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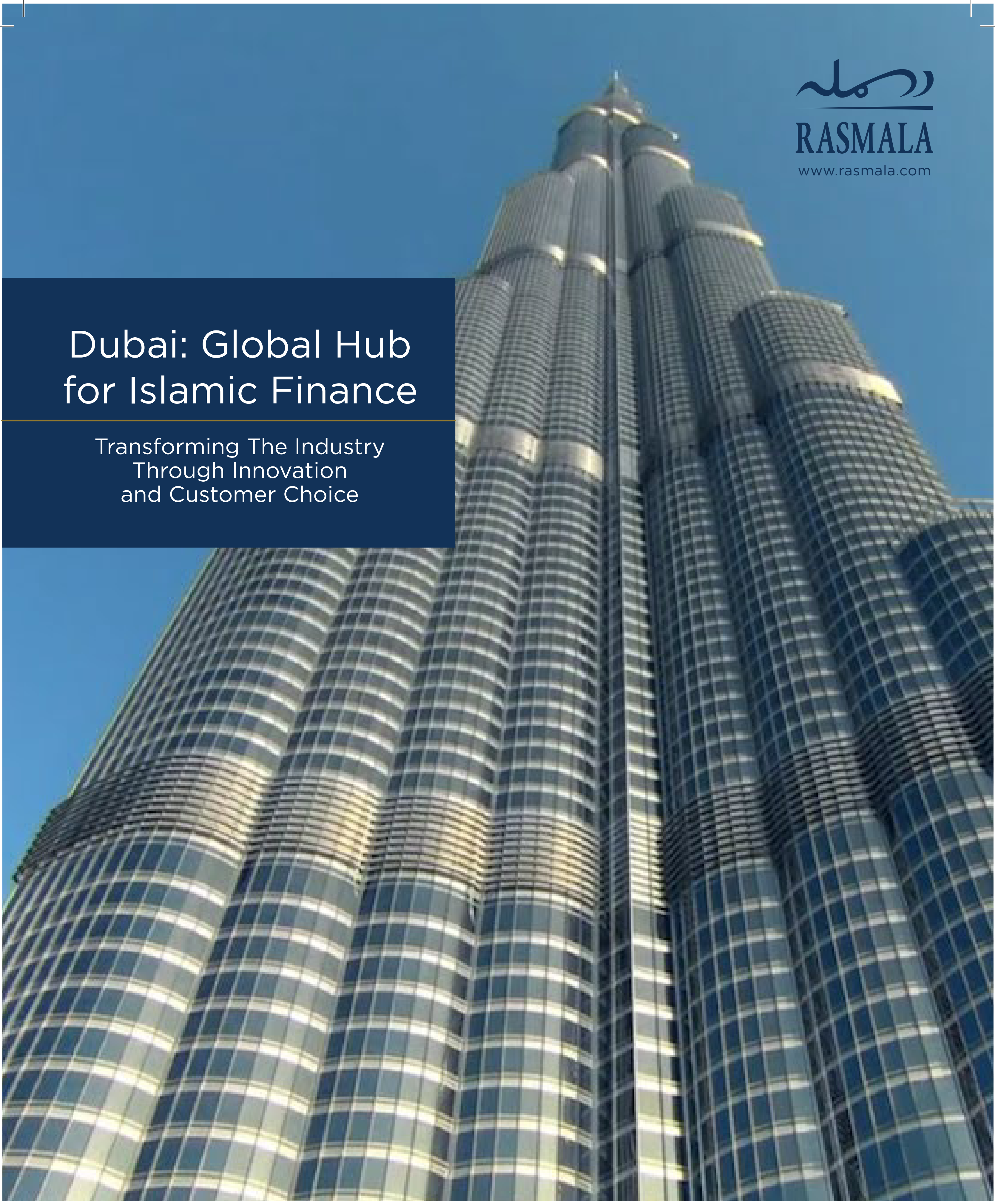

Dubai: Global Hub for Islamic Finance

Transforming The Industry Through Innovation and Customer Choice

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"When we launched our plan to become the world's capital of Islamic economy two years ago, some brothers had doubts. But today we have achieved the first goal even before the date we had set. We have a clear vision for our next achievement in 2020. Islamic finance is the most important sector of Islamic economy and sukuk are one of the most important tools of this sector. Today we are the world's biggest centers for sukuk, but our vision is even wider and more comprehensive as it takes in seven major sectors of Islamic economy"

His Highness Sheikh Mohammed Bin Rashid Al Maktoum

Introduction

Under the guidance and initiative of His Highness Sheikh Mohammed bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, the Dubai Islamic Economy Development Centre (DIEDC) is positioning Dubai as the global capital of the Islamic economy and is engaging with stakeholders to drive growth in the Islamic finance sector. Rasmala and Thomson Reuters have been at the forefront of developments in the Islamic finance industry and are actively working with DIEDC to implement a comprehensive strategy to help Dubai achieve success.

Core to this strategy is the advancement of the Islamic asset management industry which remains heavily under-penetrated and relatively unsophisticated compared to its conventional peers. Product innovation, diversification and customer choice are key considerations in improving the quality of Shari'a compliant funds. With the support of DIEDC and other government related entities with a mandate to invest public monies, a move to allocate a marginally higher proportion of funds to Shari'a compliant assets will have a multiplier effect on Dubai's Islamic asset management industry, potentially propelling it to the forefront of global Islamic asset management.

Greater diversity

Throughout the Islamic asset management industry, parochial and passive management has led to an overemphasis on local assets with limited choice for the end customer. This report looks at the opportunities presented by increased diversification in asset classes, including alternative assets (real estate, non-bank financing such as trade finance and leasing funds, and private equity) and fixed income funds (vanilla sukuk, covered sukuk, Shari'a compliant securitisation). In particular, it will examine potential reforms to the Islamic pension fund industry in the UAE.

More choice

To date, the UAE's retirees have had limited access to sophisticated and diverse pension products although generous state pension benefits do exist for nationals. Based on 8 years of historical data and 5 further years of projections, Rasmala and Thomson Reuters identify key areas of the industry to be addressed in order to deliver a high quality service with maximum choice (particularly in Shari'a compliant assets) to end customers. This report investigates how an increased demand for Shari'a compliant investment options in the UAE could catalyse reform in the Islamic asset management industry with Dubai at its centre.

Better performance

The rapidly-growing Gulf asset management industry currently loses 50% of investment offshore[1], due to an underdeveloped local industry. By innovating, diversifying and improving customer choice, the UAE will be better placed to capture this growth, support the local capital market and the entire economy.

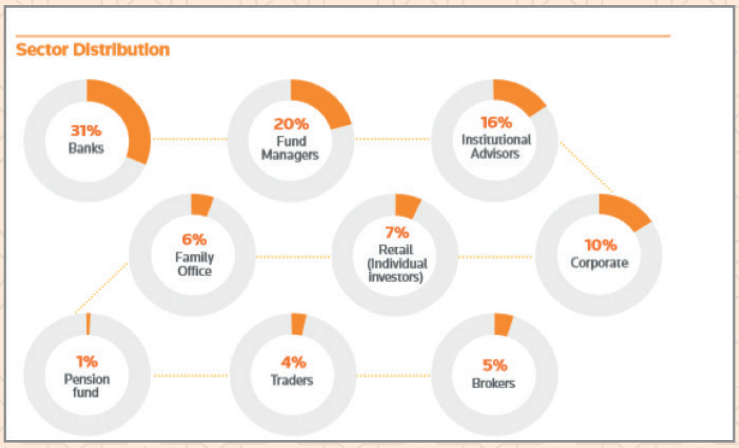
In tandem with the enormous growth in the Islamic finance industry, increasing investor demand for socially responsible investment (SRI), which emphasises ESG (environmental, social and governance) concerns, is becoming more prevalent and is supported by European Union initiatives on corporate social responsibility. One recent study found stocks of sustainable companies to outperform their less sustainable counterparts by 4.8% annually[2], and for a lower risk profile. Industry consensus is that there is significant overlap between ESG and Shari'a-compliant investments, and therefore ESG mutual and pension fund options add further choice, especially for the UAE's expat market.

