

CHAPTER 2

INSTITUTIONAL SETTINGS

2.1 Introduction

This chapter offers an overview of the history, evolution, principle, and development of Islamic finance. It serves as a broad theoretical and conceptual background for the understanding of Islamic finance, in general, and Islamic mutual funds (IMFs), in particular. These principles form the foundation of Islamic finance, while also underlying the principles of every contract established to facilitate all financial transactions and activities in Islamic finance. Moreover, this chapter offers a background about mutual funds and fund families, and then provides the star fund and star fund family definition. Finally, this chapter presents the background of the four countries under study.

2.2 Islamic Finance Framework

Islamic finance started as a small cottage industry in some Arab countries in the late 1970s. It distinguishes itself from conventional finance in its ostensible compliance with principles of Islamic law, or *Sharia*. Its growth has been accelerating ever since, in terms of the number of countries in which it operates, as well as the areas of finance in which it has ventured. After that, the industry has attracted a number of western multinational financial institutions, such as Citigroup and HSBC, which started offering Islamic financial products in some Arab countries (notably Bahrain and the United Arab Emirates), and to a lesser extent in the western world (including the U.S., where HSBC offers various Islamic financial products in New York, including home financing,

checking accounts, etc.). A number of Islamic financial products also involve the acquisition of assets (e.g., real estate, small corporations, etc.) in the west (including the U.S.) in “*Islamically* structured” financing deals.

The Islamic legal framework serves as the foundation for Islamic economics and finance. Contrary to the secular legal system, Islamic jurisprudence covers all aspects of life, including politics, economics, and finance. The final two items are usually referred together as *muamalat*. Islamic economics enjoins a productive lifestyle, and due to its adherence to the Islamic legal code, the scope of Islamic economics focuses only on beneficial activities and products. Harmful substances, such as alcohol and drugs, as well as damaging activities, such as gambling and fornication, fall out of the Islamic economic sphere (Hoepner et al. 2013).

Although interest-free banking started to emerge in the 1980s, it is still part of the conventional banking system. Moreover, the concept is narrow in its application, in that it includes other products unlawful in Islam. The emergence of Islamic banking has opened new opportunities for the development of interest-free, ethical, and transparent banking. Transactions that involve asymmetrical information, for instance, are dismissed from the system. Islamic banking and finance, and, by extension, Islamic economics found its philosophy on these three aforementioned principles (Ayub 2013).

2.2.1 Philosophy and Features of Islamic Finance

Perhaps, the most important foundation of Islamic economics, which includes under it Islamic finance, is the prohibition of *riba* (interest) and the permissibility of trade; as stated in the Holy Quran, chapter 2, verse 275. Driven by this verse, Islamic economics develops into an asset-backed economy comprising businesses, transactions, and financial instruments that are backed by underlying assets. Economic agents and

market players are also compelled to uphold moral behaviour in their dealings (Iqbal et al. 2013).

Islam does not consider money as an asset from which value can grow. Hence, there is a prohibition of *riba*. *Riba* literally means growth, and it is a term used to denote the interest demanded by a creditor upon lending money to a debtor. In other scenarios, the term also refers to the penalty imposed on the debtor upon his failure to pay the debt on time. Interest is banned as it creates imbalances in the economy.

Following this prohibition, certain financial transactions also become unlawful. For example, the purchase and selling of debt contracts should be based on their par value, and the exchange of currency, gold, and silver should be on the spot and equal in value. In other words, any trades involving these materials should not lead to one-sided loss (Hussain et al. 2016). The detailed rules and principles surrounding Islamic finance are discussed in the following subsection.

Avoiding Interest (Riba)

As mentioned above, the lexicological meaning of the word *riba* is to increase and grow. In the economic context, it refers to the contractual increase of money or commodity that has been loaned. Islam generally disallows interest as it is earned without bearing any risk. It is also clearly prohibited in the Holy Quran and *hadith*. In Chapter *Ali Imran*, verse 130, Allah said, "O Believers! Do not charge *riba* on top of *riba* and fear God so that you may prosper."

Meanwhile, in the *hadith*, the Prophet said, "While exchanging gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, exchange like for like (in equal measure) and exchange at spot. Whosoever paid more than what he received or demanded more than what he gave, verily he dealt in *riba*.

Both the payee and the receiver are equal in violating the Law of God." (Muslim 2971).

Avoiding Gharar, Gambling, and Games of Chance

The Arabic word *gharar* literally means deceit, risk, fraud, or uncertainty. Scholars of the Hanafi jurisprudence school define it as something with undetermined consequences, while those of the Shafi'i school describe it as "something which in its manner and its consequence is hidden." In Islam, *gharar* refers to the transaction of objects whose existence or description is uncertain. This uncertainty is brought about by incomplete information or knowledge surrounding the object of transaction.

