charity; such process is known as “purification” (Lewis, 2010).

Securities Commission Malaysia and ISRA-Bloomberg screening methodologies provide two different financial ratio benchmarks: cash-based and debt-based (Hashim et al., 2017). To be included in the Shariah-compliant index the cash and debt of a company in any form should not exceed 33 percent of the market capitalisation of the total equity of a company (Securities Commission Malaysia, 2018). Traditional shares and bonds that rely heavily on interest-based financing are not compliant with Islamic law and thus may not be traded in the Islamic capital market (Elfakhani et al., 2007).

Shariah compliance emphasises liquidity, solvency and non-operating interest income, (Lewis, 2010) and thus some screening methodologies use additional financial ratios. For example, the accounts receivable should not exceed 50 percent of total assets in order for a company to qualify as Shariah-compliant according to the Shariah guidelines defined by the Shariah boards of FTSE Index Series and HSBC Amanah Fund (Derigs and Marzban, 2008).
3. The Unit Trust Industry and Challenges for Islamic Unit Trusts

A unit trust fund is a professionally managed investment portfolio of securities that pool funds from investors and invest in a variety of financial assets or investment classes, which may not be available to an individual investor (Saad et al., 2010). These investment classes include government and corporate bonds, which often require a large amount of funds, which are often beyond the affordability of retail investors. Such investments are accessible in the form of pooled investments or collective investment schemes like unit trust funds (Abdullah et al., 2007; Lewis, 2010; Saad et al., 2010). Each fund has its own legal structure, capital requirement, date of maturity and expected returns (Lewis, 2010).

One major risk for unit trusts is the volatility of market activities, which affects the value of securities and bonds (Abdullah et al., 2007; Alam et al. 2016; Saad et al., 2010). However, Islamic unit trusts exhibited a smaller systematic risk and showed less variability, leading them to be considered less risky than other portfolios (Alam et al. 2016). Moreover, Shariah compliant companies tend to have a low bankruptcy risk because of the low financial leverage required (Lewis, 2010). Given the inclination of investors to move funds into safer instruments, Islamic fund managers reshuffled investment portfolios by shifting technology funds to the healthcare and energy sectors (Elfakhani et al., 2007). Other benefits of Shariah-complaint funds include a balance between risks and returns, clear legal terms and responsibilities placed upon the sponsor, and specified investment objectives for the particular fund (Lewis, 2010).

Islamic unit trusts are a subset of the overall unit trust industry and a constituent part of the Islamic capital market. The industry is regulated by the Securities Commission in order to protect financial consumers and ensure the integrity and stability of the industry. Like other Shariah compliant financial products, Islamic unit trusts must also be free from with riba (usury or interest), dubious transactions and unethical activities such as market manipulations and short selling (Abdullah et al., 2007). A less well-known feature of Shariah compliant financial products is their positive features promoting socio-economic development (Lewis, 2010). There is a set of moral principles that guide Muslims in their daily activities, namely equitable distribution of wealth and brotherhood, social responsibility and concerns about the environment. For instance, the issuance of green sukuk (Moghul and Safar-Aly, 2014) and vaccine sukuk (Badeeu et al., 2019) in recent years represents a growing trend towards environmentally and socially conscious finance initiatives.

There is conflicting evidence relating to the risk-return performance of unit trust funds in the literature (Alam et al. 2016). Researchers found that Islamic unit trusts performed better than their conventional counterparts (Saad et al., 2010) while some statistical findings suggest that the financial performance of Islamic unit trust funds does not differ substantially from that of other conventional funds (Elfakhani et al., 2007). Moreover, some studies found that Islamic funds underperform conventional funds during bullish periods but outperform conventional funds in bearish periods and also during the financial crisis (Abdullah et al., 2007; Alam et al. 2016; Boo et al.,...
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2017). Interestingly, studies show that politically connected Malaysian companies can afford more financial leverage and thus have lower required returns on equity and have higher implied growth rates than other companies (Boubakri et al., 2012; Fraser et al., 2006; Sinnadurai, 2016). Boo et al. (2017) reasoned that the contradictory findings were partly due to differences in sample periods, research design and sample populations. For instance, Saad et al. (2010) investigated the efficiency of 27 unit trusts companies in Malaysia (of which five were Islamic unit trusts) during the period 2002-2005, whereas other studies such as Alam et al. (2016) and Boo et al. (2017) adopted a longer study period with a significantly larger sample.

