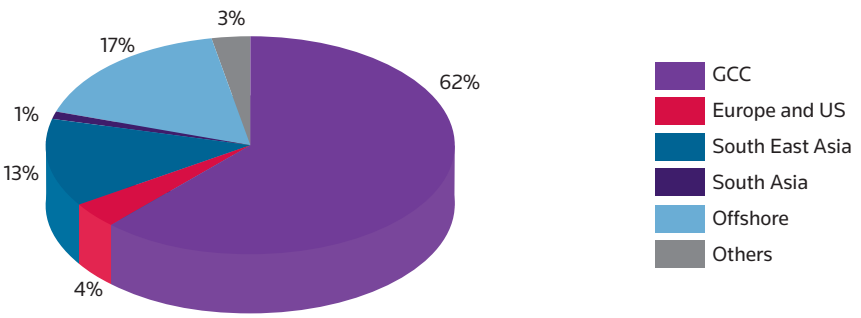
Figure 1.1

HNW and UHNW: Islamic fund distribution by size of funds, end-2008 (%)

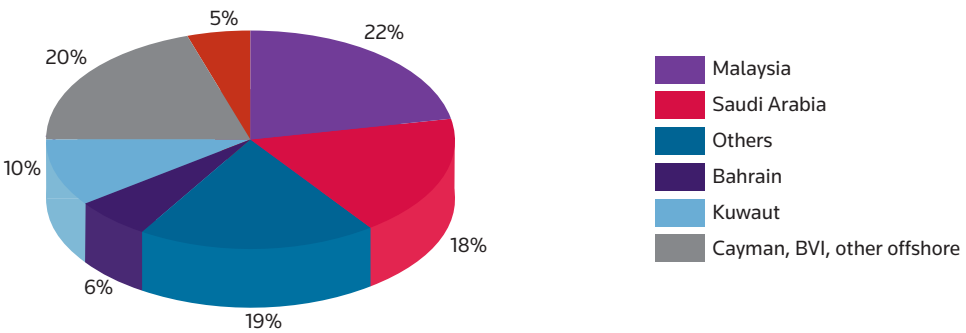


Source: Eurekahedge

In comparison, Islamic mass affluent customers are concentrated in both Asia (Indonesia, Malaysia and Pakistan) and GCC countries as the distribution of volume and size of funds demonstrate (see Figure 1.2).

Figure 1.2

Mass affluent: Islamic fund distribution by number and size of funds , end-2008 (%)



Source: Eurekahedge

Liquid assets of HNW and UHNW rose by an average 11.1% in the GCC countries and 6.5% in Asia (Malaysia, Pakistan and Indonesia) for the period 2005–2007[7]. In comparison, liquid assets of mass affluent customers rose by an average 10.5% in the GCC countries and 5.6% in Asia (Malaysia, Pakistan and Indonesia)[8] during the same period and in 2007, wealth in these markets was US$169bn and US$187bn respectively, to total US$356bn.[9] Assuming this upward trend continues, with an average growth rate of 11% for GCC and 6%

To date, Iran has maintained a relatively closed banking system but boasts the largest mass of Islamic finance assets in the world, with Iranian banks accounting for US$ 235bn or 35.7% of the total Islamic banking assets in the world according to *The Banker*.[20] Assuming that government plans for privatisation and entry of foreign investment in the banking sector go through as intended, Iran represents a haven of opportunity for Islamic banking and more importantly Islamic capital market activity, considering the enormous untapped infrastructure and commercial financing needs of the country. A number of international banks have applied to set up branches in the country and Islamic banks from the GCC, particularly the United Arab Emirates (UAE), are likely to move in to provide retail services within the next couple of years. By 2012/13 and subject to enhanced regulatory infrastructure with respect to issuance of Islamic sukuk and other capital markets instruments, Iran should be a fertile ground for high value transactions, in both equity and debt capital markets.[21] However, questions with respect to the country's Ja'afari (Shi'ite) interpretation of Islamic law may inhibit GCC bankers from engaging Iranians banks and financial institutions, which have previous shied away from Malaysia as a result of its substantially different interpretations of the boundaries of Islamic financial transactions.

