

## **Review of the trends, developments and outlook of the Islamic finance industry in the GCC**

### **Innovation, Growth and Demand**

The global size of the Islamic finance universe is estimated at approximately US\$400 billion, with the Islamic bond market expected to double to US\$20 billion by the end of the decade, according to Standard & Poor's Commentary Report "The Islamic Financial Industry Comes of Age" dated 25 October 2006. Presently, it is estimated that the Islamic finance market constitutes a mere 1% of the global finance market, a considerable part of that is GCC based and growing rapidly<sup>1</sup>. The global Islamic finance industry is growing at 15-20 % p.a. according to Sheikh Mohamed bin Jassem Al Thani, Chairman of Corecap, a regional investment advisory firm<sup>2</sup>. The global sukuk market size was estimated to be close to US\$70 billion at year end 2006, including the sukuk issued from Malaysia, Pakistan and the Middle East. This is expected to accelerate, approaching US\$250 to US\$300 billion within the next five years according to the market estimates. The largest sukuk to date were those issued by the Dubai-based Nakheel Group for US\$3.52 billion early in the first quarter of 2007. These notes were listed in both Dubai and London<sup>3</sup>. The figures for the growth potential of the nascent Islamic financial services industry are striking, confirming a prominent trend towards Shariah compliant products. Until recently Islamic finance was a niche segment of international banking, attracting mainly investors in Muslim countries. As the sector grows in size and sophistication, not only are non-Muslim investors starting to buy Shariah compliant products but non-Islamic companies and institutions are starting to consider raising funds via Islamic routes. The retail market is now developing, with the need to increase awareness amongst the target customers as this is the "grass roots" segment of the business and wherein lies the future of Islamic finance.

### **Growth potential of Islamic finance in the GCC**

In this respect, the Gulf Co-operation Council countries<sup>4</sup> (GCC) region is poised to grow the mass-market part of the business and therefore the sector itself. Within the last three years the GCC economy has grown by an estimated 74 % since 2003 to reach approximately US\$600 billion, thereby recording the region as the 17<sup>th</sup> largest economy in the world. The GCC is experiencing an unprecedented economic boom that is presenting double-digit economic growth rates and large fiscal and external account surpluses. As opposed to earlier oil booms of the 1970s and 1980s, the financial liquidity is currently being deployed in the GCC region. Irrespective of the global oil price variations, the regional economies are expected to continue to grow at a rapid pace. The "windfall" from the high oil prices for the region is predicted to

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<sup>1</sup> FT Report - Islamic Finance - "Backwater sector moves into global mainstream" by Roula Khalaf and Gillian Tett dated 23 May 2007

<sup>2</sup> Khaleej Times, 22 May 2007

<sup>3</sup> S&P Press Release entitled "Islamic Finance Industry to Benefit from London's Evolution into Major Marketplace through UK Budget Measures", Initiatives to Equalise Tax and Regulatory Regimes Strengthen the City's Competitive Position, London 21 March 2007

<sup>4</sup> The Kingdom of Saudi Arabia, the State of Kuwait, the State of Qatar, the United Arab Emirates, the Kingdom of Bahrain and the Sultanate of Oman

exceed US\$3 trillion over the next ten years. Mohsin Khan, director of the IMF's Middle East and Central Asia department told the newspaper, "the unprecedented economic boom driven by oil revenues and the recycling of regional liquidity has seen Gulf GDPs racing at a pace close to those of some of the East Asian countries. But inflation is becoming a major limiting factor<sup>5</sup>". The events of 11 September 2001 resulted in a paradigm shift for Islamic finance. The re-evaluation of our cultural and religious values and identity due to the current political climate and economic growth led to the search of faith and self which resulted in the repatriation of capital from the US and European markets (capital flight) and contributed to the development of the domestic markets in the GCC region.

Accordingly, the liquidity in the GCC countries region is lending itself to considerations of faith in our economic and financial dealings which are empowering the region to innovate a wide range of financial instruments from basic deposit accounts to capital markets products, ranging from commodity tools to corporate bonds and then to an increasing retail sector with innovative solutions for Shariah compliant products and has injected momentum into a still underdeveloped financial sector. The time, nearly forty years ago, when Islamic finance came into being as an alternative means of financial transacting for Muslims in line with their faith requirements, is now developing into a parallel offering to conventional products due to the market demand.

