Islamic finance is booming with a number of countries around the globe this year announcing that they plan to promote the sector. But, while the industry may be enjoying explosive growth and increasing product innovation, it also seems to be finding it hard to stick to the letter of the law, William Rhode discovers.

From Thailand to Tunisia, Bangladesh to Hong Kong, Morocco to the UK – the last six months has seen a number of countries announce plans to promote themselves as Islamic finance centres. Until now, Malaysia has been the world's predominant hub – mainly servicing clients from wealthy Gulf Co-operation Council (GCC) states – but such has been the exponential growth in the sector, everyone, it appears, wants to jump on the Islamic finance bandwagon.

“You could easily say that Malaysia leads the field when it comes to Islamic finance in general, though the GCC is fast catching up,” says Salim Nathoo, a partner at Allen & Overy in London specialising in Islamic finance.

The niche exists because Islamic law, known as shariah law, forbids the receipt or payment of interest, making many conventional finance products unacceptable to Muslims. The industry has come from almost nowhere 30 years ago to be worth about $700bn globally, having grown at around 15 per cent in each of the past three years, according to the Islamic Financial Services Board. The industry’s assets are predicted to grow to $1,000bn by 2013.

Growth has come largely from debt-based products. Sukuks, Islamic bonds that offer coupon profits instead of coupon interest, are the fastest-growing segment of the market, posting a 71 per cent annual increase to $32.7bn in 2007. In a report released in February 2008 – ‘2007 Review & 2008 Outlook: Islamic Finance’ – rating agency Moody’s expects overall sukuk issuance to increase by 30-35 per cent in 2008. Moody’s attributes the sharp growth partly to increased wealth in Islamic countries driven by higher oil prices, and where the compliance of financial products and services with shariah rules and principles is a big concern for many consumers. Islamic banks are reporting an average yearly asset growth rate of 26 per cent, outpacing the average 19 per cent annual growth recorded by conventional banks.

And investor interest in Islamic finance has intensified further due to volatile financial markets in the wake of the credit crunch, and the need to find suitable investments that are consistent with Islamic values.

The opportunity is enormous, but there are also challenges. For example, there is a growing demand for halal (or Islamic compliant) products and services in the non-Muslim world, but the regulatory framework is still evolving. There are also concerns about the quality and consistency of products and services, especially in countries where shariah interpretation is not well established.

Despite these challenges, the Islamic finance industry continues to grow at an impressive rate, driven by a combination of strong fundamentals, innovative product development, and growing demand from both Muslims and non-Muslims. As the industry matures, it will become more sophisticated, offering a wider range of products and services that cater to the needs of a diverse range of investors.
of the subprime crisis, according to investment manager Gartmore in a July 2008 report – “Credit crunch sparks interest in Shariah compliant finance”. In particular, apprehension about the value and quality of banking assets has led several major financial corporations, both European and US, to consider Shariah-compliant finance as an alternative means of raising capital.

Conventional equity funds have been hit hard by the subprime fiasco and continue to suffer the ongoing effects of the credit crunch. For Shariah-compliant equities, 2007 was a strong year with Islamic indices outperforming their conventional counterparts and continuing to do so in 2008 as well.

Figure 1 highlights the strength of Shariah equity funds from early on in the 2007 subprime crisis. Shariah performance tracked conventional equity markets in the early days, and at the official start of the crisis in February 2007, the Dow Jones Islamic Market Index began its move away from the declining FTSE 100 and the Dow Jones Industrial Average, and has shown consistent outperformance to date.

The changing face
Initially, appeal for the sector was defined by religious affiliation. But it has now spread beyond the world’s 1.6bn Muslim community. There is a great deal of investor interest in states rooted in Islamic culture, which apply the principles of Islamic law with varying degrees of stringency, Gartmore says in its July report.

“The Gulf states, for example, earned $1,500bn in oil revenue between 2002-2006,” the investment manager’s report adds. “They have financial institutions with limited or zero exposure to the troubled US mortgage market, and have organisations that wish to raise capital using debt instruments closely linked to underlying assets. This is a market with plenty to invest, and borrowers with strong ratings – both appealing features in the current market environment of tight credit and low liquidity.”

There are structural differences in the products offered in conventional western-type and shariah-compliant markets. Conventional bonds commit the issuer to pay investors interest on the sums invested on specific dates. Shariah principles require that financing should be used for the trading or construction of identifiable assets and do not allow the payment of interest.

There are now many forms of Shariah-compliant Islamic bonds, or sukuk, in existence, which differ from conventional bonds in that they represent partial ownership of underlying assets. The shared ownership principle, and emphasis on real assets, is of particular interest at a time when there has been concern about the degree of leverage.  