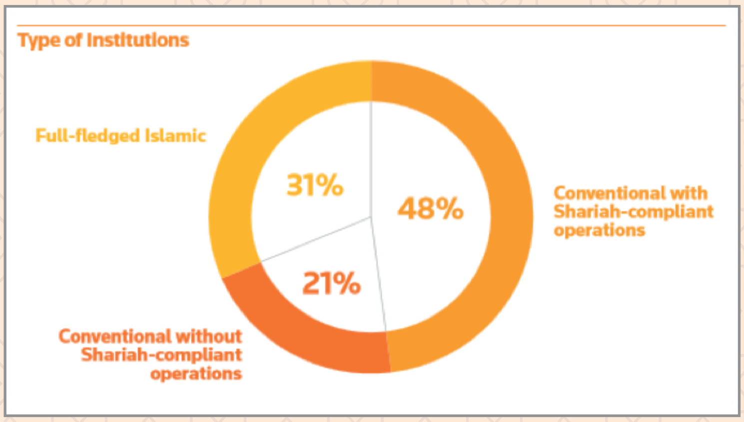
The Islamic Asset Management Industry

The State of Play

Islamic funds under management currently total US$60.65 billion[3] and are forecast to grow to at least US$77 billion by 2019[4], with Saudi Arabia and Malaysia comprising 69%[5] of the current total. However research suggests that latent demand is as much as US$185 billion[6] within five years. Despite substantial growth opportunities, without fundamental reform the industry will not be able to live up to its fullest potential in the near- to mid-term in order to bridge the US$108 billion gap in supply and latent demand.

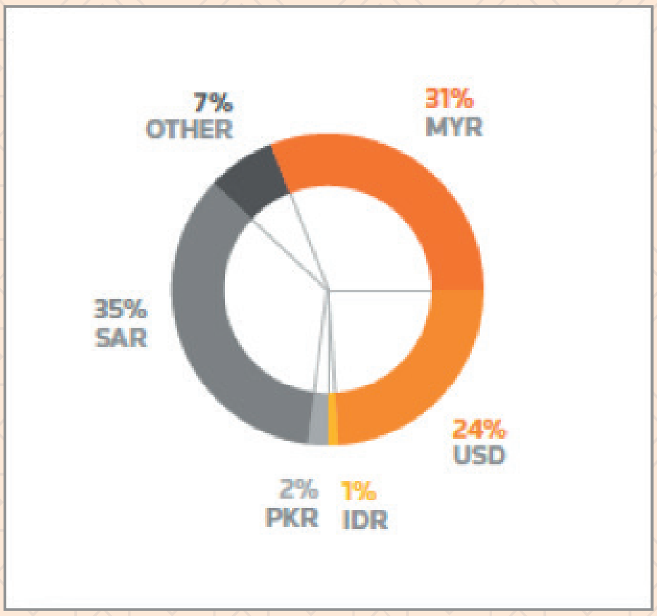
Whilst asset managers continue to target retail capital, institutional funds are pivotal to AUM growth. The current sector distribution and institutional distribution of Islamic funds globally breaks down as follows:





Other notable markets outside Saudi Arabia and Malaysia include Turkey, Pakistan and Indonesia. Pension reforms in Turkey have led to the rate of pension contributions to almost double in the year in which reforms were introduced[7], whilst in Pakistan the voluntary pension system grew pension assets over 500%[8] since 2008, and its performance has surged to 20.4% from 10.8% in 2013[9]. Indonesia is currently making revisions to Islamic pensions and pilgrimage funds that will boost its overall Islamic AUMs. Finally, China's 23 million[10] Muslims are viewed as a potential investor with currently little or no access to Islamic funds.

Islamic funds are held in 26 different currencies with UAE dirham denominated funds less than 1% of the global total[11]:



Structural Challenges

The Islamic fund industry lacks a middle ground: funds are generally either large or small. 12 funds are valued in excess of US$1 billion, comprising 43% of total fund AUMs outstanding, with an aggregate value of US$25.8 billion[12]. In stark contrast, funds valued at US$10 million or less represent approximately half of the total number of Islamic funds outstanding by the end of 2014, amounting to 1181[13].

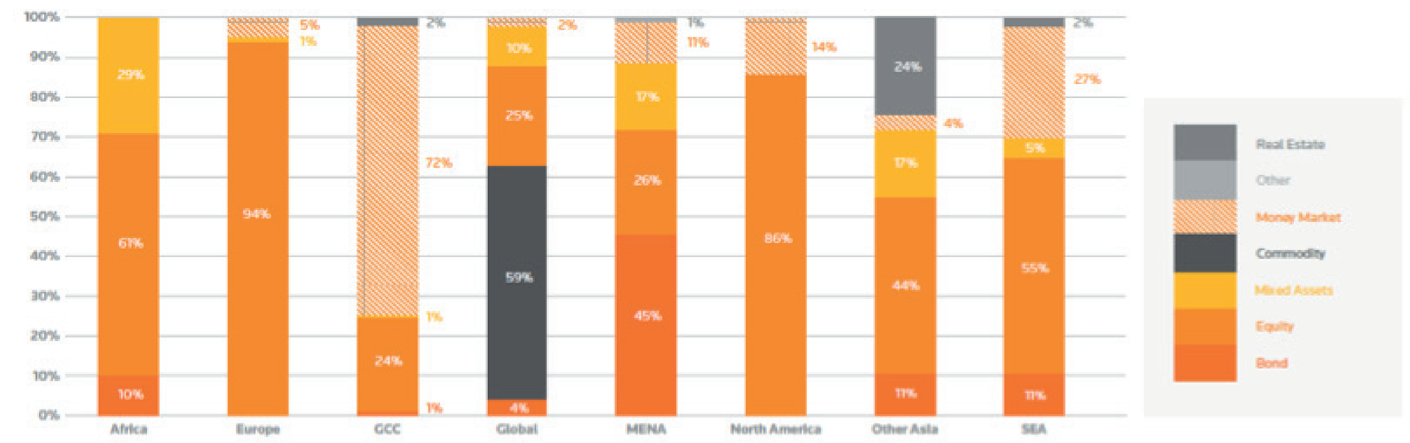
Outside of Saudi Arabia and Malaysia, the industry continues to work within a regulatory framework that is substantially less supportive than in the developed financial markets and where regulatory operating costs have increased. Much of the low levels of penetration can be attributed to a relative lack of sophistication compared to conventional funds, such as for example geographic restrictions on portfolio selection and a management style that is not proactive. The end customer therefore remains overexposed to local assets and has limited choice of asset class.

In addition, low levels of financial literacy amongst the target demographic at the retail level and poor marketing of existing Shari'a-compliant funds have contributed to a lack of penetration. Other challenges include domination of the Islamic mutual funds sector by a few large players and the requirement by the majority of institutional investors to specify minimum track records of 3 years[14]. Thus growing the retail market to achieve efficiencies of scale must go hand in hand with building a track record for the institutional market.

Industry Potential

Pension funds are often able to invest in asset classes individual investors would not normally be able to invest in – private equity, hedge funds, and increasingly Islamic investments. Developing a robust pension industry in the GCC, centred around Dubai as an asset management hub, would allow substantial growth in both the Islamic asset management industry as well as more specifically Islamic alternative assets. This is particularly relevant when discussing professionally managed pension sector assets as opposed to pension schemes that allow self-directed investment.

AUM of Global Islamic Funds Outstanding By Geographic Focus* and Asset Type (FYE 2014)



In the United States, pension funds are the largest constituent of the institutional investment community, controlling roughly $10 trillion or approximately 40% of all professionally managed assets[15]. In Australia, the pension industry is worth $2 trillion[16], roughly the size of the entire Islamic financte industry (including banking assets).

The parochial nature of Islamic asset management has stunted product innovation, diversification and customer choice. The quality of Shari'a compliant funds has stagnated and penetration levels are extremely low despite positive demographics. However, with the support of DIEDC and other government related entities with a mandate to invest public monies, a move to allocate a marginally higher proportion of funds to Shari'a compliant assets managed by high quality institutional asset managers will have a multiplier effect on Dubai's asset management industry, potentially propelling it to the forefront of global Islamic asset management.