In Islamic finance, *gharar* denotes uninformed speculation that is akin to *qimar* (gambling) and *maysir* (game of chance). These three unlawful activities are distinguished from business transactions, whose risks are analysed in depth, thus reducing uncertainty. Another important distinction is that *gharar*, *qimar*, and *maysir* are zero-sum games, where the winner takes all. Economic transactions, on the other hand, do not have the same consequences.

Since some conventional derivative instruments, such as options and futures, exhibit the characteristics of those three unlawful criteria, they are considered to be in contravention of *Sharia* principles (Md Akther Uddin, 2015). The Quran prohibits such speculative practices, "They ask thee (O' Prophet) about *khamr* (intoxicants) and *maysir* (gambling). Say: In both of them there is a great harm, although there are some advantages as well in them for men, their harm is much greater than their advantage." (Al-Baqarah 2:219).

Risk and Return Sharing

Sharia prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards between the parties to a transaction (no pain no gain strategy). This profit sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a

creditor–debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is to help increase the growth of successful projects, also provide stimulus to the economy.

2.2.2 Islamic Finance Industry

The Islamic finance industry has come a long way in recent years. The industry potential was already being recognized in 1996 by Citi Group who branched out into the sector in the form of Citi Islamic in Bahrain. Since then the recent global financial crisis has prompted academic and industry participants alike to question the overall sustainability and ultimately the viability of the current conventional financial system (Hasan & Dridi, 2010). This has in part fuelled the recent increased interest in Islamic financial products and as a result, has led to the expansion of the Islamic finance industry through the establishment of dedicated Islamic Financial Institutions (IFIs) and Conventional Banks (CBs) offering the service through a windows model.

The Islamic financial industry has not been immune to the global economic downturn although the impact has been limited (Smolo & Mirakhor, 2010 and Alzalabani & Nair, 2013). It is true that the industry did manage to avoid the brunt of the financial crisis however there were periods when Islamic banks lost heavily due in part to defaults in real estate loans and to a number of *sukuks* defaulting with many investment companies being left shaken (Wigglesworth, 2011). It has been suggested that such defaults have damaged the reputation of the *sukuk* market in regions such as the Middle East where a number of high-profile defaults have occurred (Majid et al, 2011). In general Islamic finance provides different types of investment such as Islamic bank, *sukuk*, Islamic funds. Next section will focus on mutual fund and Islamic funds.

2.3 Mutual Funds

Mutual funds are investment vehicles that invest a pool of cash collected from investors in various securities. Depending on their objective, mutual funds may invest in either strictly or in a combination of equity, bond, and real estate securities (Mahoney 2004). Mutual fund investors own a certain share of the fund in proportion with their respective contributions. Such ownership is represented by shares, called units, and can be purchased or sold at their net asset value. Net asset value is the net amount of assets owned by the fund, divided by the number of outstanding shares (Bodie & Marcus 2005, p. 108).

In general, mutual funds are either open-ended or closed-ended. An open-ended mutual fund does not impose any limit on the amount of issued units (Gremillion 2005). As new investors purchase units of the fund, new shares are issued. In contrast, a closed-ended mutual fund issue is limited to a number of units, which are introduced during the initial offering of the fund. New investors must purchase these units from unit owners. The shares of this type of fund are traded on the stock exchange and end on a specified maturity period (Pozen & Crane 1998, p. 89).

Mutual funds are associated with a number of expenses, namely, front-end load, back-end load, and operating management expenses. These costs diminish the invested capital amount. The front-end load is a cost incurred during the initial purchase of the fund, usually for brokerage services, whereas a back-end load is incurred during redemption. Operating management expenses comprises advisory and administrative fees (Levy & Post 2005, p 122; Bodie et al. 2005 p.116).

The fee amount is usually determined by basis points. A basis point is equal to 0.01 percent. Most mutual funds impose an annual fee of about 100 basis points (Bogle 2005); thus, financial regulatory authorities demand strict disclosure requirements for

funds, particularly those with high fees. There seems to be a correlation between a fund's fee and performance; funds with high fees usually provide high returns, and vice versa (Karceski et al. 2004).

Investment in a mutual fund can be done either on a lump sum basis or through regular contributions (Christoffersen & Evans 2005). In the latter, investment capital is usually automatically debited from the investor's regular monthly income. The selection of mutual fund is also entirely dependent on the investor's preference and purpose (Russell 2007, p.39).