Source: http://finance.yahoo.com
used in some financially-engineered products. "The growing importance of shariah-compliant finance reflects an important global transfer of liquidity, prompted by the oil boom. It also illustrates how emerging financial markets are increasing their depth and range," says Andrew Marshall, head of emerging market research at Gartmore Investment Management. "We also note that issuers are moving away from pricing in US dollars, with more issuers choosing the UAE dirham, Saudi riyal or Malaysian ringgit."

Growing interest

The UK is keen to benefit from the expanding market. In March 2008, the government's annual budget introduced tax concessions for sukuk and the UK Treasury has indicated that the UK could issue its first sukuk bond this year.

Malaysia can also expect growing competition from Singapore and Hong Kong, which are raising their game to tap Middle East funds keen on investing in the oil boom's economies. Hong Kong, for example, is considering scrapping a stamp duty on Islamic finance structures to avoid double taxation. Heng Seng Investment Management诸侯 engineered a shariah-compliant fund last year and, in March, a $500m exchangeable sukuk was listed on the Hong Kong Stock Exchange.

Singapore is soon to launch new guidelines for sukuk. In February, the city state introduced a 5 per cent concessional tax rate on income derived from shariah-compliant fund management, lending and insurance. It has succeeded in attracting Islamic banks such as Kuwait Finance House, which plans to manage regional funds sponsored by the group investing in Asia.

In May, Japan's Daiba Asset Management listed its first shariah-compliant exchange-traded fund on the Singapore Exchange. And DBS Group Holdings, Singapore's biggest bank, last year set up Islamic Bank of Asia, the city's first Islamic bank.

Morocco and Tunisia also moved to authorize Islamic finance last year, partly to encourage the investment inflows on which their fast-growing tourism and property industries depend. Islamic banking in Tunisia is still limited to one bank, Bank El-Tamweel Al-Tunisi Al-Saudi – an arm of Abaraka Banking Group – but Dubai's Noor Islamic Bank this summer opened a representative office seeking new opportunities in the Maghreb. Islamic finance is promising but not yet popular in Tunisia due to a lack of information, says economist Ghazi Boula from the bank.

Morocco now allows conventional banks to offer ijarah leasing products, murabaha contracts to buy and resell underlying goods, and musharaka, which are co-ownership financing structures. But some analysts say Morocco's tax regime, especially stamp duty rules on mortgage, puts Islamic finance at a disadvantage.

North Africa isn't the only place having trouble getting things off the ground. Thailand, a predominately Buddhist country but also home to 6m Muslims, lacks a legal and regulatory framework to comply with Islamic law, despite a push into the area.

"Thailand has the intention to develop an Islamic banking system, but there is a long way to go," finance ministry deputy permanent secretary Sathit Limpongpan recently told an Islamic finance conference in Bangkok. Sathit said a working group was studying ways to adapt Thailand's financial reporting, accounting and tax systems. Another goal was to develop a secondary market. Thailand had planned to issue its first $500m Islamic sovereign bond this year, but scrapped the plan because more outreach to investors is needed.

Malaysia fights for its market share

But as everyone jumps on the bandwagon, Malaysia is determined to hold on to its market share. In April, Maybank, one of the largest Islamic banks in Asia-Pacific, issued the first-ever tier-2 10-year sukuk. At 33 basis points over six-month Libor, it was also the tightest deal for a Malaysian subordinated borrower, and the second-tightest subordinated debt deal from Asia ex-Japan.

"Islamic banking and finance in Malaysia have progressed in tandem with the efforts by the authorities [through the Malaysia International Islamic Financial Centre] to promote Islamic financial services and make Malaysia the regional hub," said Ibrahim Hassan, acting CEO of Maybank Islamic at the time of the issue. "But it is not primarily to meet a religious need; instead it is being driven by a desire to offer distinctive products and services that customers want, be it in the form of pricing or product features. In the final analysis, Islamic bankers cannot take demand for granted, but must treat it as commercially-driven in order to be successful."

Malaysia's efforts to promote the growth of the sector may, in part, be driven by domestic considerations. It is a predominantly Muslim country in Asia, which has successfully established the concepts and also the practice of Islamic banking and finance.

Bank Negara Malaysia, the country's central bank, is trying to persuade global groups to enter the market ahead of its 2010 deadline to convert 20 per cent of the domestic banking sector to Islamic finance, up from the present 15 per cent.

"The move comes at a time when a shortage of employees who are qualified in the field is proving to be bottleneck for the industry. "We are in a situation where so much demand for talent is chasing very few people," says one senior banker at a local bank based in Dubai. One answer is to offer academic training in Islamic finance. In the past few years, locations such as Malaysia and Dubai have begun hosting academic and professional programmes. These are aimed at young aspiring Islamic banking and finance professionals, as well as those who already have experience in mainstream banking. Bankers note that such academic opportunities are no substitute for on-the-job training in banks and financial institutions, where new employees are taught formally and given time off to study.