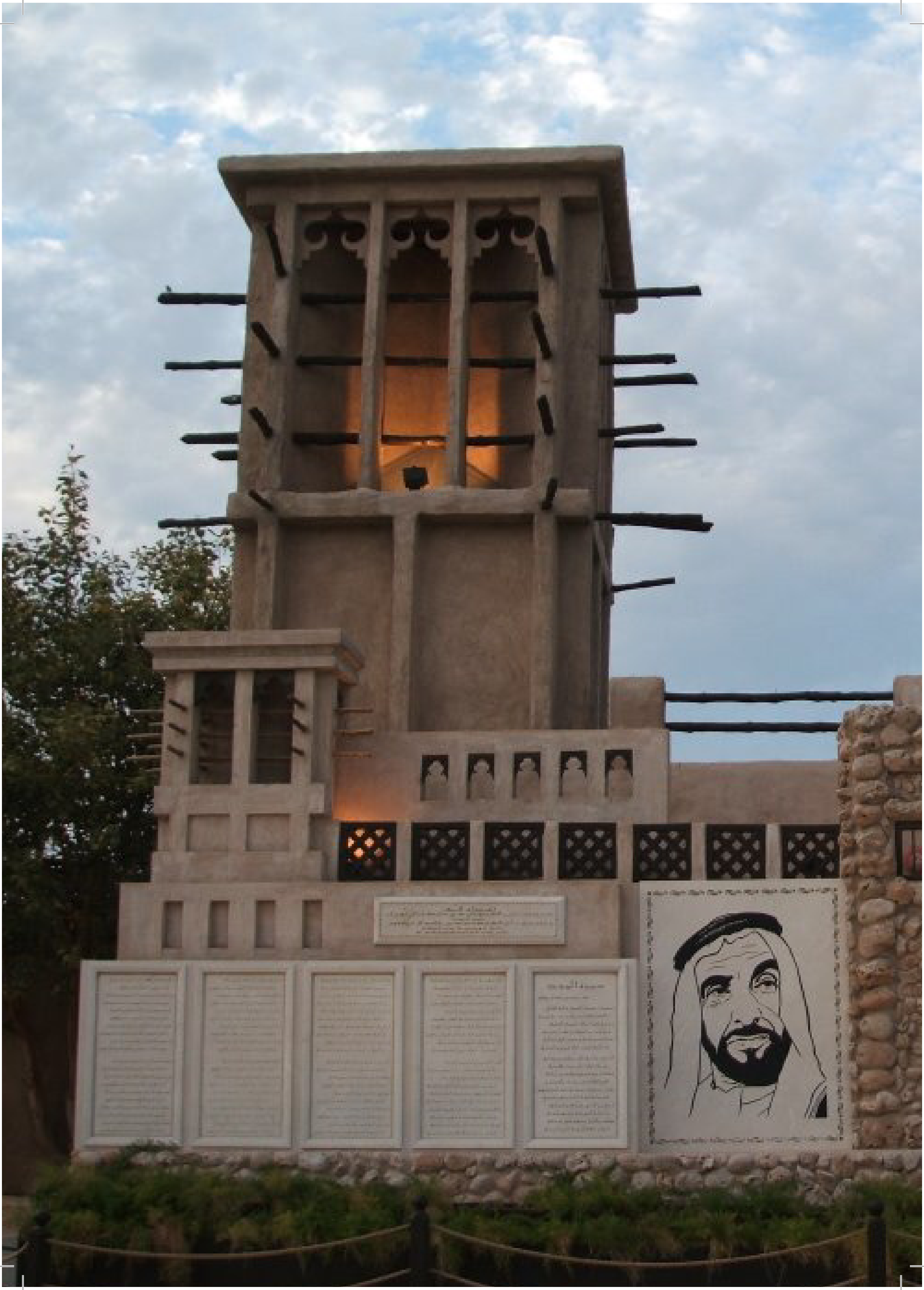
Performance data across a number of studies suggests applying socially responsible investment parameters – particularly those aligned with the United Nations-supported Principles for Responsible Investment – gives funds the framework for integrating ESG into financial analysis, the quality of which can help funds to outperform against conventional peers. Given the size of the ESG industry, which is many multiples the size of the Islamic finance industry, and the significant overlapping filters employed in the two investment industries, this data may also have relevance to the Islamic asset management industry.

Given the overlapping consensus between Islamic and ESG investing, Islamic fund managers are increasingly turning to ESG overlays to complement Shari'a compliant investment principles, thereby further reducing risk and improving performance. A recent study[17] found that 80% of past research identified a positive relationship between sustainability practices and investment performance. By way of illustration, Thomson Reuters compared the performance of three ESG strategies against their conventional benchmark, the MSCI All Country World Index, and found them to be outperformers[18].

There remains a perception amongst many investors that overlaying Shari'a compliance (or ESG) can become a drag on performance: the data suggests otherwise. Thus investor education remains a key driver in growing the Islamic asset management industry.

In addition, asset managers should seek to deepen the financial market in collaboration with governments. Investors look for cross-border passporting opportunities: there currently exist 179 UCITS funds with total AUMs of US$2.47bn representing only 4% of total global Islamic AUMs[19]. If Dubai is to compete for cross-border business it may wish to consider strategies for encouraging local asset managers to establish Islamic funds in UCITS markets and thus build scale beyond UAE investors and local market funds.

Finally, whilst asset managers continue to reach out to retail capital, institutional funds remain the key to Islamic AUM growth. Whilst 80% of Islamic funds are from retail investors, in contrast 70% of conventional funds' assets are from institutional investors[20]. Thus asset management firms with international quality standards and experience with institutional mandates are more likely to succeed in Islamic asset management.