2.3.1 Advantages of Mutual Funds

Mutual funds provide a number of advantages for investors and the economy. For individual investors, perhaps the most important benefit is affordability, especially for investors with small capital for whom stock selection analysis can be costly, financially and otherwise. Mutual funds offer a solution for such investors, as they are managed by a certified professional investment manager (Russell, 2007 p.30). Second, mutual funds allow investors to diversify their securities. By purchasing units of a given fund, investors are able to reduce their risk since the units represent diversified underlying assets whose amount usually far outnumber the number of securities that could be afforded by individual investors. The third advantage is the liquidity of the mutual fund, whereby investors can easily purchase and sell units (Obaidullah 2002, p.204).

The economy benefits from mutual funds in a number of ways. First, mutual funds improve the overall liquidity of the market, which means that the trade volume increases. Consequently, the economic well-being of the financial market can be realised. Through mutual funds, inexperienced investors are able to participate in the market, thus expanding the amount of capital available for investment and contributing

positively to the overall economy. Second, participation in mutual funds enables the accomplishment of long-term goals in the form of financial independence and stability, educational expenses, and retirement (Fortune 1998). For each objective, a specific mutual fund can be created. A pension fund, for instance, aims to provide its investors with stable growth throughout their working career to cover post-retirement expenses.

2.3.2 Mutual Fund Types

There are two main types of mutual funds, Conventional mutual funds (CMFs) and socially responsible funds (SRFs). Conventional mutual funds are a type of collective investment. Investors who share similar aims invest their funds into the pool. The manager then invests the pooled funds in certain asset classes, such as bonds, stocks, commodities, derivatives, and others (Cuthbertson et al. 2010).

On the other hand, in recent years, socially responsible funds have made important inroads in the financial market. The concept of ethics and ethical investments has long been a contentious topic in economics and finance. Investments that are done ethically and target sustainable development are the main focus of this concept. In general, SRFs aim to promote positive environmental, religious, social, and internal governance outcomes. Meanwhile, non-ethical companies are involved in business activities that promote vices, such as gambling and liquor. In a narrower definition, SRF rules out investing in questionable activities, morally or environmentally, such as animal testing and nuclear power development (Shefrin & Statman 2000).

Proponents of ethical investment argue that conducting business with ethical values offers numerous benefits for various stakeholders. Integrating ethics into business, economic, and financial decisions would broaden the benefits for not only the organisation, but also the public and the environment. Ethical companies would also

practice higher transparency and stricter corporate governance demands. Subsequently, they promote social stability and improve the overall quality of life across society by ensuring that their products and services undergo ethical processes (Baker & Nofsinger 2012). Social stability, promoted through social and moral norms and principles, contributes to the furtherance of human civilisation (Kuran 2004).

The rise of human rights activism during the late 1960s and early 1970s lent to the creation of the current form of ethical investment. This activism included political rallies and campaigns protesting against the Vietnam War and South Africa's apartheid government. As altruism grows, and awareness of consumerism, animal rights, environmental protection, and human rights increases, the case for ethics is becoming stronger (Bauer et al. 2007). Islamic mutual funds are operationally similar, but their operations must conform to *Sharia* investment precepts.

Akin to conventional mutual funds (CMFs), Islamic mutual funds (IMFs) raise cash from investors, but they are invested in *Sharia*-compliant financial instruments. Investors become shareholders, owning a share of the fund. They receive an equity position on the fund's underlying securities. Islamic mutual funds enable investors to effectively invest in a diverse set of *Sharia*-compliant securities that are managed by professional managers in concordance with the guidelines of *Sharia*. The appointment of a *Sharia* committee by the managers offers an additional guarantee of the fund's Islamicity. *Sharia* guidelines include important instructions on Islamic investing, such as asset allocation and investment practices, and the enforcement of *zakat* as a method to purify wealth (Girard & Hassan, 2008). The Islamic financial system is governed by a set of laws and regulations that collectively form a legal framework commonly referred to as *Sharia* principles. This framework also guides Muslim societies in other aspects of life, including economic, political, social, and cultural. It is derived from the

laws mentioned in the Quran, *hadith* (authentic traditions of the prophet Muhammad PBUH), and Islamic jurisprudence (Z. Iqbal 1997; Sundararajan & Errico 2002).

More specifically, investment activities must comply with certain criteria put forward by Islamic law, such as the avoidance of interest and gambling. Investments should be made only in *halal* (permissible) securities and *zakat* should be allocated. Islamic mutual funds must involve short selling and harmful activities such as narcotics and prostitution. They must not also involve interest-based financial services and deposits (Alhabshi & Berhad 1995; Bhatti 2012). Following the fulfilment of these criteria, the funds must first be approved by the appointed *Sharia* committee before they can be launched. This process aims to accomplish the main goal of Islamic finance, which is to fulfil social and economic justice and create a financial environment free from interest and other exploitative elements (Khan & Bhatti 2008). Overall, it can be concluded that there is a large similarity between IMFs and SRFs, as both prohibit immoral investments like gambling and arms manufacturing. However, IMFs also prohibit activities that conflict with *Sharia* principles. CMFs, meanwhile, allow investments in harmful activities. Next section will focus more on IMFs.