While a number of countries in the Asia-Pacific region, including Pakistan and Indonesia, have supported the growth of Islamic banking and finance, they fall short of the Malaysian example of a country that has seen the active involvement of the central bank, which has linked up with a network of financial institutions participating in the sector.

But is it really Islamic?

The market is booming but there are signs that the spirit of shariah law is being stretched. There is a level of complexity that results from the fact that products must comply with principles on risk-sharing laid down more than a millennium ago. And sceptics believe the growth cannot be sustained given the inherent conservatism of the industry. One industry participant says: "People talk about the incredible growth in this industry, but growth has been coming from tradi- tion. Middle Eastern banks which are converting into full-scale Islamic banks. These are not institutional investors who understand the complicated products that are being developed."

Broadly speaking, shariah law prohibits usury, making it difficult to offer debt, interest or leveraged products. It also prohibits investments in alcohol, gambling, tobacco, weapons or pork-related products. Scholars are divided about whether several new shariah-compliant products are Islamic. Even sukuks have proved contentious. Earlier this year, Sheikh Muhammad Taqi Usmani, chairman of the Accounting and Auditing Organisation for Islamic Financial Institutions, said that 85 per cent of all Gulf Islamic banks do not fully comply with Islamic laws. Investment in hedge funds, meanwhile, have divided the industry, with a purist minority arguing that they continue to constitute...
gambling, regardless of how they are put together.

Structured products such as derivatives have also caused difficulties. One London-based analyst says the explosion of structured products being offered over the past five years has been controversial.

“We have seen the international banks, many of them operating out of the region, developing more and more sophisticated and esoteric structured products. This has led us to the position where the shariah scholars feel the need to review whether this policy of benefiting fundamentally from the real underlying transaction is in order,” he explains.

However, private equity has mostly escaped scrutiny because Islamic principles encourage the sharing of risk and return. Earlier this year, for example, Kuwaiti buyout groups Investment Dar and Adeem Investment Company financed their £429m leveraged acquisition of luxury carmaker Aston Martin with a shariah-compliant bond and loan through German bank West LB.

Critics say some shariah scholars are too well paid and on too many boards to refuse to sanction products. “These guys have an oligopoly. If an institution wants to pay someone $8m to sign a piece of paper, then they will,” says one disgruntled product provider.

Others argue that such criticism is unfair, claiming that Islamic scholars have the best intentions. However, most concede that there is a lot of pressure because of demand to build more products on the back of the oil and gas boom.

Standardisation needed?

Some providers are calling for a more uniform approach. Like any religion, Islam is divided into many streams of thought. Different scholars have different views on what products are acceptable, frustrating providers who are not certain where they stand. Providers therefore risk developing products only to find out they are not compliant. The industry as a whole is trying to address this issue.

Without convergence and benchmark issues, a global, liquid market in Islamic securitisation cannot develop,” says an analyst at a US bank in London. “There needs to be standardisation otherwise the market’s potential will always be hampered.”

Others, however, believe uniformity is not necessary and any attempt at achieving it will obstruct growth. They say that variety and diversity are inherent to the Islamic securitisation market – based on the five different schools (madhahib) of interpretation – and that is its greatest strength.

“I don’t belong to the school of convergence,” says Raja Teh Maimunah, chief operating officer at Kuwait Finance House in Kuala Lumpur. “Islamic finance is traditionally flexible. Why go against that? Flexibility is one of its major strengths. It means there can be a broad variety of products tailored to suit the client’s needs.”

Bindeh Shah, co-founder of Amiri Capital, the Islamic long/short fund of funds provider, has commented: “We are a young industry and can be stifled by trying to impose standards on what is healthy competition. I do not think you can force all schools of thought to converge.”

Among other challenges that have been highlighted, there is continued debate on the need for a central “Shariah Council” to introduce standardisation across the industry. But many say that it is important to balance that need against that for continued product innovation and the ability to introduce new solutions to the market in a timely manner.

“The industry doesn’t need to be constrained but governed,” says one market observer. Just what is acceptable is a subject of some debate.

Salim Nathoo of Allen & Overy: “Increasingly tools are being developed to ensure that transactions previously considered incompatible with the shariah can now be accommodated, resulting in an increasing range of products.” For example, Egypt’s respected al-Azhar University has issued a fatwa, or religious opinion, calling on the faithful not to consider all interest as usury, only excessive interest.

By that measure, existing Maghreb lenders of north Africa might already be shariah-compliant, at least in the eyes of some customers. “Many Maghreb Muslims don’t consider interest to be a sin by definition. They have done conventional banking all their lives and will continue to,” comments Anouar Hassoune, a vice-president and senior credit officer at Moody’s Investors Service.

And so it seems that the future holds a dilemma for Islamic finance in balancing explosive growth with adherence to the letter of the law. But given the state of the world financial markets these days, as far as dilemmas go, one could say it’s a nice dilemma to have.