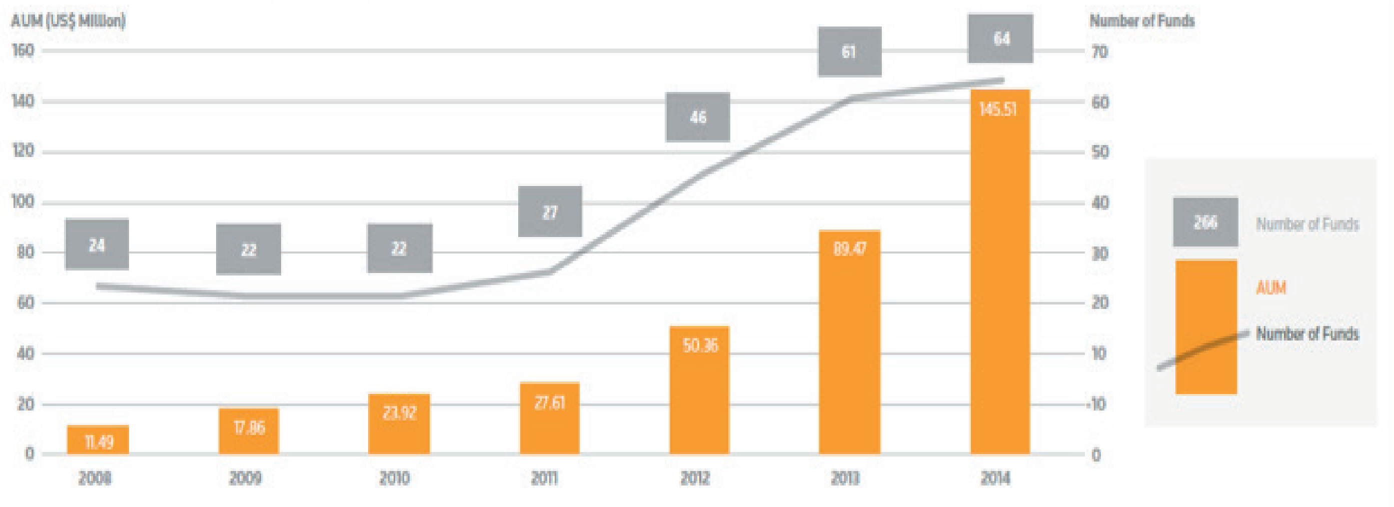


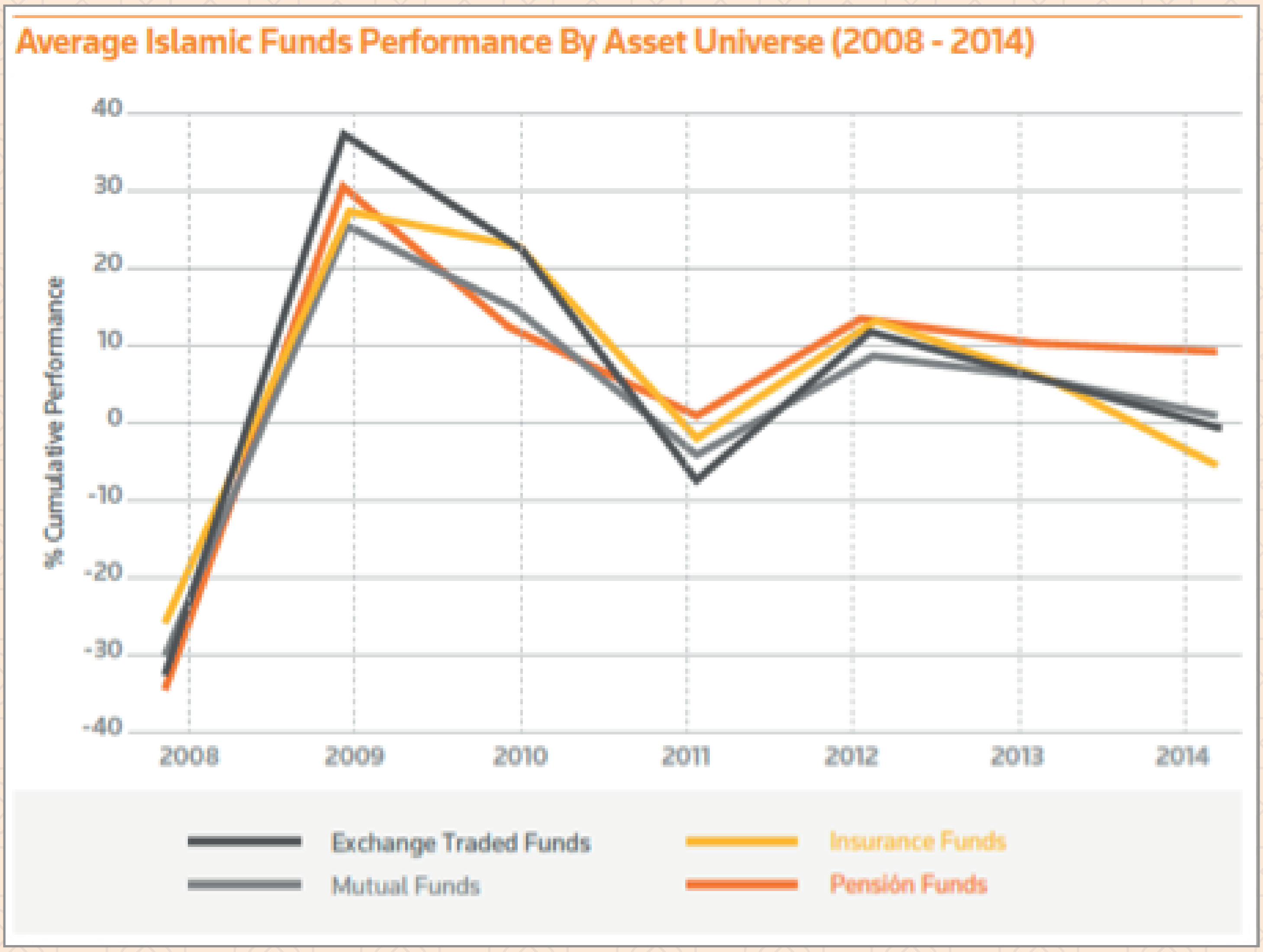
Driving Innovation and Growth through UAE Pension Funds

At total AUMs of US$60.65 billion, the Islamic funds industry represents 3.5% of global Islamic assets[21]. Pension funds contribute only US$145.51 million to this total across 64 funds[22]. Whilst being smaller in size than Islamic ETFs, Islamic mutual funds and takaful funds, Shari'a compliant pension funds have shown the most growth in AUMs averaging 65%[23] for the last 4 years. Similarly since 2008 pension funds have outperformed these other fund classes and recorded cumulative performance of 10% per annum from 2008 to 2014[24].

AUM of Global Islamic Funds Outstanding - Breakdown By Universe (2008 - 2014)

Global Islamic Pension Funds (2008 - 2014)





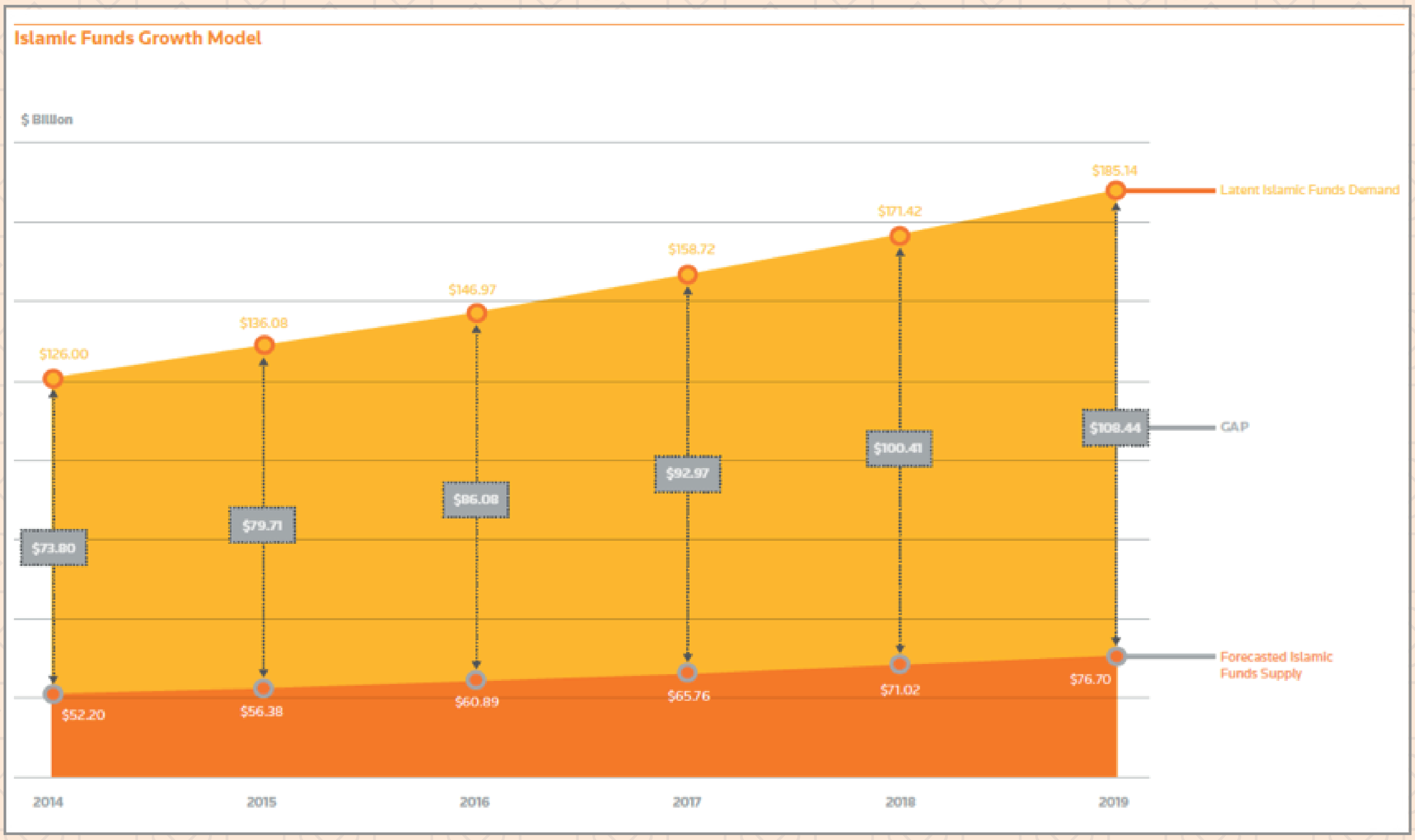
Institutional funds comprise 20% of total Islamic funds, whilst Islamic pension funds add a mere 0.25%. In contrast, 70% of the conventional funds industry is backed by institutional funds and pension funds contribute 27%[25].