2.3.3. Islamic Mutual Funds

Islamic fund management services are a rapidly growing sector of Islamic finance. Such services are necessary as Islam allows investing in equity and shares. However, Islamic and conventional finance theories differ in their definition of company share. As defined by the *Fiqh* Academy of the Organisation of Islamic Cooperation (OIC), the company share represents “an undivided portion of company assets.” Conversely, conventional finance defines the company share as a representation of the “residual claim to future cash flows (dividends and liquidation proceeds) of a company” (Elgari

2002). Therefore, from the perspective of Islamic finance, selling a company share is effectively selling “this undivided ownership shares of its assets” (Elgari 2002: 155).

The above definition fits the stance of Islamic finance, that all financial instruments must be backed by the issuing company’s tangible assets. Ironically though, the definition only seeks to justify investing in shares, since its actual implications, especially concerning shareholder rights and accounting treatment, are unclear. Indeed, on the balance sheet, ordinary shares of *sharia*-compliant companies are listed under liability and equity, while shareholders are considered as residual claimants. Hence, despite owning part of the company, their claim of the company’s assets is below that of creditors, bondholders, and preference shareholders.

The legality of trading ordinary shares allows for the establishment of Islamic funds. In its Accounting Standard 14, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), as quoted by Shah (2008: 15), states that “investment funds are permissible by *Sharia* because funds are a form of collective investment that continues throughout their term, the rights and duties of participants are defined and restricted by the common interest since they relate to third party rights. Hence, in cases where the fund is managed on the basis of agency, the shareholders or unit holders waive their right to management, redemption, or liquidation, except in accordance with the limitations and conditions set out in the statutes and bylaws.” An Islamic fund is, therefore, a specialised investment that only holds *Sharia*-compliant financial instruments, and its operations comply with *Sharia* principles. As such, it does not invest in *haram* (forbidden) and *gharar* (speculative) activities, nor does it transact with interest.

The unit holders of the Islamic fund are the *rabb al-mal* (capital owner), while the fund managers are either *mudharib* (entrepreneur) or agents of the unit holders. Islamic

fund, thus, is established on either one of two contracts. The first is *mudharabah* (profit sharing), in which the fund manager invests the capital provided by the holder in certain securities, and the former will earn a predetermined percentage of the profit. As his earnings are tied with performance, the manager's income will vary according to the performance of the fund. The second is *wakalah* (agency), in which the fund manager is given the power of agency to invest on behalf of the unit holder. Under such a contract, the manager's earnings are not tied to the fund's performance; rather, it is determined during the initiation of the contract, calculated based on the net asset value (NAV) of the fund (Usmani 2005; Ayub 2013). Other than the fact that Islamic funds must be operated within the guidelines of *Sharia*, they are similar to conventional funds. The following sections will discuss the characteristics of the Islamic fund that distinguish it from its conventional counterpart and highlight the various types of Islamic funds available in the market.

Islamic Mutual Funds: History and Current Trend

Being established three decades ago, the Islamic mutual fund industry is a continuously growing sector. The first fund was introduced in the early, a decade later, 29 Islamic funds were traded globally (Dah et al. 2015). As developed markets exhibited bullishness in the late 1990s, numerous Islamic funds were launched to benefit from the situation (Elfakhani et. al. 2005), the most common type being open-ended equity (medium to long-term growth) funds. Benchmarks for Islamic securities, such as the FTSE Global Islamic Index and Dow Jones Islamic Market Index (DJIM) were also launched. The FTSE Global Islamic Index comprises 1000 *Sharia*-compliant equities listed on the FTSE All-World Index, while DJIM comprises 2000 *Sharia*-compliant equities included on the Dow Jones World Index. Although the indices cover diverse

regions and sectors, the DJIM, relative to the FTSE Global Islamic Index, is more biased towards the US Market (Hayat 2006).

From 1996 to 2006, Islamic mutual funds exhibited significant growth. Driven by a substantial growth in the late 1990s, the number of available funds rose from 29 to 129. A similar upward trend was also recorded for the asset size of the Islamic mutual fund sector. Exceptional growth of as much as 50 percent was observed between 2004 and 2005. By 2005, the total asset size of the sector was USD16.8 billion, though the figure dropped by some margin in the following year. From mid-2000 onwards, the Islamic mutual fund industry grew along with the climb in energy prices in the Gulf States.

In recent years, the industry has seen an upsurge in the total amount of traded and held assets. The Global Islamic Finance Report (GIFR 2016) reported that the total value of global Islamic financial services reached USD2.293 trillion at the end of 2016, compared to USD2.143 trillion in 2015. Moreover, the size of the industry could potentially grow by at least 10 percent annually. The report forecast that, by 2020, the industry would grow to between USD3.151 trillion and USD4.57 trillion.