### **Demand for Islamic finance products in the GCC**

Many of the GCC countries with surplus cash from the oil boom are keen to diversify their hydro-carbon dependent economies into other sectors such as real estate, tourism, financial services and manufacturing. In the financial services sector for example, banks in the GCC region are increasingly providing Shariah compliant products, setting up Islamic windows or converting into Islamic banks. In the GCC and the MENA region today we count approximately 63 major banking institutions, entirely conducting Shariah compliant financial business including for example Dubai Islamic Bank, Abu Dhabi Islamic Bank and Emirates Islamic Bank. Dubai Bank converted to a Shariah compliant institution in early 2007. Recently, it was announced that Dubai Holdings plans to launch an Islamic bank in Ajman, while Al-Noor Islamic Bank, with a capital of approximately US\$996 million, which will be the sixth Islamic bank to operate in the United Arab Emirates has also been launched. The demand for Shariah compliant products is growing at such a pace that there will be a need for more service providers, which will lead to further growth of the sector. For example, Emirates Islamic Bank (EIB) is the fastest growing Islamic bank in the world with total assets increased from over Dh 4 billion in 2005 to over Dh 10 billion, which equates to a growth in 2006 of approximately 150 % per annum. The EIB branch network is being expanded to meet the demand. GCC banks and financial institutions are also expanding to reach beyond their national borders with openings in Malaysia, Pakistan or Turkey and are now looking to the European markets. Many foreign banks are also boosting their capabilities in Islamic finance to cash in on the increasing demand. For a slice of the market, innovation is key and UBS, for example, recently launched an instrument claiming to be the world's first Shariah-compliant investment product linked to commodity prices. In addition, a number of companies are now operating on a Shariah compliant basis. For example, Amlak, a Shariah compliant home finance company in Dubai, has increased profits by 23 %. Furthermore, the stock exchange in Dubai, the Dubai Financial Market (DFM), is now a Shariah compliant stock exchange.

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<sup>5</sup> [Arabianbusiness.com](http://Arabianbusiness.com)

In addition, the GCC governments are seeking to upgrade their infrastructure, including airport and port expansions. The Middle East has become the largest project finance market in the world, according to HSBC with US\$33 billion of finance raised for projects in the region in the first half of 2006, a third of the global total. These projects have typically been funded with syndicated loans and bonds. However, nowadays, the market for Islamic bonds (Sukuk) is also partly being used to finance the unprecedented construction boom. With a number of these infrastructure projects aimed at improving and providing public benefit, they lend themselves to the application of Shariah principles and hence, it is easier to raise financing. The Islamic financing structure that was developed for the US\$1 billion Al-Waha petrochemical project illustrates the progression of Islamic project finance as it included the first fully stand-alone Islamic financing facility for a project. Recent transactions include the Rabigh Project comprising a US\$9.9 billion financing package for an integrated refinery and petrochemicals project. A US\$600 million Islamic tranche in the Rabigh Project was provided by APICORP, Bank Al Bilad, Calyon, Citibank, Islamic Development Bank, Riyad Bank, Gulf International Bank and the Saudi British Bank. Another landmark transaction is the Saudi Arabian Basic Industries Corporation (SABIC)'s US\$5 billion Yansab project which was signed in June 2006. Furthermore, the construction of the Saudi Kayan Petrochemical Complex on the Gulf coast near Jubail, the largest of its kind, will employ Islamic finance for some tranche. Such large ground-breaking transactions will raise the demand for Islamic finance further.

## **Regional Growth potential of Islamic finance in the GCC**

### *Kingdom of Bahrain*

Bahrain has been at the forefront of the Islamic banking movement for the last two decades and has given momentum to the sector in the GCC by incorporating the largest number of Islamic financial institutions in its jurisdiction. It was also instrumental in the establishment of institutions designed to establish standards such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the International Islamic Financial Market (IIFM) and the Liquidity Management Center (LMC) to introduce uniform regulation/standardization of documentation to promote cross-border activity and the global marketing of Shariah compliant financial products. Recently, the Islamic Ratings Agency (IRA) was also established in Bahrain. The impediment to growth of Islamic finance in Bahrain is the limit in the size of its domestic (onshore) market. Nevertheless, it recognizes its position in the Islamic finance hub “wars” and needs to provide added value in its financial architecture and infrastructure. The conversion of the Bahrain Monetary Authority (BMA) into a central bank format (now known as the Central Bank Bahrain (CBB)) is a step in the right direction. This will provide a unified and central regulatory response to the financial sector operating in the Kingdom of Bahrain. The CBB's wide scope of responsibilities allows a consistent policy approach to be undertaken across the whole of the financial sector of the Kingdom of Bahrain. It also provides a straightforward and efficient regulatory framework for financial services firms operating in Kingdom of Bahrain<sup>6</sup>.