Globally, pension funds have assets in excess of $27 trillion[26] with Islamic pension funds making up 0.001% of this figure, despite Muslims representing 23%[27] of the world's population. Such massive under-penetration leaves a clear opportunity to design and build infrastructure to scale up the Islamic funds market. Dubai has already achieved significant success in attracting global financial services providers through the Dubai International Financial Centre and has become a destination of choice for the financial community throughout the MENA region. With the relevant support through, for example, initiatives like the Dubai Islamic Economy Development Centre, it can further build on its financial credentials to attract investment for pension funds with greater diversity and innovation.

The Islamic pension fund industry has a long way to catch up globally. In Saudi Arabia, Malaysia, Indonesia and Bahrain, a small number of pension funds have diversified their investment portfolios to include Shari'a-compliant products, albeit with limited impact and penetration levels. In the UAE end customers have even less choice and access to asset diversification. Most GCC nationals lack the opportunity to choose whether their pension should be invested in a conventional or Shari'a compliant manner. Overwhelming evidence supports the view that the majority of GCC investors would choose Shari'a compliant financial products[28] given similar performance, cost and quality versus the conventional equivalent. Thus there is an opportunity at policy level to require managers of local pension pools to respect the wishes of beneficiaries, and for those managers to then ascertain the extent to which beneficiaries would wish to invest in accordance with their values, and offer them the appropriate choice.

The case for Islamic finance as an industry remains compelling. Global Islamic assets were estimated around $2 trillion[29] by the end of 2014 and are expected to sustain double digit growth for the next few years. This projected double digit growth does not take account of a potential step change in asset growth as a result of new Islamic funds. In 2014, US$2.27 billion of new funds were launched compared to US$1.52 billion new funds in 2013, representing a 49% growth[30]. These figures are relatively insignificant versus global Islamic finance assets let alone the global conventional fund industry. A UAE government backed pension fund offering innovative and diverse Shari'a-compliant products would force a step change in the Islamic finance industry which has not yet been factored into projections. Beyond merely reallocating existing assets of the UAE state pension schemes, this could mean a redesign of the state pension schemes to make them defined-contribution and/or pre-funded end-of-service benefits. In addition, a convergence with ESG principles could help to align with the ethical preferences of a significant number of large investors and attract attention globally, not just regionally. Raising the quality standards of Islamic funds by incorporating ESG principles aligns those Islamic funds with the expectations of a large and growing international institutional investor base, a market worth US$59 trillion in assets[31].

Recent data show that pension assets in the GCC are estimated at over US$180 billion, or 6% of GDP, which is significantly lower than the pension assets of developed markets, where they represent 100% of GDP. There is therefore significant room for additional pension allocations. A mere 20% shift from existing regional pension funds into Shari'a-compliant funds could mean adding US$36 billion to the Islamic asset management industry[32]. With Dubai's support as a regional centre for financial excellence, this would be a solution to the global Islamic finance industry's need for scale and diversification. The knock-on effect for the local and regional economy would encompass new jobs, wealth creation and infrastructure development.



Structural Challenges for the UAE

1. Lack of scale

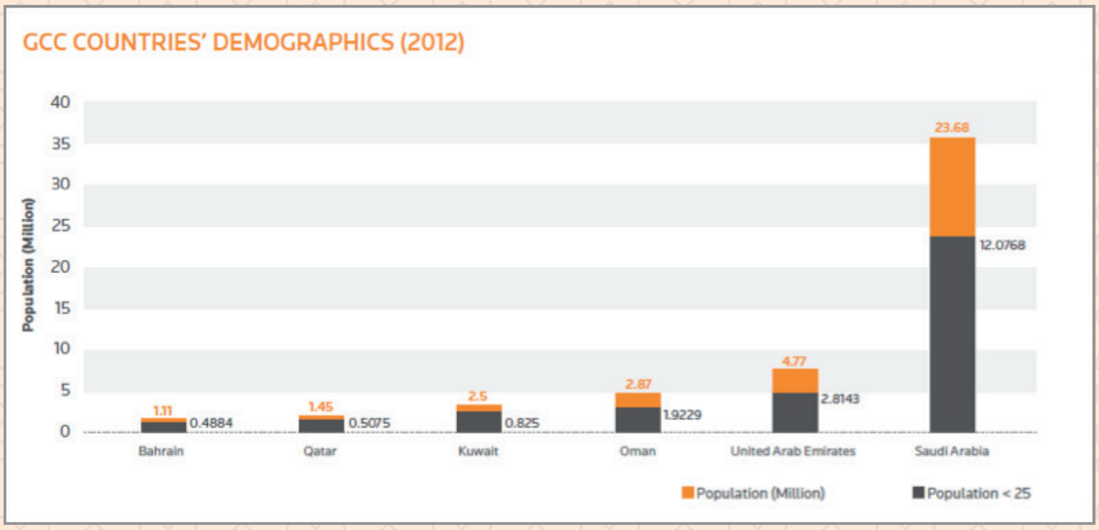
Building Islamic wealth requires a large boost in retirement savings. A lack of scale continues to apply pressure on the profitability of asset managers and therefore greater emphasis is required on attracting institutional investment to the UAE. In addition, scale is achieved not only through the creation of more pension funds, but also through the establishment of pension funds as key investors across asset classes, particularly fixed income instruments backed by infrastructure assets.

2. Lack of choice

UAE nationals currently have little or no say in whether their pension is invested Islamically or conventionally, contrary to known investor sentiments. Nationals also have little to no say in how and in which asset classes their pensions are invested.

3. The demographic crunch

The UAE population is relatively young with over half of the population under the age of 25. The workforce will grow at an accelerated pace over the next decade, piling pressure on pension payouts as workers eventually retire. Life expectancies are increasing rapidly around the Muslim world and healthcare will become a critical issue. State pensions have small amounts of savings and will cause a serious strain on GCC government funds in future. Based on data compiled by the United Nations, the old age dependency ratio for the UAE (number of people aged over 65 as a proportion of working age population (15-64)) will reach 28.8% in 2055 up from 1.3% in 2015[33]. As a result of these demographic pressures, pension funds must seek higher yields and lower volatility from their investments. In the UAE this means moving away from locally invested, concentrated funds, into professionally managed, geographically diversified and multi-asset funds. The alternative course of action to remedy these emerging funding shortfalls is either to raise contribution requirements or reduce the benefits.



4. The structural model

Pension schemes in the GCC are unsustainably funded due to inadequate contribution rates, meaning that nationals who are currently in retirement are paid for by current workforce contributions. With some of the highest payout ratios at 80%[34] (total pay-out to retirees versus total government income from payroll taxes), this will not be sustainable given the current and future demographics of the region as it will place a large strain on reserves and government funds. While the outcome will manifest itself in some years' time, it requires swift action today in order to avoid a future budgetary crunch.

5. Monotony (lack of innovation and diversification)

Although sovereign wealth funds and family offices hold significant assets in the Gulf, these assets have barely found their way to local asset managers, much less to those that follow Islamic investment principles. Many funds remain concentrated (for example in local real estate and regional stocks) and lack proactive management. Asset managers of larger funds continue to dominate the Shari'a-compliant space, and their cautious nature tends to direct them to replicating the simplest product structures and mandates. This monotonous institutional focus maintains a lack of diversification despite the market demanding greater sophistication and innovation in product development.

As a result, Islamic pension funds - generally managed by the larger players - continue to shy away from investing in alternative assets (international real estate, private equity), fixed income funds (diversified sukuk, trade finance, asset-backed leasing, securitisation) and other asset classes.

Islamic financial institutions remain small and concentrated in one or two geographies, making their portfolios riskier. They tend to avoid lowering their risk profile through geographic diversification. Takaful (Islamic insurance) products focusing on retirement and pensions are still largely non-existent and many expats in the UAE work to send some of their money back home or invest in their home markets. Estimates of monies repatriated could be as high as 40% of income[35], and much of this may be attributed to lack of suitable investment choices with asset managers in the host country.