Islamic Mutual Fund Essentials and Screening Methods

As previously mentioned, Islamic and conventional mutual funds (CMFs) are principally similar in that both pool capital from investors. Numerous types of Islamic funds exist, but this thesis concentrates primarily on equity funds. Islamic funds must be operated in adherence with *Sharia* rulings, which are manifested in the market through the *Sharia* screening methodology. Though the details may vary by market, the main principle of *Sharia* screening entails that the fund be free from interest, uncertainty, and heavy speculation. It must not invest in *haram* activities, such as

gambling, alcohol, or pornography. To ensure that the fund continuously operates within the frames of *Sharia*, it must be monitored by an independent *Sharia* committee, which usually consists of, at minimum, three scholars (Iqbal & Molyneux 2005, p.158).

The *Sharia* committee closely observe Islamic mutual funds as they invest in the stock market. Capital market regulators, in distinguishing *Sharia* and non-*Sharia* compliant stocks, establish the screening process, which looks into the income source of the stock-issuing company. A stock is considered as non-compliant if forbidden activities account for more than 33 percent of its overall revenue (Forte & Miglietta 2007). For instance, the stock of a listed groceries company whose earning from tobacco exceeds 33 percent cannot be included in an Islamic fund. The debt-to-equity ratio is also included as a criterion for *Sharia* compliance, with the threshold being 33 percent (Iqbal & Molyneux 2005, p.158). Margin trading is not permissible for Islamic mutual funds (Elfakhani et al. 2005). Any income generated from its operations should be subjected to *zakat* (obligatory charity) of 2.5 percent (Al-Qaradawi 1995).

2.4 Fund Family Background

A fund family is a group of mutual funds operated by one single enterprise. In a fund family, the funds have different investment goals and/or strategies. Since the same organization manages the whole fund family, however, individual investors may usually switches money from one fund to another without any additional commission or charge. This allows investors to be flexible in their own investment goals at a given time, depending on their specific needs.

2.4.1 The Advantages of Investing in a Mutual Fund Family

There are many advantages for the investors want to keep their money invested within one mutual fund family:

1. A consolidated statement from the mutual fund family itself offering information of investment by investors in each of the individual funds. This ensures less paperwork and a clear overview of what investors own.
2. Many mutual fund companies offer a website where money can be switched between the individual funds which make up a fund family.
3. Some funds will enable shareholders to invest at lower minimum levels in other mutual funds within the mutual fund family. This ensures that shareholders have access to funds that they would otherwise not be able to use in return for giving the fund family a company.
4. Most mutual funds would allow money to be automatically withdrawn from a checking or savings account and divided between various mutual funds within a fund family at no charge.

In rare cases, they may invest in a "closed" mutual fund that does not allow new shareholders due to an established investment in a family of mutual funds.

2.4.2 The Reasons for Creating Mutual Fund Families

It may seem somewhat inefficient to create multiple mutual funds, but the idea of a mutual fund family is really sound. The advantage of this is that it allows the individual shareholder to decide for himself or herself the type of assets that are most appropriate for his or her portfolio. Large mutual fund families have dozens of funds in the mutual fund family covering nearly every possible asset class, asset allocation, and investment strategy you can imagine. Mutual fund families can offer a broad range of

products to investors including closed-end funds, open-end exchange-traded funds (ETFs) and open-end mutual funds. All of the funds offered by an investment company comprehensively constitute its fund family.

2.4.3 Star Fund and Star Fund Family Definition

This thesis investigates the fund level effect of star fund phenomena; therefore, defining the term 'star fund' is important. Previous research such as Nanda et al. (2004) and Joo & Park (2011) defined star funds as the top five percent of funds based on the performance measurements over the preceding twelve months. They also described a fund family (asset management company) with at least one star fund as a 'star fund family' (SFdummy) and a fund family with at least one poor fund as a 'poor fund family' (PFdummy); thus, as described by them, a fund family may be both a star fund family and a poor fund family at the same time.

In any event, the focus of this thesis is on star fund families instead of star funds themselves. The same top five percent rule are applied to define a star fund as in the previous literature (Nanad et al. 2004), and also uses the term 'poor fund' as the opposite concept to star fund; likewise, defines it as comprising the bottom five percent of funds. This thesis uses poor fund family to examine whether poor funds minimize the cash flow to a fund family just as investigate whether star funds raise the cash flow to a fund family.