### *Kingdom of Saudi Arabia*

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<sup>6</sup> CBB's website

“Saudi is likely to become a very active market with more diverse projects and a considerable number of them private sector projects” according to Darren Davis HSBC<sup>7</sup>.

With the current oil prices and resultant oil revenues and planned and sustained global economic growth, Saudi Arabia is seeking new investment opportunities for its surplus revenues. Diversification, in terms of domestic and strategic international investments, was one of the main topics of deliberation at the Jeddah Economic Forum on 24-27 February 2007. Although many Saudi entities are actively managing to seek out new and other market opportunities, foreign investment in the kingdom is increasing and becoming diversified. One area of particular interest for Saudi and foreign firms is the banking sector, which has been opened up and a number of foreign banks have been licensed including Deutsche Bank, BNP Paribas, J.P. Morgan, National Bank of Kuwait, National Bank of Bahrain, Emirates Bank, Gulf International Bank, State Bank of India and National Bank of Pakistan<sup>8</sup>.

TNS/NFO, a market research company in its Target Money Survey of Saudi banking attitudes in 2000 and 2004, noted a rapid change in attitudes over the period. The variety of bank accounts and investment options grew rapidly over that period, particularly with regard to Islamic banking. It appears that Saudi banks are beginning to refine their Islamic banking products, as almost all financial institutions have begun to operate on Islamic principles and a considerable majority of retail investors in Saudi Arabia prefer a competitively priced Shariah compliant product to a conventional product. Presently, it is stated that nearly half of all Saudi deposits are Shariah compliant, as compared to nearly nil about ten years ago, which gives a clear indication of the pace of change in this sector and the potential for growth<sup>9</sup>.

### *Dubai*

“A lot of institutional investors couldn’t even access local markets and some didn’t want to because of the lack of transparency,” Dr. Omar bin Sulaiman, Governor of the DIFC commented in a recent interview<sup>10</sup>.

The Dubai International Financial Centre (DIFC), a free trade zone, aims to create a regional financial market for debt, futures, equity and commodities that capitalizes on its geographical location and the time zones between the established financial centres in the Far East (for example, Hong Kong and Singapore) and in Europe (for example, Frankfurt and London). The DIFC is attracting international financial institutions such as banks, insurance companies, asset management companies, private equity firms and other service providers (for example, heavyweights such as Morgan Stanley, Goldman Sachs, Carlyle Group, Barclays Capital, UBS, Deutsche Bank and Credit Suisse) by offering international levels of jurisdictional capabilities and transparency of corporate governance. Dubai, through the Dubai International Financial Exchange (DIFX), now lists some of the world’s largest Sukuk (Islamic bonds) including the PCFC Sukuk, the Nakheel Sukuk and the DIFC sukuk (please see the section entitled “Sukuk” below for further information).

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<sup>7</sup> FT Report - Corporate Finance - "Challenges and opportunities in world's hottest market" by Richard Dean and William Wallis" 25 October 2006

<sup>8</sup> Source: Article in Ame Info entitled “Foreign banks launch in Saudi financial market” dated 4 June 2006 and Sagia press release dated 15 November 2005

<sup>9</sup> TNS/NFO's Target Money Survey of Saudi banking attitudes in 2000 and 2004

<sup>10</sup> FT Report - Gulf Finance - "Four Centres vie for prize" by William Wallis dated 27 November 2006

Dubai over the last few years has emerged as a serious player in the Islamic finance space with the Dubai government's stated aim to become a centre of Islamic finance.

As indicated, Dubai like Singapore and London, now also benefits from the presence of multinational companies and global financial institution players. International investment banks in Dubai are increasingly offering Islamic products to tap the liquidity in the region. In addition, corporates in Dubai are starting to reduce their conventional leverage by refinancing them in a Shariah compliant manner before a listing to attract investors and elicit a competitive price on a listing.

The recent policy change by the Dubai Land Department has removed certain disadvantages that Islamic financing deals carried, with the removal of this disparity, Ijara transactions for property acquisitions are expected to get a further boost.

### *State of Qatar*

The main driver in the region is the development of infrastructure as the GCC economies prepare to broaden their economies, with the suppliers of the materials and the suppliers of credit insurance raising considerable part of the financing by tapping into the regional liquidity where the demand for structuring financial transactions in a Shariah compliant manner is growing. In this context, Qatar's main attraction is its own economy – its expanding gas productions is now among the world's fastest growing – and a niche market in project finance with over US\$130 billion of its own projects announced to be in the pipeline<sup>11</sup>. The share of Islamic banking and finance in the local banking market has gone up to nearly 14 %.