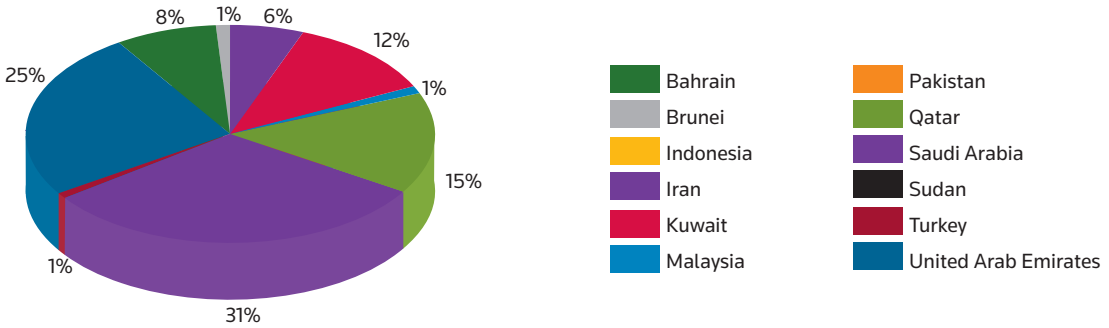
Growth presents sell-side opportunities

Tempered by the assumptions above, the growth rates for these countries are forecast taking into consideration the wide divergence of Islamic banking penetration and the upper limit of such penetration in each country. Based on estimates assuming individual forecasts for each country with respect to the optimal Islamic banking penetration and the extent of proactive and enabling regulatory environment, the total assets of the Islamic banking sectors in these countries will be worth US$1.85trn. These assets will surely require a home for investment, either in short- to medium-term financing, structured products or other capital market instruments. Among the countries included, the GCC states (with the exception of Oman), Indonesia, Iran, Malaysia, Pakistan, Sudan and Turkey will represent bankable masses as defined by a US$10bn benchmark, which provide definite opportunities for sell-side managers to market structured products and fund management solutions to these institutions for sale to their retail customer base. In addition to these markets, newcomers to Islamic finance such as Kazakhstan, the Lebanon and potentially Syria also represent future potential as a result of sustained and proactive government and central bank efforts.

We explore in Chapter 3 (at the Islamic finance institutional level) the ripple effect of such asset accumulation on the potential to market everything from overnight liquidity management instruments to long-term private equity mezzanine and debt financing to the financial institutions themselves.

Figure 2.3

Cumulative Islamic syndicated financing distribution by country, 2002–09 (%)



Source: Thomson Reuters

The GCC and Malaysia hubs

As is evident, the GCC states far outweigh the rest of the Muslim countries with Islamic finance presence in terms of syndicated corporate finance issuances, with a combined percentage of 90.6% of the US$70bn pie. This is largely driven by the concentration levels of Islamic financial institutions as discussed earlier.

In contrast, Malaysia, which is a heavyweight in terms of sukuk issuances, barely registers 1% of all syndicated issuances, most likely as a result of lower institutional push factors, i.e. lower demand for Islamic finance from institutions as a result of smaller critical mass of IFIs. With the exception of CIMB Islamic Bank and some smaller Islamic banking windows, the other fully fledged Islamic financial institutions are not active in the investment banking or capital markets arena, and therefore do not participate in local debt issuances in Malaysia. These banks are principally focused on retail and SME banking services. In contrast, there are a number of Islamic universal banks in the GCC that are active in the syndicated financing arena, albeit at a much smaller scale than their conventional counterparts. Further, there is little opportunity for Islamic banks from the GCC to engage in Malaysian deals, as a result of the differing opinions of permissible transactions between Malaysia and the GCC states. The significant distance between the two concentrations of Islamic finance activity do not permit active interaction between the bankers. However, this is likely to change in the coming years, with the establishment of GCC-based Islamic banking subsidiaries in Malaysia. Asian Finance House, Al Rajhi Bank and Kuwait Finance House have all established full service subsidiaries in Malaysia. To add to that, a number of GCC and European financial institutions have expressed interest to set up a 'mega' Islamic bank in Malaysia, with a minimum capitalisation of at least US$1bn.[1]

While Dubai was stung by perception issues, the UAE and particularly Abu Dhabi remain very strong contenders for future infrastructure spending and strong debt issues. This will see Abu Dhabi-based corporate entities along with a few UAE entities access the sukuk market in the years to come. This is in addition to the consistent growth in sukuk issued by quasi-sovereign entities developing Abu Dhabi infrastructure such as the Tourism Development and Investment Corporation (TDIC) of Abu Dhabi, which only recently issued a US$1.45bn sukuk to fund the development of its massive infrastructure projects around the capital city of the UAE.