2.5 Background of Sample Countries

The sample of this thesis encompasses four countries from the Middle East and South Asia – Malaysia, Saudi Arabia, Indonesia, and Pakistan. These countries hold about 65 percent of global Islamic equity mutual funds. According to the Islamic Fund

Management Report (2018), the Gulf Cooperation Council (GCC) region, which includes Saudi Arabia, continued to be the largest region in terms of the breakdown of Islamic finance assets by region, while, with expansion in the main markets, such as Malaysia, Indonesia, and Pakistan, Asia has the most increased market share. The same report listed Malaysia and Pakistan in the category of countries that have displayed rapid market growth and have achieved a strong competitive position in the Islamic fund management industry. The countries in this category aim to ensure that Islamic finance remains central to the evolution of their capital markets. Saudi Arabia and Malaysia are the two main domiciles for Islamic funds; the asset under management (AUM), as at the end of 2020, was 38.5 percent for Saudi Arabia, and 28 percent for Malaysia. This section presents the background of these four countries.

2.5.1 Malaysia

Malaysia is one of the South East Asian Islamic Nations. Malaysia is South East Asia's 4th largest economy. Malaysia has recorded an early history of establishing mutual funds since 1959 with its first fund management, namely, the Malayan Unit Trust Limited. Two main players dominated the industry through the 1960s and 1970s, ASM MARA Unit Trust Management and Asia Unit Trusts Berhad. When more state-sponsored mutual funds were created, the industry was boosted by a historic milestone when Permodalan Nasional Berhad (PNB) was introduced in 1979 and the first encouraging fund, Skim Amanah Saham Nasional (ASN), was launched in 1981.

The encouraging response continues to have the fastest growth in 1991 when Amanah Saham Bumiputera (ASB) made its first appearance, and explicitly planned investments for its Malay or Bumiputera citizens to encourage savings and facilitate their participation in the Malaysian capital market. Despite the financial crisis that

occurred twice between 1997 and 1998 and from 2007 to 2008, demand remains potent and attractive (Rubio et al. 2012). More interestingly, the industry was joined by several local banks by setting up their own supported funds and actively supporting the brand through broad marketing, advertisements, and distribution. This critical contribution to the stock market in Malaysia rose from 12.10 percent in 2004 to 22.39 percent in 2017.

Malaysia has a total USD171.39 billion AUM of mutual funds in Malaysia is below the market capitalization of the Malaysian stock market and the Malaysian GDP with reached USD398 billion and USD359.3 billion respectively by the end of 2018 (World Bank, 2018; Securities Commission Malaysia, 2018). The number of funds increases to 654 funds in 2018, compared to 611 funds in 2015. According to the Securities Commission (SC), there were 80 fund families in Malaysia as of 2018, compared to 55 fund families as of end-2017. Due to an increasingly strong belief and awareness that the majority of investors in Malaysia are Muslim, the mutual fund industry presented an alternative practice of investing according to the *Sharia* principles. The embroiled management of the conventional assets in the impermissible industry, especially the profitable financial sector that includes broadly interest-based transactions. Thus, the *Sharia* principles have resulted in distinguished Islamic mutual fund characteristics that have penetrated the industry since the launch in early 1993 of Tabung Ittikal, which is controlled by the Arab-Malaysian Unit Trust, followed by many other approved IMFs (Mansor & Bhatti 2011).

Currently, Malaysia contributes 28 percent USD28.6 billion of the global AUM and is ranked No. 2 based on a percentage of the overall USD105.5 billion global Islamic funds. Supported by the country's advanced Islamic financial market its Islamic fund management has been charting strong growth. Malaysia's Islamic Fund and Blueprint for Wealth Management was introduced by Malaysia's Securities

Commission in 2017. It charts the strategic path for the Islamic fund industry over the medium and long term as well as maps strategies and recommendations to improve the country's competitive edge. Moreover, it aims at reinforcement Malaysia's role as a global hub for Islamic funds, establishing Malaysia as a regional centre for sustainable and trustworthy investment compliant with *Sharia* law, and enhancing Malaysia as an international provider of Islamic wealth management services.

2.5.2 Saudi Arabia

Saudi Arabia one of the Middle East Islamic countries. Saudi Arabia is the Middle East's largest economy and grew by 2.21 percent in 2018 compared to the previous year. Saudi Arabia is home to the largest number of Gulf Cooperation Council (GCC) domiciled investment funds. The National Commercial Bank first familiarised itself with the idea of mutual funds in 1979 through its open-ended Al-Ahli Short Term Dollar Fund in the Saudi financial industry. The program was aimed at smaller investors, particularly small workers, and, therefore, experienced rapid success due to lower service charges, easy entry, and development. Saudi Arabia's mutual fund market has given its people a massive increase in business growth and financial advantage.