The Qatar Financial Centre (QFC), which opened in 2005, aims to attract international financial institutions and multi-national companies to participate in the infrastructure and hydrocarbons projects presenting opportunities in “project finance, bond issuance, insurance and reinsurance, asset management, private banking and general business support services”<sup>12</sup>. Qatar and the QFC have a strong deal flow resulting from the infrastructure development projects within Qatar itself. Qatar and the QFC could develop as a centre of Islamic finance due to these requirements.

### *State of Kuwait*

Kuwait is the most thriving market in the GCC after Saudi Arabia. The invasion by Iraq has impacted on the development and hampered the growth, which Kuwait seeks to re-establish. It has been international in mindset and due to its immense liquidity has been venturing beyond its borders for a considerable time. The Boubyan Bank and the recently converted Kuwait International Bank (formerly Kuwait Real Estate Bank) are well capitalized and preparing to garner a share of the market. Kuwait Finance House (KFH), the first Islamic bank in Kuwait, is adopting an aggressive cross-border expansion strategy.

### *Sultanate of Oman*

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<sup>11</sup> Khaleej Times, 15 May 2007

<sup>12</sup> Qatar establishes new regional model of financial centre, QFC press release dated January 2005

Oman has been slow to enter the world of Islamic finance. However, initiatives such as the offer of oil contracts in collaboration with the Dubai Mercantile Exchange (DME) are a step forward. These contracts are currently not Shariah compliant but the potential to develop Shariah compliant oil contracts is under consideration.

### **Centres of Excellence of Islamic Finance**

“Transparency, integrity, efficiency” proclaims Omar Bin Sulaiman, director general (now Governor) at the DIFC. “This is what we wish to establish here and throughout the Middle East. The financial industry is naturally very conservative. They expect and need transparency, integrity, best practice and good governance and unfortunately the Middle East has not traditionally been associated with these traits. It is only by addressing these issues that we can attract the international firms that we need to develop the financial services industry in Dubai, the UAE and the Middle East as a whole.<sup>13</sup>”

Against this background, many jurisdictions in the GCC and beyond have declared their intention to be the centre of excellence of Islamic finance, such as the Kingdom of Bahrain, Malaysia and Dubai as well as many non-Muslim states such as the United Kingdom and Singapore. Some of these centers such as the United Kingdom, have a large amount of Islamic transactions being transacted there both through the banks and the law firms. Singapore and the United Kingdom are adapting their laws to encourage Islamic finance. The Kingdom of Bahrain has been active on an international basis in this space for many years and Malaysia though actively promoting the dual banking system of conventional and Islamic has predominantly been a domestic player.

With the advent of financial centres in the GCC, the DIFC has declared its intention to become the centre of excellence for Islamic finance. The DIFC is gaining a competitive advantage as compared to other potential centres in the region by enabling ease of business conduct. The QFC may also develop as a centre of excellence of Islamic finance based on the demand to finance project finance and infrastructure developments on a Shariah compliant basis. The Kingdom of Saudi Arabia declared in May 2006 that it had dedicated three square kilometers in central Riyadh to build its own financial area – the King Abdullah Financial District – to attract local banks, companies and regulators (in particular, the Saudi Monetary Authority (SAMA)) to compete with Dubai, Bahrain and Qatar to become the region’s preferred financial centre. The sheer fact that major regional markets such as the Kingdom of Saudi Arabia and the State of Qatar - besides Bahrain and the United Arab Emirates - are all actively participating in the Islamic finance sphere means that the demand is growing at an extremely fast pace. The proliferation of international financial centres has spurred product innovation and accelerated the growth of Islamic banking and finance. There is also considerable cross-border business between the GCC states, which provides opportunities for the multi-center growth in financial centers. However, the real challenge for these financial centres is to attract international financial institutions and regional heavyweight companies to generate business in their respective jurisdictions.

### **Product innovation and development**

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<sup>13</sup> FTSE Global Markets Issue 9 September/October 2005

The rapid economic development of the GCC region spurs funding and investment, leading to greater demand by increasingly sophisticated investors for the development of Shariah compliant products that can match or replicate the economic benefits of conventional products in terms of both pricing and returns to investors. Furthermore, the increase in demand for alternate forms of asset classes, as investors seek to diversify their investments away from local real estate and equity markets, will spur innovation and the development of a variety of products.

However, the Islamic finance sector cannot just mimic conventional products but must create its own products while taking the best of the conventional development that can be made to achieve Shariah compliance. Islamic capital markets must offer competitive and innovative, indigenous Shariah compliant financial products that meet the risk/reward profiles of investors and issuers, while maintaining Shariah compliance in relation to conventional products. A lot of primary research and development needs to be undertaken and must encompass the documentation to ensure true Shariah compliance.

