

# The pros and cons of an Islamic sovereign wealth fund

Sovereign wealth funds have been regarded as highly valuable investors in propelling the Islamic finance industry. JONATHAN LAWRENCE looks the benefits and disadvantages of the fund as an Islamic entity.

Over the last couple of years the concept of a cross-border Shariah compliant sovereign wealth fund (SWF) has prompted considerable interest and not inconsiderable debate among academics and thought leaders.

In addition, consideration of issues facing Shariah compliant sovereign investment is fostered, in part, by The Fletcher School's Sovereign Wealth Fund Initiative (SWFI) at Tufts University in Massachusetts, US.

The SWFI is a unique collaboration between The Fletcher School, K&L Gates and State Street dedicated to providing strategic insights, quantitative, independent research and thought leadership on public policy issues and investment challenges facing SWFs, institutional investors, central banks, governments and international organizations.

## The pros

- An Islamic sovereign wealth fund would potentially assist the promotion of a substantial and globally based Shariah compliant asset management system. If the SWF is genuinely a global operation seeking to deploy funds around the world, then it could be an emblem for the industry as an alternative to conventional finance.
- The SWF could become the lender of last resort in the Islamic finance world in the same way that the International Monetary Fund acts as such in the conventional space. There is currently no such lender acting on a global basis.
- Giving a boost to the Islamic finance industry by moving it away from a product-by-product and piecemeal basis and pushing it to become more holistic in its outlook. The SWF could become a springboard to try out new investment themes, such as truly combining an ethical and Shariah compliant offering.

- There are currently 35 sovereign wealth funds based in Muslim countries. Approximately 16 of the 57 Muslim countries which are members of the OIC are home to sovereign wealth funds, for example the Abu Dhabi Investment Authority. Sovereign wealth funds are found in the six GCC countries. The sovereign wealth fund is a recognized and well understood vehicle in jurisdictions likely to want to become part of such a project.

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- The equity holdings of such a SWF would not be difficult to achieve. For example, nine of the top 10 equity holdings of the Norwegian sovereign wealth fund already pass the Shariah screening tests. The issue would be to diversify investments beyond equities.
- The IDB already exists as a model of a multilateral organization based on Islamic principles. An Islamic sovereign wealth fund would be

another method of Muslim countries working together. Indeed, a non-majority Muslim country could seek to be part of the SWF.

- By raising the profile of the Islamic finance industry, the SWF would hopefully have a trickle down effect to the existing financial institutions and organizations active in the area. The SWF could be an investor in the industry or encourage new investors to investigate the area.
- The SWF could be based in London, Luxembourg or another non-Muslim country venue in order to provide neutrality and to discourage partisanship amongst countries with a larger Islamic finance market. Non-Muslim jurisdictions may well compete fiercely in order to host the new entity and to try and steal a march on other countries by looking to gain an advantage for their own domestic Islamic finance industry.
- An Islamic SWF could be a model for other SWFs by investing in multiple assets, encouraging passive investing and demonstrating good governance methods.

## The cons

- Such a fund would be under even greater scrutiny and subject to the danger of Islamophobia, when acquiring strategic stakes in companies across the world. It would be subject to being accused of suspect commercial interests and could be used by politicians to set back the progress of Islamic finance generally.
- Some authors have thought it more useful to develop an Islamic-compliant mega-bank rather than a sovereign wealth fund. A bank could potentially have a more active and high profile agenda. Although this would be a rival to the IDB and the banking industry has its own well documented issue.

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“ **SWFs have proved a powerful way to pool collective wealth and apply it in a strategic and considered way** ”

- If there is an underlying tension in a project, such a fund would have to be multilateral in nature and would therefore not meet the classic definition of being ‘sovereign’ in nature. This is not an insurmountable hurdle. The SWF may encourage other countries or types of organizations to act collectively to hedge their exposures.

- The asset classes in which such a fund could invest would be limited by the rules of Shariah in comparison to conventional sovereign wealth funds. Therefore it would start off at a disadvantage on the investment playing field.
- The International Islamic Liquidity Management Corporation (based in Malaysia and established in 2010) has been set up to be a lender of last resort in the Islamic finance industry and there is an argument that this role is better suited to an entity specifically set up for the purpose.
- Such a fund may harm the availability of Sukuk in secondary markets. Traditionally, sovereign wealth funds tend to trade little compared to other funds. Therefore if the new entity bought large amounts of Sukuk then it would do little to encourage other investors.

- Political hysteria may lead to a reduction of investment opportunities and therefore to an inward looking investment strategy only into Muslim countries. Political sentiment against sovereign wealth funds is already heightened and an actively marketed Islamic sovereign wealth fund could be hampered from the start.

## Conclusion

My personal view is that a Shariah compliant sovereign wealth fund is an idea worth pursuing and merits more research. SWFs have proved a powerful way to pool collective wealth and apply it in a strategic and considered way. The Islamic finance industry may do well to have a flagship fund to further its cause. (2)

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