6. Barriers to growth

Investment restrictions by local funds and awqaf (endowments) restrict the growth of pension assets by directing investment into local equities, local real estate and some limited fixed income products. Not only does this introduce cyclical volatilities exaggerated by local sentiment and investment environment, it also has the potential to constrain returns and may result in a budgetary deficit, further aggravated by demographic trends.

There also remains a perception amongst conventional fund managers that Shari'a compliance implies a heavy cost burden on a fund. The reality is that costs of ensuring Shari'a compliance from the outset of a new fund, and monitoring on an ongoing basis, are trivial or marginally incremental. For the larger funds, these incremental costs are recovered in economies of scale. Indeed most of this perception challenge can be mitigated by a process of education.

Reforming the UAE pension fund industry

The establishment of a pension scheme for expatriates and reforming the end-of-service gratuity model in the UAE has been the subject of much discussion within the country. Such an initiative would encourage funds to remain domiciled within the UAE financial system. Bahrain has taken the initiative to improve returns on its pension assets by establishing a company (Osool) for the purpose of managing Bahraini pension assets. However within the UAE, no timeline nor concrete steps have been announced to reform the pension and end of service model.

To date, governments in the Islamic world have generally held back from encouraging pension funds and takaful operators to play a role as key investors in large scale infrastructure, as is the case in developed conventional financial markets. Such large scale, long term assets can help pension and takaful funds to match their liabilities and achieve profitability similar to the conventional funds industry. A UAE initiative to incentivise pension and insurance investment in infrastructure would strongly enhance the country's credentials as a global capital of Islamic asset management. Such an initiative would be best placed through the DIFC as the region's most dynamic financial centre with access to investment banks of international quality who have the capability of lead arranging project sukuk for infrastructure development.

As an example of how government incentivisation can reform the pension fund sector, in Turkey the rate of pension contributions almost doubled in the year following the introduction of pension reforms[36], while the voluntary pension system in Pakistan grew pension assets over 500%[37] since 2008. Privately funded Islamic pension systems are now active in Pakistan, Turkey and Malaysia, and Islamic pension products are now available in the UK and Australia despite relatively low Muslim populations. Early adopters of Islamic pension reforms have required time to establish themselves. The pension markets in Pakistan, Turkey and Malaysia may reach maturity in a few more years. Pakistan introduced its Voluntary Pension Scheme (VPS) in 2005, Turkey's reforms to its private pensions date from 2013, and Malaysia's Islamic Private Retirement Scheme (PRS) has only just been established (31 January 2015) following its earlier establishment of conventional PRS in 2012.

Malaysia tops the Islamic pension fund sector with 33 funds (US$59.34 million AUMs), most of them launched in 2012 and 2013, followed by Pakistan with 21 funds (US$51.19 million). The UK has 10 funds (US$31.44 million)[38].

Later adopters, including potentially the UAE, are likely to achieve tangible results much sooner especially if reforms to the model are introduced in conjunction with other product initiatives (such as incentivising takaful operators to invest in infrastructure, or pledging to shift a proportion of existing state managed funds to Shari'a compliance).

The following sub-sections summarise the reforms applied to pensions in Turkey, Pakistan, Malaysia and Australia with data supplied by Thomson Reuters.

Turkey

• Turkey leads the way on pension reforms in Islamic countries, encouraging pension contributions with a 25% state contribution.

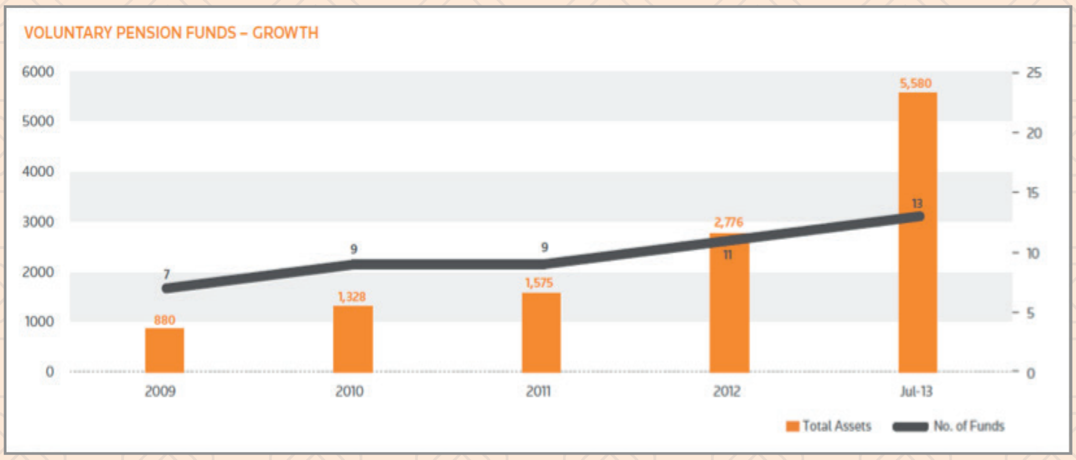
• The reform went into effect on January 1, 2013.

• The new law encourages contributions by granting a 10% tax deduction of gross income. For 2012 pension policy sales increased 27%. After introducing the new reform, the rate of pension contributions doubled versus the year prior to reforms.

Pakistan

• The voluntary pension system in Pakistan grew pension assets over 500% since 2008.

POSITION AS OF JULY 2013	
Total assets of pension fund industry	Rs.5,580 million
Net assets	Rs.5,355 million
Total number of pension funds	13
Shariah-compliant pension funds	7
Conventional pension funds	6
Number of pension fund managers	7



• Shari'a-compliant pension funds now account for over 60% of total pension fund assets.

• Growth since 2010 is a result of positive changes in the tax regime, favourable market conditions, launch of new pension funds, and an increase in the number of investors.

• As of July 2013, Shari'a-compliant pension funds represent Rs.3,404 million AUMs (US$32.5 million) versus conventional pension funds worth Rs.2,176 million AUMs (US$20.8 million).

• After the introduction of the Voluntary Pension Scheme in 2005, Shari'a-compliant funds have outgrown conventional pension funds and now account for over 60% of total pension fund assets.

• Regulatory and fiscal policies have accelerated pension growth. The Securities and Exchange Commission of Pakistan states that government patronage has popularised the culture of long-term savings through pension funds, increasing savings rates and providing social security to senior citizens.

Malaysia

• Two pension schemes are offered:

1. Defined benefit plan (for civil servants) – the government promises a specified monthly benefit upon retirement with no contribution from the employee.

2. Defined contribution plan – a proportion of salary is set aside each year by an employee and a company for the benefit of its employee.

• Malaysia implemented a Shari'a compliant version of the Private Retirement Scheme (PRS) building on the models adopted by countries like Pakistan and Turkey, thereby allowing customers the choice of purchasing a variety of products from private asset managers, and enabling access to private sector Shari'a compliant offerings. Demand has increased as a result of a growing middle class, increasing product sophistication, a shift to ethical values in investments in the wake of the global financial crisis and greater general awareness in wealth management and retirement planning.

Australia

• The compulsory pension system is driving growth in Australian Islamic wealth managers who are targeting a potential market of US$20 billion.

• The pension system was created in 1992 to boost national savings and combat the effects of an ageing population.

• Employers are legally mandated to contribute 9.5% of employee salary into a retirement fund chosen by the employee.

• The Australian pension industry is the 4th largest in the world and the same size as the entire Islamic finance industry (including Islamic banking assets) – approximately $2 trillion.

• Pensions add more than 2% to Australia's annual GDP from fee revenue alone.

• Global pension funds are targeting US$656 billion in high quality returns from Australian commercial property assets and infrastructure. vGlobal liquidity from sovereign and institutional investors is therefore deployed in developing Australian office, retail, industrial and social infrastructure assets.

Selecting a model system

The UAE has not yet formalised the adoption of what is known as the "three pillar system" - state pension, occupational pension and private pension. With an appropriate framework in place, both nationals and non-nationals may have access to one of these three models. Briefly they are summarised as follows:

1. State pension: publicly managed, provided by the state, secures a minimum standard of living, financed by payroll tax.

