

# Investment News

## Monthly Bulletin from the Investment & Risk Team

August 2015

### Last Month in Brief

Greece's stock exchange plunged by over 20 percent on its first day of trading after having been closed throughout July. The fall, driven by banking shares, was the worst daily performance since 1985 - the start of modern records. The reopening of the exchange loosens the Government's controls on financial activity. Discussions of a third Greek bailout are ongoing but the IMF have indicated reluctance to act without further conditions on pro-growth economic reform (and progress in its implementation), debt relief agreements, and conditions for debt sustainability. Greece is now set to fall into a deep recession this year, with analysts expecting a fall in output of up to 7 percent of GDP.

Initial ONS figures indicate that the UK's GDP has increased by 0.7% in the second quarter of the year, raising talk of a raising of the BoE base rate next year. The announcement marks the tenth consecutive quarter of positive economic growth and leaves the UK around 3.4% higher than its pre-crisis peak in the first quarter of 2008. Growth has been imbalanced across sectors with the services sector most dominant and manufacturing facing pressure due to the strengthening of Sterling against the Euro.

Chart 1: Equity Indices

Equity markets generally ended the month higher

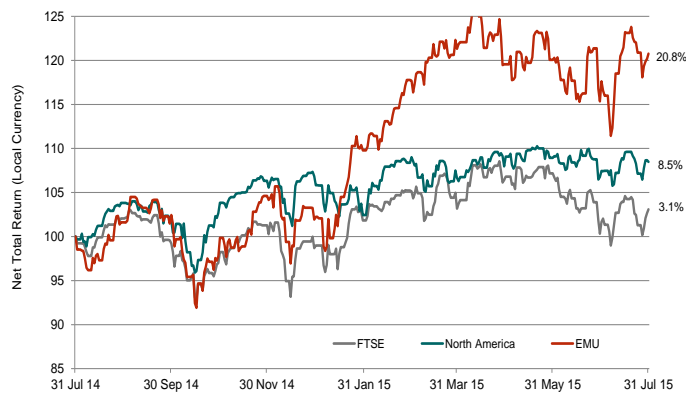


Chart 2: Sterling Credit Spreads

Credit spreads were largely unchanged

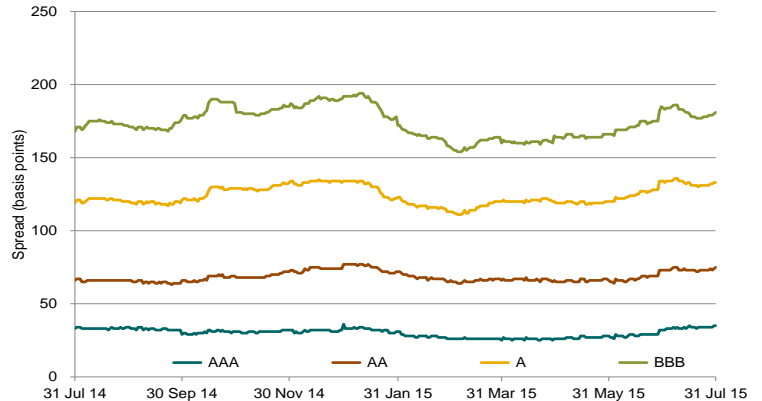


Chart 3: Gilt Yields

Yields fell for longer maturities

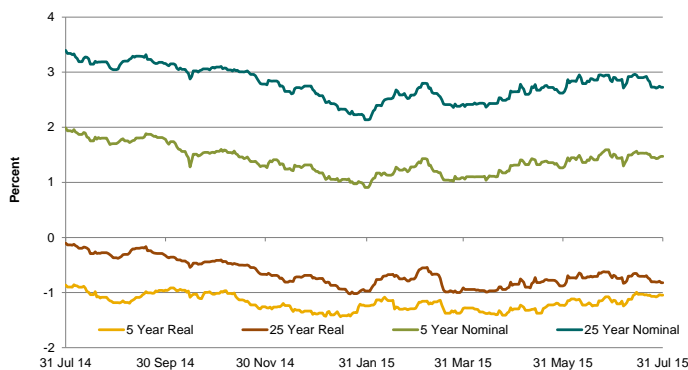
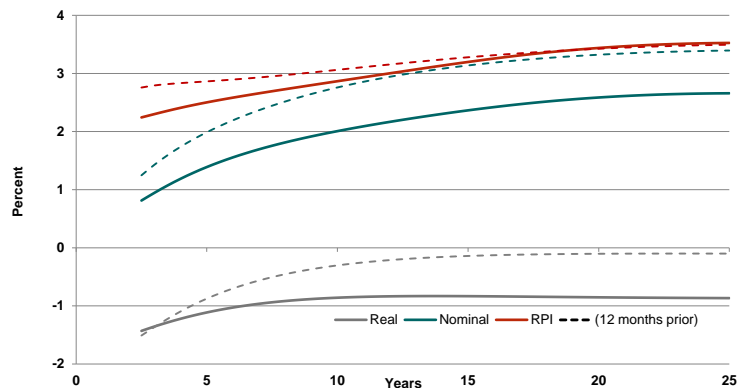


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous	Latest	Previous
CPI increase (annual change)	0.0%	0.1%	Base rate	0.5%
PPF 7800 funding ratio	84.8%	84.1%	QE Level	£375bn
Halifax house prices (monthly change)	1.7%	-0.1%	VIX (volatility) index	12.12
IPD TR property index (monthly change)	1.4%	1.2%	\$/£ exchange rate	1.56
				1.57

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

## Islamic Finance

Islamic finance (or Sharia-compliant finance) is the name given to a system of finance that is consistent with Sharia (the Islamic legal system) principles and in recent years it has seen significant growth (see Box 1).