Alam et al. (2016) evaluated the performance of Malaysian unit trusts and compared them with Islamic unit trusts, using four parameters: risk adjusted return of unit trust, market timing abilities, selection performance and persistence. The performances of both conventional and Islamic unit trusts are almost equivalent to their expected performances and reacted positively to market returns throughout February 1995–July 2009. However, Islamic unit trusts performed slightly better than the conventional ones during and after the financial crisis. With regards to market timing abilities, Alam et al. (2016) found that fund managers in Malaysia have unyielding market timing ability across the 17-year study period. Based on persistence analysis, the authors found non-significant persistence in Islamic unit trusts throughout 1999–2012. When selectivity performance is considered, however, the performance of Islamic funds is slightly better than that of conventional funds, during the financial crisis and post-crisis.

The study of Alam et al. (2016) is echoed by a statistical study conducted by Boo et al. (2017). Based on a sample of 448 mutual funds (131 of them were Islamic funds) throughout the period from 1996 to 2013, Boo et al. (2017) found that Malaysian Islamic funds outperformed their conventional counterparts in the riskiest asset class, equity, especially for the period before and during the financial crisis.

3.1. Challenges for the Islamic Unit Trust Fund Sector
The Shariah prohibition against riba (usury) and gharar (excessive risk or uncertainty) results in a less diversified investment portfolio compared to their conventional counterpart. Unlike conventional fund managers, Islamic unit trust funds managers mainly invest in equity markets (Elfakhani et al., 2007) and real estate (Lewis, 2010) and at the same time avoid investments that are deemed Shariah non-compliant thereby limiting exposure to a variety of financial assets (Alam et al. 2016). Shariah non-compliant instruments include fixed income instruments such as treasury bonds and bills, certificates of deposit, warrants and derivatives (Elfakhani et al., 2007). Lewis (2010) commented that geographic expansion of Islamic finance could compensate for the loss of diversity due to strict the Shariah screening adopted by the majority of Islamic fund managers. However, geographic expansion leads to legal challenges especially in the secular states of the West which do not have recognition of Shariah in commercial law. Unlike Middle Eastern countries – especially where the civil code of the Ottoman Empire was applicable – many countries do not reference Islam in their legal systems (Buang, 2007). In countries like Malaysia where a dual-
banking system exists, conflicts exist between the need to comply with both Shariah and Civil courts, especially when secular laws still apply when they contradict religious practices.

Another challenge to Islamic unit trusts lies in financial consumer behaviour. The lack of appreciation and understanding of Islamic finance (Lewis, 2010) and low consumer awareness (Jamaludin and Gerrans, 2015) affect decisions in Islamic unit trusts. Unit trust consultants play an important role in promoting Islamic unit trusts and creating awareness of the investment choices available (Jamaludin and Gerrans, 2015). Marketing Islamic unit trusts could gain the confidence of investors (Elfakhani et al., 2007), especially if potential investors are given information as to how a fund is managed, how investments are selected, and how fee and remuneration are structured (Lewis, 2010). In addition to that, a number of empirical studies have indicated that religion (Jamaludin et al., 2012), return expectation (Alam et al., 2016), risk tolerance (Jamaludin and Gerrans, 2015) and past performance (Jamaludin et al., 2012) affect investment decisions. These studies showed that attributes other than risk and return are valued by investors.

4. Conclusion
This paper provided an argument, based on the nature of Shariah compliance, that the Islamic unit trust fund is uniquely different from its counterpart i.e. conventional unit trust funds. However, Islamic unit trust funds in the Malaysian capital market are less prevalent compared to the long standing and prevailing conventional unit trusts. This imbalance can be tackled by the policy makers and regulators, particularly the Securities Commission, which is in a good position to promote Islamic unit trusts to potential investors.

One main challenge to the Islamic unit trust is its investment portfolio. Islamic unit trust funds are less diversified than conventional unit trusts because of stringent Shariah guidelines. Financial products that are available to conventional funds are not available to Islamic funds (Abdullah et al., 2007). Another challenge to Islamic unit trusts -- which is a common challenge to all Islamic financial products -- is the need to harmonise existing legal systems with Shariah principles. Current banking regulations or secular law in general are in contradiction of Shariah rules, making it difficult for civil courts to enforce Shariah law in the event of breach of contract, especially in secular states.

The growth and development of Islamic finance rests on the collaboration of multiple stakeholders ranging from policy makers, Shariah experts, the Securities Commission to marketeers. Islamic banking and finance is founded in a tradition with deeply entrenched religious values and ethical concerns about social responsibility. The benefits of Islamic unit trusts are well-documented (Abdullah et al., 2007; Alam et al., 2016; Lewis, 2010). Environmentally and socially responsible investments such as green sukuk and vaccine sukuk demonstrate their significance to the Islamic capital market. These socially responsible investments represent an opportunity for Islamic financiers to build Islamic economies more inclusively and at the same time allow
global investors to take part in funding environmental projects and delivering social impacts. Islamic unit trusts have the potential to fully participate in this endeavour.

5. References


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