2. Occupational pension: privately managed, maintains a standard of living, financed by employee and company contributions.

3. Private pension: privately managed, contributes to incremental standard of living, financed by personal savings.

In addition to the selection of a particular model, asset managers can look to provide Islamic pension funds either through an Islamic "window" or on the basis of a 100% Shari'a compliant model. These may be summarised as follows:

• Islamic window: Asset managers can carve out and segregate an allocation from existing funds which may be redesignated as Shari'a compliant through a parallel selection strategy, but which uses recognised industry filters to ensure compliance. Shari'a governance must be formalised through the appointment of a Shari'a board and changes to the regulatory framework may be required. Fund providers would need to ensure infrastructure and service provision - from the collection of policy contributions through to the payout of dividends – is properly segregated from conventional operations and regularly monitored for Shari'a compliance.

• Fully Islamic model: Given GCC investors' strong preference for Islamic product where cost, quality and performance is at least equivalent to conventional alternatives, the fully Islamic model has been particularly successful for the banking industry. Asset managers whose entire operations and products are fully Shari'a-compliant are therefore similarly likely to thrive but have yet to establish themselves as a credible rival to conventional fund managers. For the Islamic fund industry to be a success in Dubai, fund managers and investors alike will seek government incentives and initiatives. For example, the establishment of a stand-alone, state-backed pension fund focused entirely on Shari'a-compliant investments could channel significant capital into UAE assets, and stimulate its Islamic finance sector. A model fully Islamic pension fund sector that builds on initiatives in other jurisdictions would burnish Dubai's credentials as a global capital of the Islamic economy, and would be a potential solution to the need for scale within the Islamic finance industry.

In order to explore a workable model more specifically, it may be constructive to consider the pension landscape in terms of two distinct components: UAE (and GCC) nationals (who are recipients of state pensions) and non-GCC nationals (end-of-service lump sums).

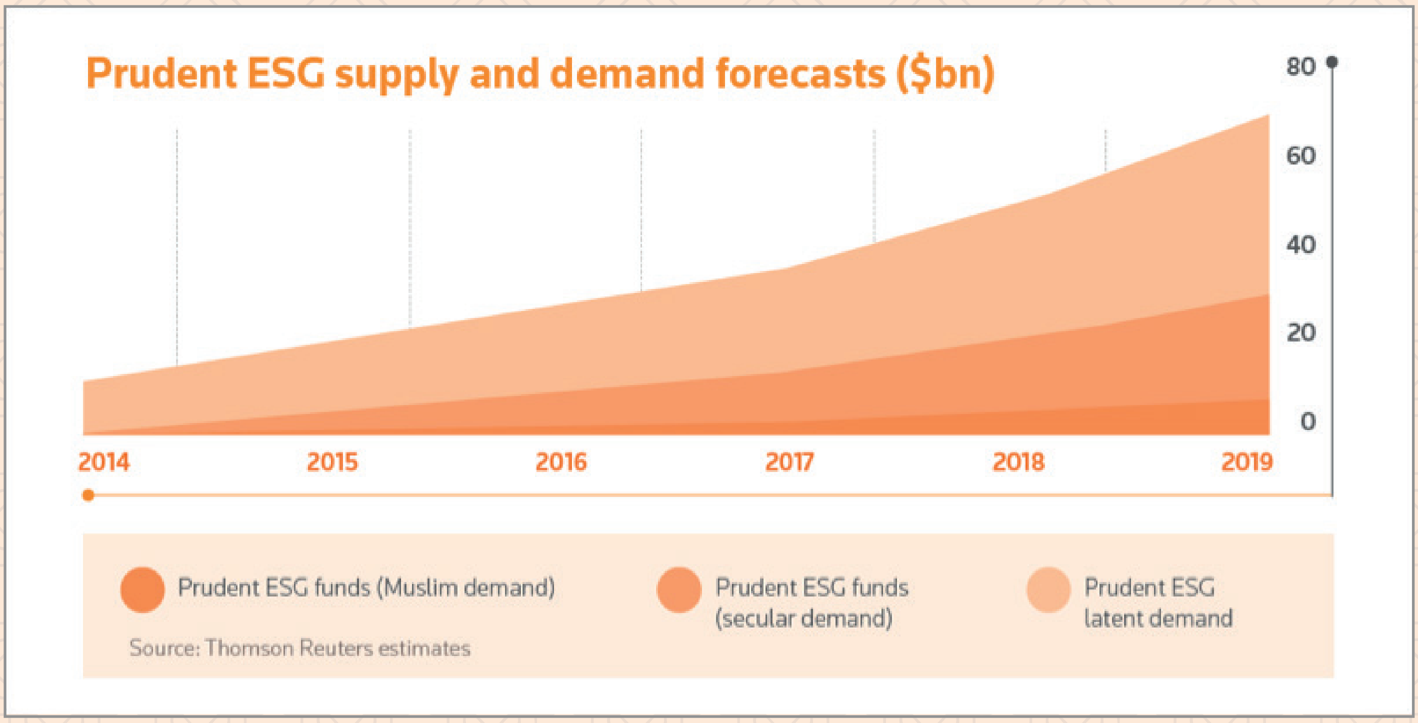
For UAE/GCC nationals, we may consider either redirecting existing investments towards Shari'a-compliant vehicles or offering a range of pension/investment options which implies a move away from a defined-benefit to a defined-contribution structure. This type of reform would help combat the emerging funding shortfalls but has been resisted so far on the grounds of not offering adequate protection to the individual participant. A more workable middle ground that may emerge over time is a twin-benefit system: a trimmed-down version of the current (and generous) defined-benefit system along with supplementary defined-contribution "top-up" pension. These top-up contributions could introduce choice to the individual.

For non-GCC nationals, there is currently no requirement for end-of-service benefits to be funded in advance. Instead most companies pay these to employees leaving the firm on a pay-as-you-go basis. The pool of assets supporting these benefits is therefore very low since companies deem a prefunded pool of end-of-service payments to be an inefficient use of capital. The risk of default on these large obligations is consequently significant and has led to much discussion in the industry regarding the need to obligate employers by law to pre-fund. The scale of the obligations has been estimated to be approximately AED3.4 billion (US$0.93 billion) for companies in the FTSE UAE Dubai Nasdaq 20 index[39], and therefore across the whole UAE employer base would be expected to be several times this. The introduction of a form of expat pension benefit would help to alleviate this significant risk.

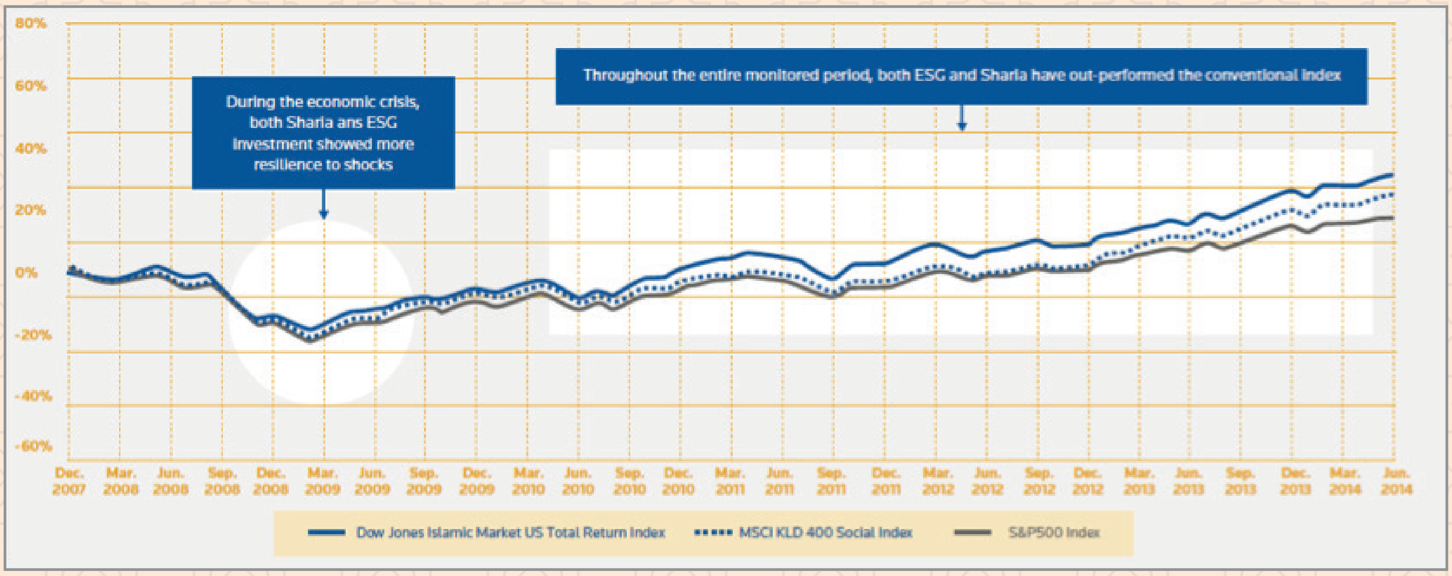
Giving Customers More Choice: Islamic vs. ESG