Saudi Arabia is characterized as highly family-oriented occupying businesses that have deeply ingrained ancient tribal solidarity system with nomadic merchant lifestyle that embracing complex interconnections compared to what exists in the West. Saudi family businesses have significantly contributed to the country's GDP and national employment, contributing around 33% of the country's GDP (Alhebrri & Al-Duais, 2020). Becerra et al. (2011) show that the millionaire families throughout the world own 39% of global wealth, and Saudi Arabia is on top of the list of the highest concentrated country of ultrahigh-net-worth (UHNW) families whose earnings are over USD100

million. This gives an advantage to the owners of these investments by providing new financing opportunities.

The Kingdom has undergone major changes in the overall number of mutual fund programs, and hence the industry has developed as a stable financial investment choice. Saudi Arabia has a total USD120.2 billion AUM of mutual funds is below the market capitalization of the Saudi stock market and the Saudi GDP with reached USD496 billion and USD787.3 billion respectively by the end of 2018 (World Bank, 2018; Saudi Capital Market Authority, 2018). Data from the Capital Market Authority (CMA) showed, the number of mutual funds equal 607 funds compared with 270 funds in 2015. As of 2018, Saudi Arabia in the Middle East had 41 fund families, compared to 33 fund families with USD98 billion as of the end-2015 (www.Tadawul.com.sa). More than 65% of the mutual fund schemes in Saudi Arabia are *Sharia*-compliant (395 of 607 funds). The growth of mutual funds in Saudi Arabia was impressive over a short time span. The target was initially on customers of private banks, but later all Saudi banks began paying attention to other markets, including middle income and top-tier expatriates. The influential Islamic institutions have also begun to extend their coverage across financial instruments to serve the state's citizens with a more sophisticated and ethical approach to investment programmes. Besides financial deposits and basic savings and current accounts, Islamic institutions have implemented numerous investment programs aimed at controlling the savings of citizens relevant to *Sharia* law.

2.5.3 Indonesia

Indonesia is one of the South Asian Islamic Nations. Indonesia is seen as a future economic giant. It is the largest economy in Southeast Asia and the world's seventh by purchasing power parity. Since 1998, the country has not experienced negative GDP

growth, and, over the past few years, economic growth has stabilised around the solid 5 percent range, and marginally to 5.1 percent in 2020 and is expected to rise to 5.2 percent in 2021 (International Monetary Fund).

Rapid economic growth, low public debt, and a young population provide the ideal ingredients for a booming mutual fund industry for Indonesia. In Indonesia, the number of mutual funds is on the rise, although the amount of assets that they hold has shown a less clear pattern in recent years. As of 27 June 2014, the aggregate net asset value (NAV) of the mutual funds increased to USD1.4 billion, up from USD1.3 trillion at the end of 2013, but down from the point of 2012; data from the Financial Services Authority (OJK). Indonesia's mutual fund industry remains small relative to other countries and vis-à-vis the domestic banking sector, which, in December 2013, accounted for approximately 80 percent of total financial system assets (Financial Stability Board). Indeed, the entire financial sector was comparatively small in 2013, with assets equivalent to 72 percent of GDP, which leaves enough space for growth. Indonesia's assets from the mutual fund industry rose at a considerably slower rate in 2018 in light of worries about the US-China trade war.

Indonesia has a total USD36.6 billion AUM of mutual funds is below the market capitalization of the Indonesia stock market and the Indonesian GDP with reached USD486 billion and USD1,024.6 billion respectively by the end of 2019 (World Bank, 2018; Bank Indonesia, 2018). In addition, the number of mutual funds increases to 651 in 2018 compared with 608 in 2015 (Indonesia Financial Services Authority). Indonesia has 86 fund families according to the Asset Management Industry in Rating Perspective (2018), compared to 77 fund families containing USD32.5 as of end-2017. At the end of August 2018, 7.9 percent of the mutual fund industry comprised Islamic mutual funds, up from 7.1 percent in December 2017. The 210 Islamic mutual funds – 28 of

which were launched in 2018 – reflect a net asset value of USD2.9 billion, 4.08 percent of the overall market.

2.5.4 Pakistan

Pakistan is one of the South Asian Islamic Nations. In implementing mutual funds, Pakistan was at the forefront of developing countries. The first open-end mutual fund was launched in 1962, and, after 1966, closed-end mutual funds. All have been State-owned. The rules were adopted in 1971 to allow private sector companies to launch closed-end mutual funds. In 1983 the first closed-end private sector fund was launched. The Pakistan Mutual Funds Association (MUFAP) was founded in 1996. In the same period, as a result of successful government policies and incentives, the performance scale of the stock market also saw new heights, recording a rise of more than fifteen times in the net assets of the mutual funds between 2003 and 2008. The 2008 financial crisis curbed the growth trend as the economy and capital markets deteriorated sharply and the mutual funds deteriorated afterwards. After 2008, the industry was steadily and slowly trying to recover and regain its momentum of growth. However, a lack of understanding of the complexities and significance of the economy's mutual fund industry has resulted in the government's tax policies that have seriously affected the industry's growth (Muhammad & Nadeem, 2007).