Developed products with Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards are being utilized by the Islamic finance industry including products such as Murabaha, Ijara, Sukuk and retail products have been offered to clientele includes Hajj packages, Tawarruq facilities and Lifestyle products. Products under development include hedge funds, derivatives, profit rate swaps, CDOs, CLOs, hybrids and capital protected products. The characteristics of selected products are discussed below.

### *Sukuk*

A headline in the Financial Times read “My name is Bond, Islamic Bond” in relation to the purchase of Aston Martin by Investment Dar and Adeem Investments of Kuwait<sup>14</sup>.

There has been a substantial increase in Islamic bond issues in the last five years with over 170 Sukuk issues in 2006<sup>15</sup>. According to market estimates, the current size of the market is between US\$100 to US\$120 billion. The Sukuk market is breaking record after record with large scale deals such as the recent innovative equity-linked US\$3.5 billion Ports, Customs & Free Zone Corporation ("PCFC") Sukuk and US\$3.52 billion Nakheel Sukuk. The Sukuk market has witnessed exponential growth over the last five years to become a significant financing tool today in the GCC. The large allocation of the Nakheel Sukuk to European investors (40 %), higher than that allocated to traditional buyers in the Middle East (38 %), is evidence of the Sukuk becoming more than just a niche product for Muslims<sup>16</sup>. Furthermore, it appeals to a broad range of investors. For example, banks, fund managers, private banking clients, insurance companies and hedge funds subscribed for the Nakheel Sukuk<sup>17</sup>.

The growth in Sukuk demonstrates the maturity of the Islamic finance industry. The most popular and standardized structure is based on Ijarah contracts, which makes the Sukuk equivalent to a floating rate note in terms of its financial characteristics. The majority of new

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<sup>14</sup> FT "My name is Bond, Islamic Bond" by Gillian Tett dated 13 March 2007

<sup>15</sup> Prof. Rodney Wilson, "Global Islamic Capital Markets"

<sup>16</sup> Ame Info article entitled “DIB breaks another world record in Sukuk” dated 9 December 2006

<sup>17</sup> Ame Info article entitled “DIB breaks another world record in Sukuk” dated 9 December 2006

Sukuk issuance in 2006 was of this type, the main alternatives being Salam and Murabaha Sukuk, which yield a fixed return, the former typically for three months, corresponding to a treasury bill, while the latter, usually running from three to seven years corresponds to a bond.

According to an article entitled "Trading Potential in Sukuk and Equities" in the Islamic Finance News Guide 2007, "The issuance of short-term dated Sukuk is very much in its infancy stage but there is major growth potential... The development of Islamic short-term Sukuk as investment products also means the creation of another asset class, appealing to both Islamic and conventional investment houses and investors at large. The short-dated Sukuk could be a way of mobilizing Islamic funds across jurisdictions and across the globe... The short-term dated Sukuk... would be the vehicle from the onset, to allow active trading on the secondary market and permit cross-border transactions trading instruments".

With outstanding Sukuk debt estimated at US\$45 billion by the international ratings agency, Moody's Investors Service<sup>18</sup>, the market is still miniscule in relation to conventional bond issuance, which saw sales rise to US\$6,220 billion in 2006, according to Dealogic, the data provider. However, it is expected that the Sukuk market will continue to grow, surpassing bilateral debt financing, as it is an instrument used to diversify risk by obtaining finance from a wider pool of investors on the capital markets.

### *Hedge Funds*

The concerns raised by Shariah scholars in relation to the compliance of hedge funds with Shariah has impacted on their credibility and has as a result delayed their launch into a wider market across many jurisdictions. One obstacle to be addressed in relation to the development of Shariah compliant hedge funds is the issue of short selling. Initially, some solutions utilized "wrapper" structures. These have now been superseded by structures which are fully Shariah compliant on a "look-through" basis. The structure developed by Amiri Capital, for example, is fully Shariah compliant in terms of its shorting structure, equity screening system and compliant segregation of its assets away from conventional funds. A second obstacle to the introduction and delivery of Shariah compliant hedge funds is that the prime brokerage documentation has to be revised to ensure that it is expedient and acceptable to the various hedge fund managers. A third obstacle is the availability of real time stock screening capability to assist hedge fund managers to make investment decisions in a timely manner. This issue is currently being addressed and a number of providers are entering the market such as Amiri Capital who provide stock screening services to fund managers to enable them to trade in a Shariah compliant universe. A fourth obstacle is that Islamic hedging solutions are complex to structure in accordance with the Shariah. However, an increasing number of high net worth and institutional investors are generally using alternative investment products as a means to diversify their investment portfolio. As a result, development of a Shariah compliant hedge fund is currently a "hot topic" in the world of the Islamic finance sector.

