

Emerging economies – offering the possibility for innovative product development

Majid Dawood – Chief Executive Officer- Yasaar Limited, Dubai, U.A.E.

With recent events in the financial markets since last summer we have seen an upheaval and concern not witnessed for a considerable amount of time. The bull markets had stampeded around the world and we have seen record highs for some time since the mid 90's. Interest rates have been low, credit was easy, unemployment levels were extremely low and growth targets were being exceeded everywhere. Stock markets kept looking up and the property markets were "going through the roof". But now the piper needs to be paid.

The sub-prime crisis, credit crunch, oil, food and commodities prices rising beyond levels not seen before have focused concern on inflation and employment levels. The fear of recession looms. However, it is not all doom and gloom as the press would have us believe or otherwise. This scenario tends to be a form of cycle that results in booms and busts being based on a debt related economy.

The surge in development activity in the GCC region urged by the windfall from oil price rises is leading to some innovation in the emerging economies. With Crude oil futures prices hitting the US\$140+ per barrel and the capacity for utilisation in the region at the level of US\$40 per barrel, leaves the balance of the price per barrel above that level available to invest outside the region. Also at these levels it becomes economic to drill for oil in areas that were uneconomic previously. Areas either offshore or even the tar sand deposits are becoming an attractive proposition along with alternative fuel options. The main beneficiaries are likely to be the emerging markets and Islamic finance; but the sectors that are being targeted are real estate and food along with other opportunities that may be regionally attractive.

What was once considered as a niche market, Islamic Finance is now a multi-billion dollar global industry. In addition, as Shariah compliant products become increasingly more innovative and sophisticated, the potential for future growth is widely acknowledged. Islamic financial institutions are looking to Shariah compliant investments in response to excess liquidity, while individuals are increasingly aware of the possibilities: Islamic financial institutions are expected to serve between 40-50% of the world's Muslim population within a decade. The demands from the GCC countries to utilize the oil revenues to develop their infrastructure will require imaginative thinking, and creative financing on a Shariah compliant basis as dictated by the government policies to encourage Islamic finance. Qatar alone has plans to execute US\$130 billion worth of projects over the next few years and Islamic finance has a 17% market share in the total assets of the Qatar banking sector last year.

The growth rate phenomenon is demonstrated by the sheer fact that Islamic finance is now active in 75 countries. There are currently over 320 Islamic equity funds in existence globally, of these 125 are in the GCC alone and manage assets exceeding US\$30 billion. 'Non-traditional' Islamic funds have grown from just 12 in 2001. These include real estate, hedge funds, fund of funds, managed accounts and structured products. Sukuk have been growing considerably and the total global issues of sukuk or Islamic bonds due to their appeal to both corporate and government entities are expected to reach US\$200 billion by 2010. Whereas Takaful - Sharia'a compliant insurance – is currently growing by approximately 20% per year and the Re Takaful will follow on from the success of the takaful industry. The total estimated size of Islamic finance market is expected to rise from its current size of US\$700+ billion to as much as US\$4 trillion in five years according to Salah Mohamed al-Jaidah, CEO of Qatar Islamic Bank.

Many of the International bulge bracket banks are looking at a range of Shariah compliant products and structures among them hedging tools, and this highlights the development and progress the industry is making as a result of a demand driven requirement for Islamic finance products in line with the requirements of Shariah. These developments are integral to the view that high demand for Shariah compliant products across the world will engender the overcoming of the hurdles to the industry's development through innovation.

The ramifications of the geopolitical issues still causing an undercurrent and industrialisation of the emerging markets, principally India and China, have increased the demand for oil and hence the price rises and the contra effect on transportation and therefore commodities. These challenges will focus the development of innovation and in the case of Islamic finance the further move from Shariah compliant to Shariah based. This has been evident from the Scholars tolerance levels changing to what can be accepted under the principle of *Darrurah* (necessity) and for how long. This is also giving impetus to what can best be described as the next or second generation of Islamic finance products.

The Middle East is currently one of the most exciting emerging markets on the global financial scene. Alongside the rapid development of cities such as Dubai and Bahrain comes the innovative expansion of a financial services industry that has become a major global player.

Some of the innovations we have seen over the years since the removal of the Gold standard and freeing up money supply has led us to many reversals of fortune and then after re-workings and refinements of the products has created larger and more creative versions that have today led to the sub-prime crisis and credit crunch. The emerging markets must bear these in mind as they embark on the journey to financial nirvana. In my view the Islamic finance market is an emerging market in itself. There are many attributes of Islamic finance that negate the boom bust cycle as the leveraging is limited, trading of debt is forbidden and the non existence of underlying assets being unacceptable will provide a solid, robust and sustainable alternative. Today we see the liquidity in the oil producing countries as a source for business but the longer term aspects are still to be determined over time and will lead to the further growth of Islamic finance. The Bretton Woods deal allowed the US to become the largest engine of finance and provided the funding for the war ravaged and new nations to borrow from the US due to its huge surpluses, now however, that is very different, those self same war ravaged and new nations have the surpluses and the US is the borrower and therefore hostage to political and other considerations of these nations.