Kuwaiti debt capital market activity remains unclear, particularly as a result of weak government support and the lack of a strong corporate governance culture, which will deter investors from participating in Kuwaiti issuances, at least until the dust settles from the latest crisis that unfolded in the Kuwaiti investment banking sector.

In South East Asia, Malaysia will continue to generate its consistent flow of local currency sukuk issues from all types of corporates for a long time to come, along with increased listings from corporate entities from neigbouring countries. Indonesia has only started to issue sukuk, and in a matter of couple of years, will see at least US$1.5bn-worth of combined issuance from both sovereign and corporate entities waiting to tap the market, after the immense popularity of the Global USD Sovereign sukuk issued in 2009.

Other countries such as France, Germany, Hong Kong, and Lebanon are all vying to establish their debut benchmark sovereign sukuk, most of which will be issued in the next two to five years.

Table 2.1

Total actual and project ed sukuk issuance, 2005–13 e) (US$m)

	2005	2006	2007	2008	2009YTD	2010E	2011E	2012E	2013E
Bahrain	891	898	1127	891	1403	1,000	1,100	1,200	1300
Brunei	0	580	222	31	107	250	250	300	300
Kuwait	0	450	200	0	0	0	250	400	500
Indonesia	59	1020	193	678	1,487	1,500	1,600	2,000	2000
Malaysia	8,747	16,607	25,062	5,721	6,313	10,000	15,000	20,000	25000
Pakistan	600	247	1065	0	210	200	600	1000	1000
Qatar	0	752	300	301	0	1000	2000	2000	2000
Saudi Arabia	500	2,824	5,683	1,874	2,917	5,000	8,000	10,000	10000
UAE	950	21,035	11,052	5,996	1,900	2,000	4,000	4,000	4000
Other	0	167	130	0	67	500	1000	1500	2,000
Total	11,747	44,413	44,904	15,492	13,809	21,450	31,800	39,900	45,100

Source: Islamic Finance Information Service

assets and profits rates on their deposits. In principle, Islamic banks should not be exposed to profit rate risk or rate of return risk, since the majority of their funding come from profit and loss sharing investment deposits (mudaraba-based). This should theoretically cushion the effects of asset return volatility and rate variability. However, IFIs operate in markets with mainstream/conventional financial institutions and this exposes them to market forces of varying degrees. Combined with a proportionately higher balance of outstanding fixed rate medium-term murabaha financing, Islamic banks may risk their profit margins in the event that market benchmark interest rates increase. Indeed, a study by the author examining the financial stability of a widely distributed global sample of IFIs demonstrated that financial stability[4] is inversely related to the level of fixed rate assets outstanding on the balance sheet.[5]

"There is a definitive captive market for profit rate swap products"

Hence, there is a definitive captive market for profit rate swap products. If only 50% of the total financing portfolio is considered assuming a loan/asset ratio of 60% and total assets of approximately US$500bn, the size of this market is estimated at a notional value of at least US$150bn. If each transaction is around the US$150m notional value mark, then there is a captive opportunity for at least a 1,000 transactions, if not more.

Foreign exchange market potential

Countries in Asia and the Middle East are slowly integrating with the global system, particularly in respect of trade and investment. International flow of assets and liabilities from the emerging markets in these regions has grown much faster than the rest of the world. Figures 3.4 and 3.5 demonstrate the year-on-year growth rates of external/foreign assets and liabilities positions of banks. As is evident, growth rates for both GCC countries (excluding Oman) and countries with Islamic finance presence have exceeded the equivalent global growth rates in external positions from 2003 onwards. The growth rates are particularly accentuated in the GCC.