### *Shariah compliant mutual funds*

Initially, Shariah compliant mutual funds were plain vanilla. However, fund providers are currently developing more sophisticated tailored products to provide added value to investors.

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<sup>18</sup> FT Companies: Islamic Finance - "Shock fades as deal break records" by David Oakley dated 18 January 2007

Recent developments have also included the 3i Group's launch of Enmaa', a US\$100 million Shariah-compliant public fund and NBK's launch of the first Shariah-compliant Watani KD money market fund.

#### *Shariah compliant private equity funds*

Private equity firms are also entering the Islamic finance landscape. Al Mal Capital is planning a private equity fund to be approved by the UAE Central Bank, while Corecap is planning on a private equity fund to invest in companies in the region.

#### *Shariah compliant structured products*

The development of structured products is in full gear and most international banks' structuring departments are busy attaining knowledge of Shariah compliant financial requirements to fulfill the growing demand for such products. Shariah compliant capital protected products are now being offered in the market to provide value added Shariah compliant investment opportunities. They are structured in the same way as floating rate notes or equity linked notes and enable conventional banks to both price and distribute these products.

#### *Shariah compliant mortgages*

The property finance requirements will develop the retail end of the market globally. There are a number of products in the market place covering residential, commercial and development financing. Islamic banks in the UK are providing Shariah compliant mortgages in the residential market. Large Shariah compliant home financiers (for example, Amlak and Tamweel), which are poised to enter the regional markets as well, are providing Shariah compliant mortgages in the residential market in Dubai. These home financing products require insurance and this growth will lead to the development of the Islamic insurance (Takaful) sector to complement the retail banking business.

#### *Derivatives*

It is expected that derivative products will witness a similar growth to the Sukuk market as they become a component of Shariah compliant products or structures available to investors. It is expected that stock exchanges and other service providers or enablers being established in the region, including the Dubai International Financial Exchange (DIFX), the Dubai Multi-Commodities Exchange (DMCE) and Dubai Mercantile Exchange (DMC), will contribute to the continued growth of the sector. However, developments in this area are currently in their infancy as increased awareness and education is required amongst providers and investors.

#### *Islamic Profit Rate Swap (IPRS)*

According to the article entitled "The Evolution of Islamic Hedging Solutions" in Islamic Finance News Guide 2007, "the Islamic Profit Rate Swap (IPRS) was introduced to assist in the management of profit rate risks thus enhancing cash flows". The IPRS replicates the economic benefits of interest rate swaps in a Shariah compliant manner. This direct similarity in the products allows conventional banks to provide Islamic hedging solutions. According to the article entitled "The Evolution of Islamic Hedging Solutions" in Islamic Finance News Guide 2007, the IPRS is "a mechanism structured to allow bilateral exchange of profit

streams using two parallel and back-to-back Islamic marked-up sale transactions (Murabahah)<sup>19</sup>. It comprises three possible structures:

(a) In IPRS, a series of Murabaha sale and purchases are made, allowing parties to swap or exchange profit rates from fixed to floating rate or vice versa.

(b) In Islamic Cross-Currency Swap (ICCS), a similar mechanism can also be applied for the purpose of cross-currency swaps. It is a financing structure constituted by a Shariah compliant bridge facility with an embedded Islamic US\$/RM cross currency swap and taken out through a 5-year Syndicated Dual-Tranche Islamic Facility. The Murabaha sale and purchase will be transacted to enable the parties to exchange one income stream of currency with another, for example Malaysian ringgit to US dollar.

(c) In Islamic Forward Rate Agreement (IFRA), there is a mutual agreement between the parties to conduct a Murabaha transaction in a single specified time period. IFRA resembles the IPRS<sup>19</sup>.

#### *Commodity Murabaha Program-i (CMP)*

According to the article entitled “The Evolution of Islamic Hedging Solutions” in Islamic Finance News Guide 2007, CMP “serves as an alternative deposit product for corporate and institutional clients based on a globally acceptable Islamic structure. Unlike a deposit or loan contract involving a borrower and a lender, the CMP product is based on a sale and buy-back contract which complies with the Shariah principles of Murabaha. The product offers features such as fixed return with an unlimited deposit size”. The basis of the Murabaha transaction is the purchase and sale of metal commodities as the underlying assets through metal traders on the London Metal Exchange (LME). This form of transaction is not an ideal one and though approved by some Shariah scholars they have done so as no alternative exists. However, there is expected to be a novel replication of this in the works and should be announced shortly.