### Key principles

Sharia prohibits the acceptance of interest in exchange for lending money (*riba*), since this is a relationship that favours the lender at the expense of the borrower. Money is viewed as a measuring tool for value and not an asset in itself, and thus one should not be able to receive income from money alone.

Sharia also prohibits unnecessary risk and gambling, hence arrangements where there is uncertainty involved in the future delivery of an underlying asset are usually forbidden - effectively ruling out options, short-selling, speculation and many commercial insurance products.

Equity financing of companies is permissible, so long as companies are not engaged in prohibited practices (lending, gambling, and production of alcohol, pork, tobacco, weaponry or pornography).

### Islamic approach

These principles have led to Sharia-compliant financial products being developed. These include sukuk which are financial certificates similar to bonds and takaful, a form of co-operative insurance. As different scholars take different views about what is acceptable practice there is a lack of consensus about what constitutes Sharia compliance.

Because interest is forbidden, Sharia-compliant lending requires that financial institutions have to share in the profit and loss of the

enterprise that it underwrites, or provide a service such as supplying an asset. This stems from the idea that one 'lawfully' becomes entitled to profit only when one bears the liability of risk of loss.

Common sukuk structures therefore include:

**Sukuk Al Ijara** – Sale-and-lease back structures that use revenues from an underlying asset (eg building) to pay investors.

**Sukuk Al Musharaka** – All parties contribute capital, with profits shared at a pre-agreed ratio or declining basis. Losses are shared in proportion to capital contributed.

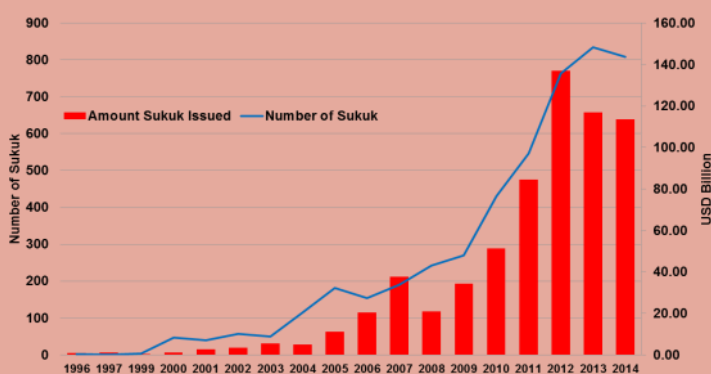
**Sukuk Al Murabaha** – A financier buys a good or investment and then sells it to a customer with a mark-up.

### Box 2: Sukuk

Sukuk is derived from the Arabic work 'sak', meaning 'title deed'. These are financial certificates that typically differ from conventional bonds in the following manner:

	Conventional Bonds	sukuk
Asset ownership	No share of ownership in an asset. A debt obligation only.	The investor has partial ownership in the underlying asset.
Investment criteria	Any that complies with local legislation.	Sharia-compliant assets only.
Issue unit	Each bond represents a share of debt.	Each sukuk represents a share of the underlying asset.
Issue price	Based on the issuer's credit rating.	The face value is based on the market value of the underlying asset.
Investment rewards and risks	Coupon payments for the life of the bond, with the principal to be returned at maturity.	Holders receive a share of profits from the underlying asset (and accept a share of any loss incurred).
Effects of costs	The performance of the underlying asset doesn't affect investor rewards.	Higher costs related to the underlying asset may translate to lower investor profits and vice versa.

### Box 1: Global aggregate sukuk issuance



Source: Thomson Reuters

Islamic financial assets currently total more than USD 1.8 trillion. Of this, the sukuk market surged from USD 60 billion in 2010 to USD 110 billion in 2013, with Ernst & Young predicting growth will reach USD 900 billion by 2017. The bulk of sovereign issuance comes from Malaysia, Indonesia and the Gulf States. However, in June 2014, the UK became the first Western government to issue (£200m) Islamic bonds.

### Appeal and risks

The main appeal to non-Sharia-compliant investors is that sukuk contracts offer a potential source of portfolio diversification, and exposure to markets that may not be captured in more traditional fixed-income indexes for example the Gulf States and South East Asia.

Risks include both a systematic market risk component (eg foreign exchange risk, equity price risk) and a risk component that is specific to Islamic financing (eg credit risk, Sharia-compliance risk). Credit risk for fixed rate *ijara* and *musharaka* can be quite serious, since sukuk contracts do not have access to hedging instruments to cover such exposure.

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