This trend is likely to continue in the medium- to long-term as the investment of surplus wealth gathered during the past couple of years will be seeking investments in high growth regions, the likes of Asia and the former Commonwealth of Independent States, besides the usual investment flow into to Europe and the US. Consequently, higher volumes of foreign exchange transactions will be required to support the increased flow of funds both inward and outward. In particular, both financial institutions and clients will increasingly require short- to long-term hedging solutions for their asset and liability exposures in foreign currencies. For the past couple of decades, the Islamic currency market has not developed at all as a result of Islamic restrictions on currency forwards. Consequently, most IFIs either take the risk on their profit and

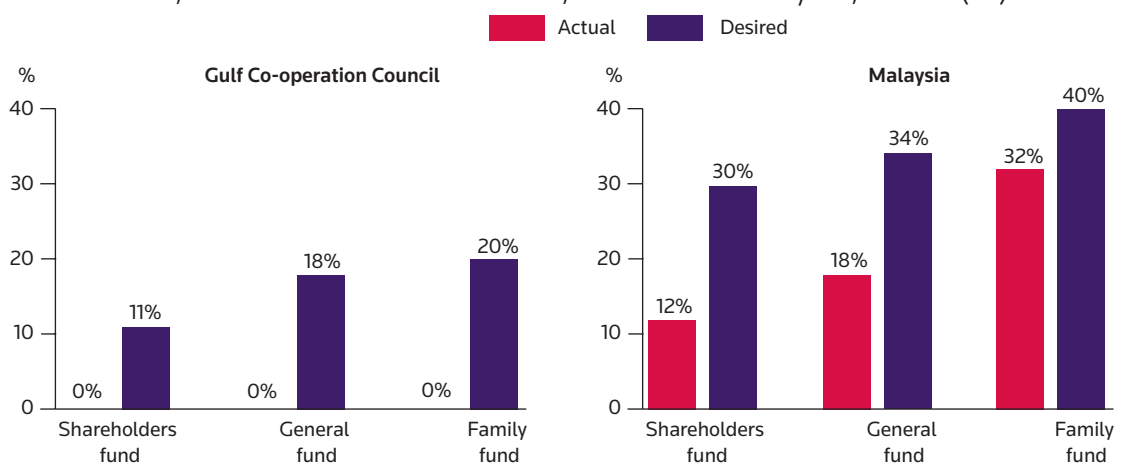
Takaful/Islamic insurance institutions opportunities

Like their conventional counterparts, takaful companies need access to long-term investment solutions, ranging from all types of funds covering a whole spectrum of asset classes and risk appetite, to fixed income long-term deposits to cover for family takaful claims. To date, the spectrum of liquid investments available to takaful providers to market to their wealth management customers has been very narrow. At any given time, there are approximately 40-50 funds available, with serious imbalances in asset allocation as a result of a smaller variety of funds. The growth of funds to cater to long-term investors will definitely stimulate the growth of this industry, and vice versa. Opportunities also exist in developing long-term deposit products that provide fixed income streams. These opportunities can be synergised with the needs of IFIs for long-term funding solutions, considering the IFIs over-reliance on short-term depositor funding (see IFI section above). This can be done by establishing fixed income funds that securitise the IFIs pool of financing assets such as auto financing, residential mortgage financing and the long-term project financing portfolios.

Nevertheless, in if one is to judge by US dollar size, the takaful /Islamic insurance industry is still in its nascent stages of development compared to its elder Islamic banking sibling. The total takaful contributions for the year ending 2007 were estimated to be only US$3.646bn, excluding Iran which registered contributions of approximately US$4.15bn.[7] Nevertheless, considering the underlying fundamentals, it is likely to grow at the same pace as the Islamic banking industry, if not faster. The industry registered a year-on-year growth in takaful contributions of 30% globally for the period 2005-2007, while the majority of the Muslim-populated markets have little or no access to takaful cover.

Figure 3.8

Corporate sukuk, actual and desired levels, GCC and Malaysia, 2008 (%)



Source: Dr. A. Rahman Tolefat Presentation at the World Takaful Conference 14 and 15 April 2009

Natural yields

The other option recommended by some is to utilise the market-determined natural yields based on each asset's class' return profile. For instance, ijara sukuk and ijara mortgage assets can pay according to the rental yields of the particular assets. In the UK, for example, property fund managers regularly park their extra cash with other property fund managers and receive a yield based on market rental returns. However, this is really only active in the UK and it is unlikely that it such a system will develop in the Middle East and Asia (with the exception of Malaysia), where property fund managers are not as efficient and sophisticated as in the UK and pricing and yields are readily available.

The reality is that most Islamic banks therefore also skew their retail customer funding towards paying out competitive deposit rates rather than enterprise returns on assets based on the natural yields of the particular assets.