#### *Commodity Murabahah Financing-I (CMF)*

According to the article entitled “The Evolution of Islamic Hedging Solutions” in Islamic Finance News Guide 2007, CMF also serves “as an alternative financing product for corporate and institutional clients. The product mechanism is basically the reverse of the CMP. This product provides working capital financing to corporate clients without such clients having to have ready assets”.

The Shariah scholars together with industry players have been playing a vital role in providing support and guidance towards the development of innovative Shariah compliant solutions. In addition, the regulators are encouraging the initiative and providing direction, supervision and approval for these products.

### **Shariah principles and process leading to issue of a Fatwa**

Islamic banking is similar to conventional banking with additional elements of an ethical nature and faith-based prohibitions. These restrictions mainly cover the application of:

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<sup>19</sup> The Evolution of Islamic Hedging Solutions by Azrulnizam Abdul Aziz in Islamic Finance News Guide 2007

- (a) interest (Riba), which is forbidden as money is not regarded as a commodity, only a medium of exchange;
- (b) ambiguity or incomplete disclosure (Gharar), which is not permitted in transactions/contracts; and
- (c) gambling (Maisir) is prohibited.

Certain commodities such as alcohol, armaments, pork or any of their associated activities and ethically unacceptable sectors such as pornography or tobacco are considered Haram or forbidden.

### *Basis of Shariah*

Shariah compliance is the application of the Fiqh Al Muamalat, the part of Shariah law that relates to financial transactions. It is primarily derived from the Holy Quran, the Hadith (the sayings and conduct of the Prophet Mohammed pbuh) and the Sunnah (the practices and traditions of the Prophet Mohammed pbuh). Its secondary sources are Ijtihad (legal reasoning), Ijma (consensus of Shariah scholars) and Qiyas (analytical deductions and reasoning).

There are four principal Schools of Islamic jurisprudence or Shariah. They are the Hanbali, Shafi, Hanafi and Maliki. The fifth school, the Imamiya, is predominantly used by the Shia's. At the recent inter-religious meeting in Amman, Jordan, three further Schools of Islamic jurisprudence were accepted, namely Abadiya as used in Jordan, Zayadiya as used in Northern Yemen and Khoja/Bohra school as used by the Bohri and Ismaili communities.

The Schools of Islamic jurisprudence have converged in their interpretation of Shariah law, particularly in the financial area. Furthermore, the divergence of interpretation between the GCC states, the Kingdom of Saudi Arabia and Malaysia is narrowing. The practicalities of finance demand this convergence and the view of the Shariah scholars more recently has been to develop a "best of breed" i.e. the starting point to be considered by a Shariah scholar is the financial structure followed by finding the solutions in the Holy Quran

To become a Shariah scholar, the individual needs to have completed his learning of Shariah law and specialize in Fiqh al Muamalat if he intends to practice in the financial arena. To be proficient in the international marketplace, the individual further needs to be proficient in Arabic (so as to do research in old documentary materials), English, banking terminology, financing structures and legal documentation.

### *Shariah scholars and Shariah compliance service companies*

Any Islamic finance product, transaction, fund or initiative will need to be certified as Shariah compliant for it to be used or marketed as an acceptable Islamic finance product. Without a certificate of Shariah compliance, the product would be unacceptable to investors. Investors in assessing the Shariah compliance of a product on offer would consider the identity of the Shariah scholars as well as their expertise, experience and reputation (mainly gained by his appearance on the Shariah Boards of many noted institutions). Investors also consider the Shariah scholars' receptivity to new structures and solutions in this fast expanding sector which is strongly demand driven.

Until the appearance of Shariah compliant service companies, institutions had to rely on appointing one or more scholars via separate contracts. However, AAOIFI and DFSA rules

require a minimum of three Scholars to constitute a Shariah Board and this will become an accepted standard across the industry. Accordingly, this was not efficient or cost effective as institutions had to liaise with each of them and to draw them together in a team. However, the advent of Shariah compliant service companies has simplified the process. Institutions enter into a contract with a Shariah compliant service company to obtain guidance on Shariah aspects of their initiatives. A Shariah compliant service company provides a one-stop shop: institutions obtain professional services from an established team of Shariah scholars. The Shariah scholars, who are owners or partners of the Shariah compliant service company, review the structure, legal documentation and marketing materials following which they determine the Shariah compliance and issue a Fatwa or certification of legal opinion.

