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Islamic Finance May Be On to Something

Banks and mutual funds that comply with Islamic law have largely evaded the fallout from toxic debt

By Frederik Balfour

Kuala Lumpur - This might be a good time for investors to pick up a copy of the Koran. Stocks and other investments that adhere to sharia, or Islamic law—though hardly unscathed—have fared better than the broader market. That's thanks largely to rules that forbid investing in collateralized debt obligations and other toxic assets that have caused the carnage in conventional financial circles.

A big part of the appeal of Islamic finance is its simplicity. Speculation is taboo under sharia, and there's a ban on assessing interest because the Prophet Mohammed said debts must be repaid in the amount that was loaned. Money proffered must be backed by collateral, and if financial instruments are traded, they generally have to sell for face value, which deters banks from repackaging debt. "This is one way to keep both feet on the ground," says Rozali bin Mohamed Ali, head of an Islamic finance university in Kuala Lumpur.

That doesn't mean Islamic finance won't suffer in an economic downturn. Because they must hold collateral, Islamic financial institutions tend to have more real estate assets than Western banks do. So far, sharia-compliant banks—mostly in the Gulf region—haven't suffered because housing prices there have held up relatively well. But if those markets were to dive, there could be trouble, says Mohamed Damak, a credit analyst at Standard & Poor's (MHP). "Banks most exposed to [real estate] will feel an impact if there is a sharp correction—whether they are Islamic or conventional," he says. Particularly vulnerable may be Dubai Islamic Bank, where two former executives have been detained in a real estate scandal and 30% of assets are tied to property. DIB Chief Financial Officer Mohamed Al-Sharif acknowledges the 30% exposure but says the bank won't suffer because "we only go after prime locations."

Evaluating the performance of *sukuk*—the rough equivalent of bonds—is more difficult. Banks have issued some $70 billion in *sukuk*, a drop in the bucket compared with the $36.8 trillion in bonds outstanding worldwide. And since many scholars say *sukuk* can be resold only at face value, there's not much of a secondary market. It's clear, though, that the global credit crunch has put the brakes on *sukuk* issuance. The market quadrupled, to $24 billion, from 2004 to 2007, but this year it has fallen by 31%, according to researcher Thomson Reuters (TRI).

For investors in stocks, Islamic finance doesn't differ dramatically from Western principles. To be sharia-compliant, companies can't run casinos or sell tobacco, alcohol, pork, or pornography, and debt can't exceed 30% of equity. Such rules leave more than half the companies in the Standard & Poor's 500-stock index—including Microsoft (MSFT), Southwest Airlines (LUV), and Nike—in compliance. "You can be an ethical investor without being Muslim," says Arne Lindman, CEO of Prudential Fund Management in Asia.

While sharia-compliant equities have performed in line with conventional stocks over the years, the prohibition on excessive debt has given Islamic mutual funds a lift in recent months. Two-thirds of new money now flowing into the sharia-compliant Amana Funds at Saturna Capital in Bellingham, Wash., comes from non-Muslims. The two funds have fallen by 27% and 33% this year, compared with the 41% decline for the S&P 500. "People are trying to hide from leverage by investing in our funds," says Monem Salam, Saturna's director of Islamic investing. "But when leverage gets acceptable again, they will go somewhere else."

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