A poorly designed tax system, where the rules and their application are not transparent, overly complex, or unpredictable, may discourage investment adding to project costs and uncertainty. Systems that leave excessive administrative discretion in the hands of tax officials tend to invite corruption and undermine good governance objectives fundamental to securing an attractive investment environment (Gasior, K. 2013). The steps taken over the past few years have been harmful to the sector of mutual

funds. It was quite unfortunate that multiple taxation irregularities and issues plagued the mutual fund industry, which expanded each year rather than finding any resolution. It is also disappointing that the cases filed in the Honourable Courts have now been pending with no result for years. Such issues contribute to the administration costs, which reduce the investor's return. The government has been hampering the same through taxes and other anomalies rather than promoting savings and investments in the country (Naveed et al. 2020). Given these challenging circumstances, the industry has been persistent in its survival and attempting to put in new creative products that meet the requirements of the investors. Nonetheless, the truth remains that if it had not faced the tax problems it has over the years, the mutual fund industry would have been a lot bigger.

Pakistan has a total USD4.2 billion AUM of mutual funds is below the market capitalization of the Pakistan stock market and the Pakistan GDP with reached USD71 billion and USD315.3 billion respectively by the end of 2018 (World Bank, 2018; Pakistan Stock Exchange Limited, 2018). In addition, the number of funds increases to 255 funds in 2018, compared with 221 in 2015. According to the Securities and Exchange Commission of Pakistan report (SECP 2018), Pakistan has 30 fund families, compared to 22 fund families containing USD2.59 billion as of end-2015.

Islamic mutual funds began in 1995 with the launch on 13 July 1995 of the first Islamic mutual fund Al Meezan Mutual Fund of Al Meezan Investment Management Limited. Islamic equity gross assets have risen from USD800 million in 1996 to USD3.6 billion in 2003 (Abderrezak 2008). According to him, in 1996, there were 29 Islamic equity funds, and, in March 2009, this number grew to 232 funds based on the list given by Failaka Advisors. In 2018, the AUM Islamic Fund Management of Pakistan contributes 2.3 percent or USD2.2 billion globally. Following table summarize the

important information for these four countries. For economic details of the four country from 2007 to 2018 see appendix 1.

Table 2.1: Summary of Information about Countries under Study (2018)

	Saudi	Malaysia	Indonesia	Pakistan
No. of fund family	41 Family	80 Family	86 Family	30 Family
Total mutual fund	607 Funds	654 Funds	651 Funds	255 Funds
Asset under management	120.2 billion	171.4 billion	36.6 billion	4.2 billion
No. of Islamic mutual fund	395 Funds	371 Funds	210 Funds	83 Funds
AUM of Islamic mutual fund	39.4 billion	28.6 billion	2.9 billion	2.4 billion
Stock market capitalization	496 billion	398 billion	486 billion	71 billion
Gross domestic product (GDP)	787.3 billion	359.3 billion	1,024.6 billion	315.3 billion
Stock. M. Cap (% of GDP)	63.1	110.1	46.7	22.5
AUM (% of GDP)	15.3	47.7	3.6	1.3
AUM (% of Stock. M. Cap)	24.2	43	7.5	5.9

Source: The World Bank and Stability Report (IFSI, 2020)

2.6 Overall Summary

This chapter provides an overview of the history, principles, and development of Islamic finance and IMFs. It also discusses the general background and advantages of mutual funds and IMFs. In addition, it discusses the background of fund families and star families.

The principles of Islamic finance include the prohibition of *riba*, *maysir*, *gharar*, and any dealing with forbidden activities and commodities, while enjoying profit and loss sharing and payment of *zakat*. These principles come from two main sources, which are the Holy Quran and *hadith*. If both sources are silent regarding some issues, Muslims will refer to *ijma'* and *qiyas*.

The chapter also discusses the differences between IMFs, CMFs, and SRFs. Although the three types are generally similar in terms of operations, IMFs and SRFs differ from CMFs as they prohibit immoral investments that may be harmful to people and society. IMFs also differ from CMFs and SRFs as they prohibit investments that do not comply with *Sharia* principles.

This chapter also provides background about the economic, mutual fund industry, and Islamic mutual fund industry of each country under study. The majority of the population of the four countries are Muslims, which reflects the focus of this thesis on the countries with most Islamic investment and most Islamic mutual funds. Saudi Arabia and Malaysia lead the Islamic finance and investment with the most IMFs of the thesis sample. The mutual fund industry in Pakistan has been affected by the government decisions, especially after the finance crisis in 2008.

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