A gathering force

THE RISE OF ISLAMIC FINANCE OUT OF ITS HEARTLANDS IN THE MIDDLE EAST AND MALAYSIA OFFERS A CAPITAL FUNDING OPPORTUNITY THAT IS EXPANDING AS OTHERS DIMINISH. **SAFDAR ALAM** EXPLAINS THE BACKGROUND AND THE WAY AHEAD FOR SHARIAH-COMPLIANT BANKING AND FINANCE PRACTICES.

Traditionally Islamic finance has been strongest in the Gulf Cooperation Council (GCC – the Arabian peninsula states minus Yemen) and Malaysia, but over the last few years many more have started to take an interest in banking and finance practices that are consistent with Islamic law (Shariah). Many countries have changed or adapted local laws and regulations, such as the tax and company codes, to permit the practice of Islamic finance and an increasing number are doing so (see Box 1).

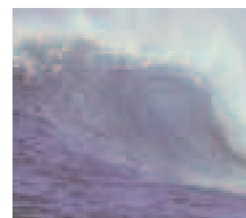
While the use of Islamic financial instruments is growing and becoming more widely understood, obstacles remain to further rapid expansion. The worst of the credit crunch may have passed Islamic finance by, but it has undoubtedly been affected. For example, state-owned holding company Dubai World had to restructure its debt repayments after one of its sukuks got into difficulty.

Another issue is the lack of homogeneity between Islamic products. Islamic finance practices have developed differently in different parts of the world and there is no significant cross-border standardisation. Linked to this lack of standardisation is a rise in intervention by the scholarly authorities, who can pronounce on whether a financial product conforms to Islamic principles and whether it is truly Shariah–compliant or not.

However, there is widespread recognition among banks and corporates that bringing Islamic finance products into the funding mix can help widen the investor base and open up new markets and sources of liquidity. Tapping new markets and overcoming cultural and legal barriers are not always straightforward tasks, even for strongly rated companies with vast experience of tapping capital markets, but multinational corporations, both financial and non-financial, remain interested in Islamic finance and investors in the GCC. The GCC countries may not have a large population but there is substantial wealth and liquidity in the region, and its cultural and religious make-up means that its capital markets and investors will remain wedded to Shariah-compliant financial instruments.

THE CRUNCH BITES The impact of the financial crisis in late 2007/early 2008 was not immediately felt in the GCC region. It was suggested by some that the principles that guide Islamic banking had kept Islamic financial instruments free of direct involvement in the credit crunch. Excess leverage and the use of and exposure to exotic securities are incompatible with Islamic finance principles. As a result, Islamic banking appeared to avoid some of the consequences felt by the global markets. The avoidance of certain kinds of risk exhibited by many players in the Islamic banking industry in the Middle East accordingly left them relatively unscathed by the credit crunch.

The general view as the crisis unfolded was that many Islamic financial institutions had been insulated from the worst effects because of the underlying principles of Islamic finance. Shariah does not allow interest to be paid or received under any circumstances, so Islamic finance cannot use instruments where interest is an essential component; in the Western finance system, on the other hand, the concept of debt and interest is the very lifeblood of liquidity. Similarly the use of instruments such as credit default swaps (CDS) and some derivatives are not permitted in Islamic banking



because they are not linked to underlying assets and their inherent uncertainty characterises them as speculative.

But as the crisis went on it became clear that Islamic financial institutions and the economy of the GCC countries were not completely sheltered from the effects. On closer examination it transpired that the cause of some financial problems in the Middle East was related to the very restrictions imposed by Shariah on the types of assets and funds where investments could be made.

Islamic principles forbid investment in certain industries (alcohol, tobacco, pork-related food products, weapons and defence, pornography and gambling) and in interest-bearing debt obligations or businesses with a substantial amount of interest income. GCC-based Shariah-compliant funds therefore tended to invest in asset classes such as local equity, property and real estate. Ultimately, the funds became overinvested in such assets, which, given the limited supply, resulted in an asset bubble. In some parts of the GCC, the real estate market surged. When the bubble eventually burst, funds holding those assets (including bank-owned funds) were faced with large write-downs and the risks associated with an undiversified asset base became clear. And even though Shariah-compliant finance would not touch interest-bearing debt, it did incorporate pricing linked to interest rates and so was subject to the same risk and leverage elements as conventional debt.

BRINGING ISLAMIC FINANCE PRODUCTS INTO THE FUNDING MIX CAN HELP WIDEN THE INVESTOR BASE AND OPEN UP NEW MARKETS AND SOURCES OF LIQUIDITY

GAUGING THE MARKET After some substantial falls in regional asset prices, many commentators in the GCC are now cautiously optimistic. There are still concerns – counterparty risk remains high on the agenda – but there are signs that confidence is returning to the GCC.

One way to gauge the progress of Islamic finance is to see how the Islamic capital markets have been catching up with the conventional capital markets as they operate in parallel in the GCC. Non-financial GCC-based corporates trying to raise finance are increasingly looking to Shariah-compliant sources, often after discussions between the board and significant shareholders. For corporates, diversifying their funding sources into new areas is good business, especially at a time when sources of credit are constrained. Shariah-compliant finance opens up a whole new seam of finance and access to new investors.