### *Timing*

As soon as an institution is considering entering the Islamic finance arena, it should initiate a dialogue with and involve the Shariah scholars either on an individual basis or through a Shariah compliance services company from the outset to save time and costs. It would also be beneficial for an institution to appoint a Shariah Board on a retainer basis as Shariah issues keep arising following the issue of the Fatwa and the implementation of the transaction or the launch of the product. This is because investors may have questions or request modifications or variance in the structure. Furthermore, regular Shariah audits (e.g. on a monthly, quarterly, bi-annual or annual basis) are necessary in many cases to ensure the transaction or product is Shariah compliant. The Shariah Board would charge a fee for conducting the Shariah audit.

### **The challenge of promoting education and awareness**

Islamic finance has developed extremely rapidly. The expertise of market players and investment professionals in Islamic finance is key to the development of a global industry. Training is required for new entrants in the market to demystify the concepts of Islamic finance and to understand the principles of Shariah law as well as to keep market practitioners up to date with the cutting edge developments, innovative products and transaction structures, risk management and all the myriad requirements of the fiduciary responsibilities of finance and banking.

To further promote education and awareness, Islamic finance courses and training are offered to market practitioners and students globally (irrespective of religious affiliation). For example, the DIFC has also launched the first executive MBA in Islamic finance in association with Cass Business School in the UK. In addition, initiatives such as the International Centre for Education in Islamic Education (INCEIF), a knowledge education centre, established in 2006 to serve as catalyst in creating high calibre professionals for the global Islamic banking and finance industry, are essential and need to be more widespread.

Beyond that, the education of the target market is required to understand the product, in particular the product certification by an independent Shariah board and the ongoing monitoring of compliance with Shariah. Concurrently, a direct relationship with the international media needs to be implemented to attain worldwide recognition and acceptability of the Islamic finance as an ethical or socially responsible investment (SRI) appealing to both conventional and Islamic customers. Ethical and SRI investments do not really have a dedicated platform and will find that the Shariah compliant product range meets a number of their requirements and will take up Shariah compliant offerings. The Islamic

finance sector will grow beyond the Muslim investing market by attracting institutions involved in the ethical or SRI space.

### **Future outlook**

The total market size is estimated to be somewhere in the region of US\$600 billion for Islamic Wealth Management (IWM) and by 2013, it is expected to grow to more than US\$1 trillion. The numbers demand focus and attention from all players in this space. We expect to see the growth in the proportion of Islamic fund assets in relation to conventional assets. This is due to the perception that interest in Shariah compliant products is rising amongst both Muslims and non-Muslims. Islamic finance is growing and becoming a parallel offering in banking services also appealing to the ethical and socially responsible markets.

The boom has led to the development of new products and refinement or fine-tuning of existing established products to introduce sophisticated financial instruments (for example, convertible Sukuk, pre-IPO Sukuk and exchangeable Sukuk issues). There are also debates about the development of an Islamic repo, which will presumably involve the use of Sukuk or other Islamically acceptable securities. However, the issues of clearing and settlement of Shariah compliant investments and equities flows need to be considered, along with currency denomination issues that need to be settled in this industry. In addition, the secondary market for Islamic instruments is essential to the long-term establishment of the sector through the enhancement of risk management. In the case of Islamic hedging, there have been encouraging developments by industry players in introducing different structures with different mechanisms, resulting in global perspective for the industry. The innovation of new products will result in standards that are adaptive and effective in the evolution of financial innovation.

Initiatives have been taken by the likes of the Islamic Financial Services Board (IFSB) to bring standardization and uniformity to the sector in its rampant growth. The IFSB is an international standard setting organization based in Malaysia, which has been created to issue global prudential standards for the Islamic finance industry inclusive of banking, capital markets and insurance. It also undertakes research and coordinates initiatives on industry related issues. AAOIFI is recognized as the main standard setting organisation in Islamic finance for the accounting and auditing functions as well as Shariah standards. AAOIFI has now issued over 56 standards on accounting, auditing, governance, ethical and Shariah standards, including a statement on capital adequacy. Over the years, AAOIFI has taken significant steps to encourage the application and enforcement of its standards throughout the world. It has done so by producing high quality standards that are internationally recognized and have made particular effort to ensure that their standard setting process constitutes strong cooperation amongst interested parties. In addition, convergence of thought among Shariah scholars of the different schools of Islamic jurisprudence could lead to the creating of a virtual *madhab* free environment in Islamic finance.

The rate of growth in this industry is crucial to all global operators actively targeting the market. However, development is currently sporadic and constrained by a shortage of appropriate skills which need to be addressed by the promotion of education, market awareness, training and research to ensure market practitioners and investors understand the various financial and investment opportunities, essential to the varied phases of development in Islamic finance around the world. Islamic financial institutions and banks will need to

address ignorance, overcome existing prejudices and educate their customers on their value proposition.