

Flexible structures



Executive summary

- From a corporate perspective, Islamic finance is a flexible tool and, providing certain criteria are met by the borrower, funding is available.

In the endless media coverage of the current economic crisis, born from the credit crunch, it was something of a relief and pleasure to be able to hear some reasonably positive messages for funding and capital markets. They came during the ACT's recent breakfast briefing on opportunities in Islamic finance, sponsored by Gatehouse Bank. Delegates at the briefing were given a comprehensive overview of the topic by a high-quality group of speakers with considerable experience. While the principles of Islamic finance will not suit every business or borrower, it offers more flexibility and scope for structuring transactions than might appear on an initial examination.

A POTENTIAL FUNDING SOURCE Since its early beginnings during the 1960s in Egypt and Malaysia, Islamic financing has grown into a \$200bn market. Although this is a relatively modest total on a global scale, it points to a potential source of funding for borrowers that should not be ignored. The largest single market remains Malaysia (most of the Islamic funds generated within the country are lent to borrowers in the country) and overall development is patchy across the Islamic world, with very little activity in North Africa, developing markets in the Gulf region and nascent markets in Asia (outside of

Malaysia), especially Indonesia, the world's most populous Islamic state. Islamic finance has not been immune to the global credit crisis and sukuk (bond) issuance in 2008 has been lower than in the previous three years as a result of investor reluctance as evidenced in every other bond market around the world.

The delegates at the breakfast briefing heard from Neil Miller, a partner at law firm Norton Rose, about some of the legal issues that corporates need to be aware of. Miller said that the main difficulties with Islamic finance were not driven by the interpretation of religious principles, but by the more traditional (in financial terms) credit and structuring issues. There are processes that need to be managed and tested in certain jurisdictions (such as insolvency structures), but all the speakers voiced hope that as the market matured, these types of principles would become more widely understood and established in robust legislative environments. Alternatively, culturally established contractual arrangements – such as arbitration – may also evolve towards more generic forms.

CORPORATE PERSPECTIVE Providing that businesses meet some straightforward criteria, they can consider Islamic finance for a wide

Islamic finance: Implications for UK corporate treasurers

The challenges of Islamic finance for UK corporates

- **To what extent can Islamic banks fill the funding gap?**
 - The largest Islamic bank in the world (Saudi Arabia's Al Rajhi, with total assets of \$33.2bn) is still small by international standards.
 - Initially, Islamic finance will be providing funding solutions for UK corporates in tens of millions, not billions.
- **Corporates will:**
 - want/need to diversify their source of funding and so should invest in such expansion;
 - have to be active in sectors which are acceptable to shariah; and
 - preferably have an existing business profile or operations in the Gulf Cooperation Council countries.
- **Legal costs will be higher on the first Islamic finance transaction**
 - But there will be healthy competition between UK law firms!

Historical perspective: Major milestones

1970s	1980s	1990s	2000s
Birth	Development	Rapid growth	Coming of age
<ul style="list-style-type: none"> • Limited number of Islamic financial institutions • Essentially start-ups • Little debt, large capital bases • Non-existent client base • Principles still uncertain 	<ul style="list-style-type: none"> • Growth in number and size • Deposit base built up • Geographic expansion into Asia • Principles become more consistent 	<ul style="list-style-type: none"> • Spectacular growth (oil shocks) • Intellectual momentum • Retail is the key driving force • Refined principles 	<ul style="list-style-type: none"> • Growth unabated • Internationalisation continues • New entrants and new forms of competition • Market appears fragmented • Principles subject to a new wave of criticism

Government encouragement

The government has been giving its own encouragement in recent months to the development of Islamic finance in the UK, writes *Graham Buck*.

Back in May, the economic secretary to HM Treasury, Kitty Ussher, called it "one of the most exciting, innovative financial services sectors around" and said ministers were keen to develop it further. The Islamic mortgage market is already worth more than £500m a year and the UK's sharia-compliant banks have more than 40,000 customers.

More than 20 London-based banks already provide Islamic financial services – a total that exceeds the rest of Western Europe combined – and the UK has Europe's only standalone Islamic financial institutions, including investment banks, a retail bank and a takaful (pooled insurance products) provider.

Ussher cited moves to standardise tax and regulation for Islamic and conventional finance, the introduction of Islamic savings schemes for ISAs in 2005, sharia-compliant child trust fund accounts and, last year, a new tax framework for sukuk.

More recently, the government has reviewed the possibility of sterling-denominated sukuk, as a sharia-compliant asset that banks could use to back sharia-compliant retail assets and to increase the available range of Islamic finance products. It began a consultation process on the issue late last year and published the findings in June.

The government is "serious about making London a world centre for Islamic finance", added Ussher, an ambition that would be helped by its issuance of sukuk.

However, issues remain that need to be ironed out, such as standardised documentation and corporate governance, improving practitioners' understanding of Islamic finance and raising public awareness of the products available.

Over the past few months, government ministers have been discussing the remaining barriers in the areas of tax and regulation, standardisation, education and awareness with its Islamic Finance Experts Group. A paper setting out UK strategy for Islamic finance in the years ahead was scheduled to be published before the end of 2008 (although the recent crisis in Western financial markets may have pushed back this timetable). When it appears, the document will confirm whether, following this period of debate, the government is proceeding with sovereign sukuk issuance.

The minister emphasised that the government considered the sector as "hugely important" in maintaining the UK's competitiveness in financial services and ensuring that the Muslim community in the UK has access at the retail end to competitive financial products. So it is likely that all sides will go to great lengths to overcome any sticking points.

And recent events mean that London is determined to encourage any sector that holds out the promise of growth.

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FLEXIBILITY, SCOPE FOR STRUCTURING AND COMPETITIVE EDGE: ISLAMIC FINANCE OFFERS A FUNDING OPPORTUNITY THAT BUSINESSES SHOULD NOT IGNORE, AS PETER MATZA REPORTS.

variety of corporate funding purposes including:

- acquisition financings;
- project finance;
- asset finance (real estate, oil rigs, etc); and
- on a secured or unsecured basis.

To date, secured (asset-backed) financing has been the most popular format but unsecured forms are growing in popularity, as is the ratings process. Anouar Hassoune, of ratings agency Moody's, reminded the audience that a rating for an Islamic financing was not a measure of compliance with necessary principles but reflected the nature of the structure when assessing default/loss given default. Interestingly, the flexibility of Islamic structures means that covenants and/or a security package can be structured to fit into the corporate's existing profile (subject to market conditions!). Accounting issues remain a challenge but generally speaking will fall inside IFRS if correctly structured.

BROADLY COMPETITIVE From a market perspective, Islamic products are broadly competitive with conventional products and pricing is generally comparable to the conventional market. Price discovery is an issue in markets where there is not a fully developed yield curve but if/when HM Treasury begins its long-awaited issuance, that may speed up market growth and transparency for UK corporates. In addition, there is now a level playing field in the UK from a taxation perspective and other European countries are following suit, including France and Germany.

There is clearly work to be done in bringing together investors and borrowers in this area of finance. The credit crisis has slowed progress in establishing market norms but the consensus from the experienced speakers at this event was that growth will be renewed after the current downturn passes.

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