One Western company that has made progress in this area of finance is GE Capital. In November 2009 it became the largest US conglomerate to issue a sukuk, which raised $500m. The company – which has established an $8bn financial joint venture with Abu Dhabi state-owned investment vehicle Mubadala – is on record as saying it wants to become a regular sukuk issuer.

Many other corporations may also follow and adopt a dual approach, raising both conventional and Islamic finance. Traditionally sukuk tenors are between three and five years, so it may be appropriate for a corporate to issue a long-term dollar bond of 15-20 years alongside a shorter-tenor sukuk. However, many Middle East investors prefer to invest in strong local names, so, initially at least, corporates may well have to pay more than local institutions if they want to raise finance in the region.

Box 1: Reach of Islamic finance

Islamic finance operates right across the globe. The traditional centres are the GCC countries and Malaysia, which have predominantly Muslim populations. Malaysia is a long-established centre for Islamic finance, the legal basis for which goes back to the Islamic Banking Act 1983, and Islamic banking assets in the country total $30bn.

Western Europe has seen a significant rise in Islamic finance operations. In the UK there are two driving forces behind the spread of Shariah-compliant finance: London is a major global financial centre keen to be open to innovative developments, and the country is home to a sizeable minority Muslim population. Established in September 2004, the Islamic Bank of Britain was the UK's first FSA-approved Islamic bank and the first standalone Islamic retail bank in the Western world. Other Islamic banks have entered the UK market, as have Islamic insurance companies.

Other European countries have also shown considerable interest in Islamic finance. In France, another country with a strong Muslim population, banks have long embraced Islamic finance.

Outside Europe, Islamic finance has started to develop in the Commonwealth of Independent States (CIS: a loose association of most of the former component republics of the Soviet Union). Kazakhstan, with a population of just over 16 million, 72% of whom are Muslim, has become the most prominent player in the region. Its adoption of a law on Islamic finance in early 2009 resulted in local and international Islamic institutions setting up in the state. Back in 1997, the Islamic Development Bank (IsDB), based in Jeddah, Saudi Arabia, opened one of its three regional offices in Almaty, the largest city in Kazakhstan and the country's commercial centre. Islamic finance is also developing in other CIS countries, in particular the central Asian states of Azerbaijan, Turkmenistan and Uzbekistan, which have predominantly Muslim populations.

Islamic finance is also making progress in regional financial hubs in Asia, notably Hong Kong and Singapore. Both have declared an interest in developing an Islamic finance market and have issued licences for Islamic institutions.

LACK OF STANDARDISATION Because many of the interpretations of the principles behind Islamic finance have developed in local markets, from an international perspective they appear to be fragmented, with little cross-border co-operation. What is permissible in one country, for example, may not be in another. This heterogeneity is further complicated by each financial institution having its own religious advisers, which creates difficulties in the co-ordination of standards for, and agreements about, individual products. Standards that apply in Malaysia are in some cases very different from those in operation in the Middle East, although this situation is slowly changing.

Also many products are bespoke. For instance, individual institutions develop natural hedging products, the equivalent of interest rate or foreign exchange hedges, to protect their positions. And as there is no standardisation, different Islamic financial institutions have ended up adopting different legal stances and methods of execution. It all makes for a difficult marketplace with complex documentation and can result in uncertainty for counterparties. Standardisation initiatives are under way, but it is fair to say that changes come as a culture shock for many market participants. Bankers and regulators will need to join together and support the initiatives.

Areas where work is needed include hedging products and default scenarios. Hedging has not been widely used to date. The area is of particular interest to non-financial corporates and regional Islamic banks act as intermediaries, offering risk products to customers, potentially backing the risk out with larger institutions. But uncertainty hovers over the legal status of default in the Middle East and other regional hubs. The outcome in cases of default is unclear largely because of the absence of standardisation, which opens up institutions to an unwarranted degree of risk.

Islamic finance cannot look to replicate conventional Western financial products which contradict the spirit of Shariah and would be certain to start a critical debate among boards of scholars, and affect industry credibility. Instead, Islamic finance needs to continue to build on the success it has enjoyed to date, looking to produce innovative but increasingly standardised solutions that respect the history and culture of the GCC countries.

For more on a similar theme see ISDA steps up to the plate, P20.

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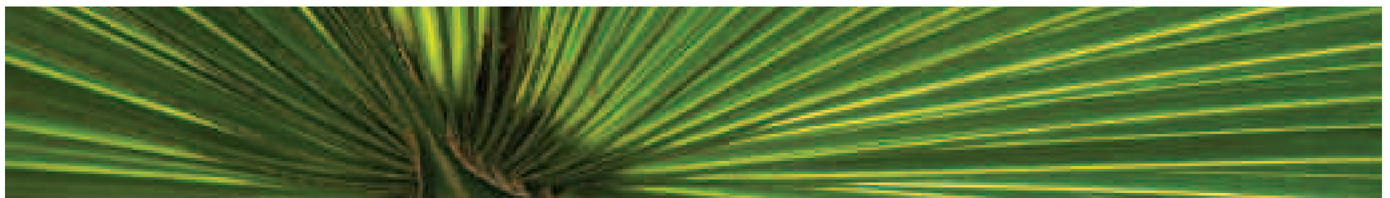

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