Ethical governance mechanisms employed in the Islamic finance industry have strong overlapping consensus with mechanisms in the responsible investing industry. A key element of the responsible investing industry are institutions and asset owners that integrate non-financial (environmental, social and governance or ESG) factors into their financial analysis. Given that ESG investments represent over US$59 trillion[40] versus the Islamic finance industry's US$2 trillion, we believe aligning Islamic finance with ESG has the potential to accelerate growth in the Islamic finance industry.

A study by Thomson Reuters suggests that an intersection between ESG and Islamic investing (referred to by Thomson Reuters as "Prudent ESG") could account for US$23 billion additional demand by 2019 for the 12 largest OIC markets[41]. Despite strong demand demographics, the Islamic fund industry has been unable to reach its full potential due to the quality and sophistication of products and limited policy support. However Dubai's position as the leading regional financial centre and its stated intention to become the global capital of the Islamic economy has the potential to provide appropriate policy support for the development of the Islamic fund sector, as well as further promote Islamic finance by overlaying ESG principles.



The combination of Shari'a and ESG screens has the potential to reduce risk profiles of portfolios, enhance performance, and attract ethical investors. The following graph illustrates that each alone (ESG and Shari'a investment strategies) need not be a drag on performance as is commonly assumed by conventional investors, but can outperform a conventional benchmark. Each addresses a different component of risk and in combination these factors can be complementary.



Policy support in Dubai and the UAE

The Socially Responsible Investments (SRI) industry, worth over US$21.4 trillion[42], offers a natural crossover appeal to Shari'a sensitive investors. Just as we advocate for Islamic pension funds, the UAE can capture global interest by transferring a portion of state owned pension mandates to support ESG-Islamic pension funds. A robust and institutionalised pension industry is a key indicator of a mature financial services industry and this report has drawn upon several country-specific case studies. As has been stated, there is significant room for the growth of pension assets in the GCC, and attracting 20% of existing assets could channel US$36 billion[43] to the Islamic asset management sector – over half of the total current assets under management.

Support at Dubai governmental levels for an ESG-Islamic investment industry by pioneering regulatory standards could become a competitive advantage for Dubai versus not just other emerging and frontier markets, but developed markets as well. Building a common regulatory requirement for companies, private and public, to report on sustainability/ESG issues with an emphasis on materiality of reported data would allow ESG investors to find hidden value in long-term focused companies. Investors would benefit from assessing management of prior ESG risks and allow for a more activist role, thus promoting a shift towards a sustainable economy in the UAE.

Leveraging the ESG industry

The ESG industry has greater depth and breadth than the Islamic finance industry and therefore has immediate access to investors seeking sophistication and diversification. Islamic funds have the opportunity to leverage off this existing institutional framework. Shari'a compliant product diversification off the back of the ESG industry gives clients greater opportunity to invest across asset classes such as real estate, private equity, listed equities, commodities and fixed income assets, spanning sectors and management styles globally. This will allow local UAE asset managers to change the perception of Islamic funds from simply being a tool for portfolio diversification to becoming a primary investment asset class, propelling them to the forefront of global Islamic asset management. This increase in the variety of products and services available is likely also to attract the expat community who tend to seek non-local asset managers with a global outlook.

Changing the way business is done in the region

As financial services institutions introduce ESG compliant versions of their products and services, non-financial corporations may be encouraged to adopt similar principles in their investment processes. Corporations adopting ESG principles are able to realize cost synergies through innovation, and resource efficiencies that improve the bottom line via sustainable products. A recent study demonstrates that it is in the best long-term interest of corporate managers to include sustainability into strategic management decisions.

80-90% of case studies show that sound ESG standards positively influence stock price performance, improve operational performance, and lower the cost of capital[36]. Ethical business is not only socioeconomically beneficial, but also makes sound commercial sense.

Sustainability

According to the Global Sustainable Investment Alliance, more than 30% of global assets are now managed in a sustainable and responsible manner[45]. Present trends suggest that the inclusion of sustainability parameters into the investment process will become the norm in the years to come, and these principles are supported by policy initiatives from the European Union. The sentiments of many who invest in Islamic funds already overlap with the strictest criteria of the ESG investor, most of whom remain unaware of Shari'a compliant investing and its overlapping consensus. Nurturing an ESG-Islamic industry may also create the potential for a green sukuk market that the UAE can foster locally by supporting non-carbon based green energy financing. Indeed the UAE is already a world leader in renewable energy as exemplified by the scale of the Masdar City project which will serve as the headquarters of the International Renewable Energy Agency (IRENA).

Conclusion and Next Steps

The Islamic asset management industry has failed to take root amongst its core demographic. Its total assets represent a tiny fraction of global funds and its product offering is narrow and parochial, lacking choice, diversification and quality.

And yet latent customer demand is massive. Penetration of financial services amongst the global Muslim population is low with proven substantial room for growth. Investors in the GCC increasingly demand sophisticated Shari'a compliant savings, pensions, insurance and mutual fund products. They are no longer satisfied with inactively managed savings schemes, largely invested in conventional local stocks and interest-bearing bonds. They seek Shari'a compliance, focus on ethical values, and wish to diversify into a range of alternative and fixed income products – such as sukuk, leasing, trade finance, securitisation and other asset-backed instruments – as well diversify geographically.

During the last 15 years - and particularly since the establishment of the Dubai International Financial Centre - Dubai has proven itself to be a centre for financial excellence in the Middle East and North Africa region, as well as one of the world's leading centres for innovation in Islamic finance through the structuring and arranging of a number of industry breakthrough transactions. From non-vanilla sukuk to structured investment products, Dubai has shown itself to be a pioneer in Islamic investment banking. By combining the attractiveness, talent and resources of the DIFC with the ambitions of the Dubai Islamic Economy Development Centre (DIEDC), Dubai now has the potential to achieve the same success in the Islamic asset management space.

In order to realise latent demand projections, and simultaneously propel Dubai to the forefront of the Shari'a compliant funds industry, we propose a public consultation process: we propose that leading local fund managers engage with Dubai government to incentivise the creation of multi-asset class multi-geography funds, particularly to meet the long term savings requirements of the local population. We propose that Dubai and the UAE's state-owned savings institutes establish working groups to transform the way they interact with and appoint professional private sector asset managers, in order to improve their performance.

By diverting 20% of investments in existing regional pension funds into Shari'a-compliant funds, US$36 billion would be added to the global Islamic asset management industry, a jump of over half the existing AUMs. Dubai has the potential to capture this market and once again transform the Islamic finance industry. Meanwhile Malaysia has already signalled its intention to take the lead by suggesting that the Employees Provident Fund (EPF) – Malaysia's largest savings and pension fund with over 14 million members and AUMs of MYR667.21 (US$151 billion)[46] - plans to offer an opt-in for Shari'a compliant retirement savings for EPF members[47]. As it stands today, over 40% of the EPF portfolio is already invested in Shari'a compliant assets, and a move towards a fully compliant fund offering to members who express a preference may have a seismic impact on the industry.

Over the coming months, Rasmala and Thomson Reuters will be conducting further research into transforming Shari'a compliant asset management in the UAE, particularly the pension fund sector, and following public sector consultation will report back on our findings in early 2016.

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