Correlating benchmarks

As is evident, this is both an asset and liability side conundrum. Islamic banks cannot price their investment/assets away from conventional benchmarks, since conventional benchmarks are the expectations of the majority of funding sources. This can only be resolved in countries where conventional benchmarks cannot have an overwhelming influence, i.e. countries which do not rely on international banking and conventional banks form a small part of the overall banking system with Islamic banks forming the majority portion. There are no markets with such high levels of Islamic banking penetration in the world (with the exception of Iran and Sudan). On the assets side, pricing cannot be efficiently determined for each and every asset class and in addition, the funding sources expectations would skew the Islamic bank's return expectation for their asset portfolio towards conventional benchmarks.

This is evident from the deviation between the fundamental asset returns and the returns paid out to depositors in Islamic banks. The author conducted an extensive study utilising 37 Islamic banks over a period of six years and found that Islamic banks in several countries skew the returns paid out to depositors to suit market returns, even where the return on assets are fundamentally different from market returns (see Tables 6.1 and 6.2). This phenomenon is generally known in the Islamic banking circles as displaced commercial risk, or DCR.[2] Therefore, are there real alternatives to establish an Islamic banking benchmark at this stage of Islamic finance? Not really. Any benchmark that is established will closely correlate to interest-based benchmarks or competitive localised benchmarks. However, if such a benchmark were to be established, it would require the input of all the major Islamic banks in the world, including

Table 6.1

Correlation between benchmark deposit rates and ROIAH*for Islamic banks, 1995–2005

		Correlation ROIAH-deposit rates			
	N	Pearson	Sig	Spearman	Sig
Algeria	6	-0.082	-	-0.029	-
Bahrain	39	0.152	-	0.221	-
Bangladesh	41	0.401	**	0.289	*
Brunei	4	0.050	-	0.000	-
Egypt	16	0.453	-	0.333	-
Indonesia	14	0.556	**	0.385	-
Jordan	13	0.790	***	0.835	***
Kuwait	8	0.963	***	0.976	***
Malaysia	16	0.878	***	0.955	***
Pakistan	10	0.371	-	0.468	-
Qatar	15	0.952	***	0.958	***
Saudi Arabia	11	0.588	*	0.523	-
Tunisia	11	0.853	***	0.892	***
Turkey	15	0.173	-	0.214	-
UAE	20	0.703	***	0.701	***
Yemen	11	-0.090	-	-0.075	-
Total	254	0.254	***	0.633	***

*Notes: *** significant at the 0.01 level, ** significant at the 0.05 level, * significant at the 0.10 level.*
** ROIAH stands for Return on Investment Account Holders fund calculated as the profit paid to investment account holders divided by the Average Investment Account Holders fund (opening and closing balance)*
Source: xxxxx

Table 6.2

Mean asset spread (difference between ROIAH and ROA) for Islamic banks, 1995–2005

Country	N	Mean (%)	Median (%)	StdDev (%)	Min (%)	Max (%)
Algeria	6	3.02	2.94	1.03	1.95	4.23
Bahrain	39	3.84	1.98	4.81	0.12	25.07
Bangladesh	41	1.46	0.90	1.68	0.07	7.76
Brunei	4	0.69	0.67	0.17	0.51	0.92
Egypt	16	1.65	0.96	2.54	0.01	10.26
Indonesia	14	3.40	1.19	6.13	0.03	23.06
Jordan	13	1.05	0.91	0.73	0.40	3.07
Kuwait	8	1.53	1.46	0.17	1.42	1.92
Malaysia	16	0.57	0.20	0.96	0.03	3.83
Pakistan	10	2.35	1.86	1.46	1.10	5.71
Qatar	15	1.83	1.07	2.01	0.03	6.34
Saudi Arabia	11	2.58	2.79	1.82	0.06	6.05
Senegal	4	1.71	1.64	1.43	0.04	3.53
Tunisia	11	10.59	0.35	13.70	0.01	29.67
Turkey	15	1.83	1.66	1.34	0.08	5.41
UAE	20	0.87	0.6	0.73	0.08	2.87
Yemen	11	1.82	1.42	1.39	0.69	5.48
Total	**254**	**0.024**	**0.011**	**0.043**	**0.000**	**0.297**

Source: xxxxx