Wealth management is a huge industry and one of the most profitable. With the current oil boom the focus has been on the development of the nations which are the oil producing countries. Here we have the spend taking place in their own backyards to develop their infrastructure, markets and industrialisation. This is very different from the former oil booms where the spend was in the developed markets and in a manner that was negative in some ways. Local or "imported" expertise has been established to manage the money from within the region. Large international banks and fund managers have set up shop in the region to provide better access and service to the clients. In this regard foreign investors are investing record amounts in the local bourses where they can and where sufficient data, international standards, governance and transparency are available. Other service providers, such as the info gateways and data providers such as Thomson Reuters and Bloomberg are based in the region to enable provision of information to their clients. The rating agencies are on ground to provide ratings services to the local enterprises so as to achieve a level playing field for the investment market to undertake the due diligence to make informed decisions.

The increased wealth resulting from the Oil boom has accelerated the infrastructure development of the Gulf Co-operation Countries (GCC) and thus the enterprises in the region, which in turn are looking at funding their growth and development through Islamic finance where possible, leading to

the growth of the Islamic finance sector as well as the banks and their involvement in the growth. One of the worrying aspects is the heating of the property market and the attendant exposure of the banks to this asset class. The rise of private equity is another area that has encouraged the Shariah compliance of the target companies as that being a requirement of the approval of investment in these companies by the Shariah Boards of these funds. Conversion of companies to Shariah compliance post private equity investment means a lot more companies will qualify for inclusion in the Islamic indexes and meet the requirements of some of the larger and stricter Shariah Board requirements. The coverage in the international press of the Sovereign Wealth funds, these funds are boosted by the oil boom and as mentioned earlier there is a lot of liquidity that cannot be absorbed by the region and also any rational mind knows that a diversification is absolutely essential, so a lot of buying good assets globally has become the rule. We have seen that some of these have taken advantage of the credit crunch and sub-prime crisis by buying stakes in good companies and financial institutions who have found issues with their capital adequacy levels.

Products such as Sukuk, private equity, hedge funds, "next generation" commodity murabahas are being availed and with the recent controversy about sukuk we expect some further innovation from the industry practitioners, lawyers and not least the Shariah Scholars. Some European bankers believe investors are in seeking assets untainted by the turmoil gripping other parts of the financial markets. As investment in Islamic finance products tends not to be sensitive to interest rates as charging interest is not permitted under Shariah, making sukuk, or Islamic bonds, immune to the credit crisis in the international bond and banking industries. At present the majority of issued sukuk are from Malaysia and the Gulf Cooperation Council countries (chiefly through the UAE and Saudi Arabia), and one of the German states issued one. There are plans to issue sukuk from the UK (a rolling program of about US\$4 billion) and China; and it seems that Hong Kong's pivotal regional role in banking and finance and global financial expertise could be used for both developing financial instruments and marketing them for the Chinese markets. The emerging markets will play a big role in the development of Islamic finance and its attendant innovation. Besides the India/China markets there is growing interest from Brazil and Russia too. In my view, as the French jump start their bid for Islamic finance; Germany, Spain and Italy will not be far behind. All these areas will have to cater to their local populations but also to the Muslim populations in Eastern Europe, at the same time the take of Islamic finance will grow among the non-Muslim customers due to the 'participatory' nature of the Shariah compliant products.

The UK has led the development of Islamic finance in the West and due to its position as one of the major financial centers in the world one can expect a lot of development there. France and Germany have stated their interest in Islamic finance and so has India, which is the second largest Muslim country. There is considerable interest brewing also in the United States and it will not be long before that market also joins in the fray for a market share.

Variations on themes from conventional products are being converted to Shariah compliance where possible, but the time for primary development of Shariah products is now being put into practice. The development of the commodity murabaha in Malaysia where the physical commodity of Palm Oil is traded is a move from the LME paper trail based product that has been the standard for liquidity management accepted by the Islamic banks under the consent of *Darrurah* (necessity). There has been a huge development in structured products for the Shariah compliant wealth management industry and due to some of these providing capital protection have gained momentum in raising the awareness in the market for those investors who wanted to tread cautiously.

These are the innovations now being created in the Islamic finance arena. The requirements for the underlying assets to be Shariah compliant is the challenge for the developers of innovative products along with the Shariah criteria and financial ratios which determine compliance. Based on these

precepts, what I term the second generation products are being developed. The Scholars are continuously challenged by the structurers of products to research the Shariah, review, to understand and determine what is the intention of these products, is the underlying compliant and does it meet the requirements of Shariah. Not only that but with recent issues of hedge funds, short sales and underlying assets being Shariah compliant plus the on-going Shariah adherence of the entire product are essential for the success of any product, innovative or otherwise.

With the demands in the market place for placement of funds and the uncertainty in the developed markets the attention has turned to the emerging markets where the returns look promising and also to the Islamic finance market or the GCC region due to the liquidity levels. All these factors combined are pushing the areas and their practitioners to be more inventive, creative and to some extent more Islamic. New ideas are being developed by the various players to innovate in their respective fields to deliver to the investors what they require. Alternatives are being sought to supplant what many feel have been failures in the market. After all the lauding of the governance and management of the economy by the Federal Reserve under Alan Greenspan are being questioned. The conventional market has to some degree through its unregulated innovation and extreme debt trading and leveraging has led to the result before us. This is not the first time and unless addressed, will not be the last time. The meltdown in progress in the conventional market has brought the Islamic finance alternative to the forefront. Leveraging has helped develop the conventional markets at a phenomenal pace but has also led to reversals. Islamic finance due to its Shariah criteria, where debt cannot be traded and leveraging is limited, may not set a frenetic pace of development but it ensures sustainability.

The markets are always evolving and products are being enhanced continuously spurred on by investor demand, jurisdictional dictates and tax implications. The Islamic finance sector, in its need to address the needs of the Muslim investors under the entire gamut of fund management and product offerings, has to keep pace with the conventional market developments and to ensure Shariah compliance the market practitioners are taking the challenge posed by more and more of the Scholars to adhere to these precepts and criteria being set.

Major institutions are now establishing these capabilities ranging from the global banks, commercial banks, Islamic banks, leasing companies, fund managers, wealth management companies, supra national organisations such as the World Bank, Asian Development Bank, the ministries of finance and central banks worldwide. With this much interest we can expect considerable innovation in the field.

In terms of Hedge Funds, Citigroup have announced a range of Shariah compliant hedging tools, and other financial products. These developments are in line with the high demand for Shariah compliant products across the world and will be instrumental in ensuring that the hurdles to the industry's development will be overcome through innovation.

Sector products, such as specialist telecom funds, energy, healthcare and pharmaceutical funds are considered Shariah compliant sectors and are the focus of many wealth management entities that are eager to get a share of this market based on their expertise in the relevant fields of enterprise. As a result we have seen the development of Shariah compliant stock indices from Industry leaders such as FTSE, Dow Jones and more recently, MSCI Barra and Standard and Poors.

On the other hand the insurance industry is growing rapidly across the Middle East, and projecting annual growth of around 20% in insurance premium payments over the coming years. Due to income growth and rising populations, market liberalisation, the vast rise in insurable assets stemming from abundant local liquidity and associated rocketing in project financing in the Gulf Co-operation Council

region, and the growth of Islamic finance itself will lead to innovation and the development of the retail sector, where the real market lies.

Islamic retail banking is also flourishing in the GCC through the launch of fully-fledged Islamic banks and the Islamic finance units operated by conventional retail banks. *Noor Islamic Bank*, which has a market capitalisation of US\$3.1 billion, was the latest to start operations in the sector in Dubai early this year.

Islamic products, which were first sought to help pious Muslims in managing their wealth, are now also being used by non-Muslim clients. The latter's number could swell as fearful Western investors search for cover to protect their funds and reach expected growth targets.

CONCLUSION

Innovation is essential and with the wealth being created the service providers in this sector are being creative and developing leading edge products to provide better returns to differentiate themselves from their competitors to gain a larger share of the market. Innovation is good but it must be tempered with regulation by stress testing these innovative products to ensure their sustainability and robustness to avoid the crises we have witnessed time and again. A lot of the problem seems to stem from the fact that many of the products are not properly regulated, involve trading of debt and are highly leveraged. With the rising demand in the Islamic marketplace the innovation will be engendered in the management of the wealth being created and being based on Shariah, which is by its criteria rather conservative and should avoid such reversals of fortune witnessed in the conventional financial sphere. Is the financial world ready for the ethics, social responsibility and conservativeness of Islamic finance? As the current crisis unfolds and the rescues of banks, financial institutions and Freddie Mac and Fannie Mae are attended to, then we shall see the result of the direction for finance in general and Islamic finance in particular.