ISLAMIC FINANCE

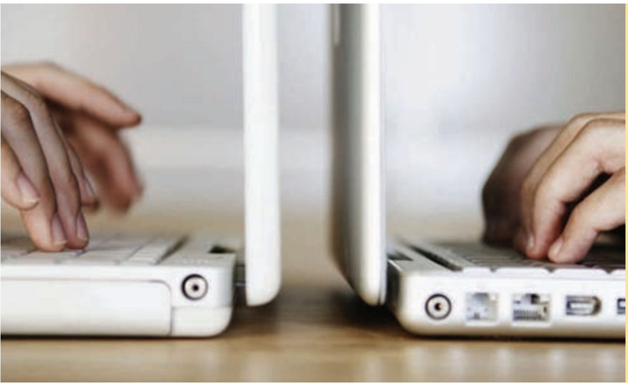
challenges and opportunities

ABOUT THIS RESEARCH

Islamic finance – challenges and opportunities was written in co-operation with the Economist Intelligence Unit. It is based on their global survey of 173 executives from the financial services industry with varying levels of involvement with Islamic finance. These represented a diverse spread of institutions: 14 per cent work in Islamic banks, 29 per cent in Sharia-compliant windows within conventional banks, and 20 per cent in conventional funds investing in Sharia-compliant products, while 31 per cent described themselves as other types of investors in Sharia-compliant products.

Our thanks are due to the survey respondents for their time and insight.

KEY FINDINGS



- **Among our survey respondents, more than one-half thought that the global Islamic finance industry would grow by 10-20 per cent over the next three years.**
- **A shortage of expertise in the industry and a lack of regulatory harmonisation are seen as the biggest obstacles to growth, both being cited by over 40 per cent of respondents.**

INTRODUCTION

The troubles afflicting conventional banks since mid-2007 have led to more attention being paid to Islamic alternatives. While the modern Islamic finance industry is still young, it has been growing at rapid rates for several years, largely on the back of an oil-fuelled economic boom in the Middle East. Comprehensive data are lacking, but volumes of sukuk (Islamic securities) issuance surged between 2002 and 2007, with much of the demand coming from non-Islamic investors who were simply attracted by good investment opportunities. With awareness of the industry rising, sharia-compliant commercial and retail banks have expanded their operations, especially in the core markets of the Middle East and South Asia, but also in newer markets with substantial Muslim populations, including Sub-Saharan Africa and parts of Europe. Since then, the subprime crisis has afforded advocates of Islamic finance an opportunity to emphasise sharia principles relating to debt and risk, finding a receptive audience beyond the Muslim world.

For Islamic financers, highly complex structured products such as subprime and derivatives were seen as unacceptable because they were so far removed from their underlying assets. Sharia principles suggest that it is acceptable for financiers to make profits, but these must be based on real assets, not simply making money from money. Risk must be shared between lender and borrowers, as trading in excessive risk (gharar) is prohibited, and the charging of pure interest (riba) is ruled out in favour of profit-and-loss sharing or a fixed-cost mark-up. Since the mid-1960s, there have been various attempts to put these 1,400-year-old principles to work in modern financial institutions. Such efforts have gathered pace since the mid-1990s with the help of a new generation of scholars that are both financially literate and expert in sharia principles.

There appears to be great potential for further growth in the industry, which is still at a relatively early stage. However, there are also a number of challenges associated with developing a new industry with a different approach to risk management. It is notable that although Islamic banks were unscathed by the subprime crisis, many have since suffered from the negative effects of the broader recession, including a collapse in property prices in Dubai, where many Gulf Islamic banks had substantial exposure. The first sukuk defaults occurred in 2009, from two Gulf-based corporates, Kuwait's Investment Dar and Saudi Arabia's Saad Group.

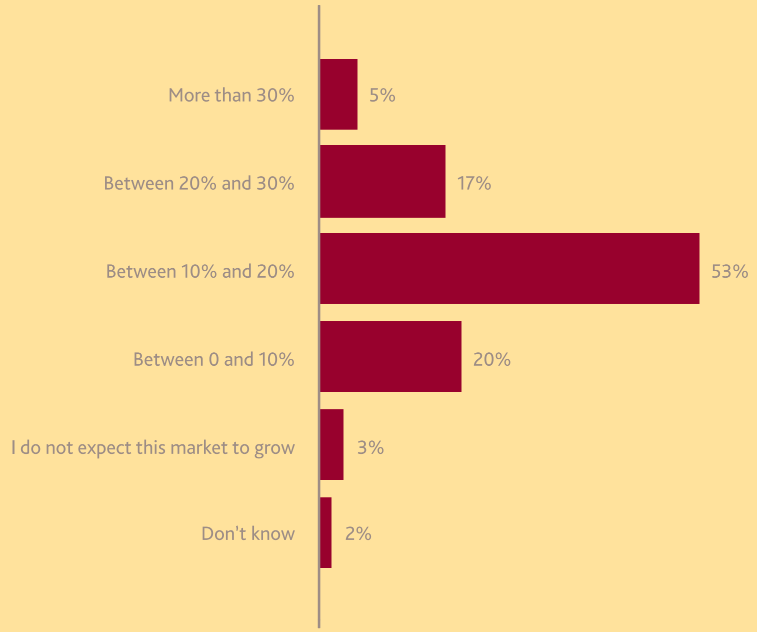
This survey of senior executives from the financial services industry reflects upon the prospects for further growth and product diversification within Islamic finance, while also identifying a number of pressing challenges that the industry will face over the coming years.

- **Just under one-third of respondents thought that Dubai would be the leading international centre for Islamic finance issuance and investment in 2012, while just under one-quarter said it would be the leading centre for Islamic finance trading.**
- **New business development is likely to focus in particular on sharia-compliant investment funds and wealth management.**
- **The core retail products still offer the greatest revenue potential, according to the majority of respondents.**
- **Expansion plans are concentrated in the Middle East, but a few are looking at newer markets.**

MORE THAN ONE-HALF OF THOSE SURVEYED THOUGHT THAT THE GLOBAL ISLAMIC FINANCE INDUSTRY WOULD GROW BY 10-20 PER CENT OVER THE NEXT THREE YEARS.

Of those who thought differently, slightly more tended towards the side of caution, with 20 per cent predicting growth of up to 10 per cent, and 17 per cent predicting growth of 20 per cent-30 per cent – a finding that might have been very different if the survey had been conducted two years ago. The strongest growth potential was seen in the industry's core base of Muslim retail investors, although 17 per cent of respondents also saw scope for a significant increase in demand from state agencies from Muslim-majority countries.

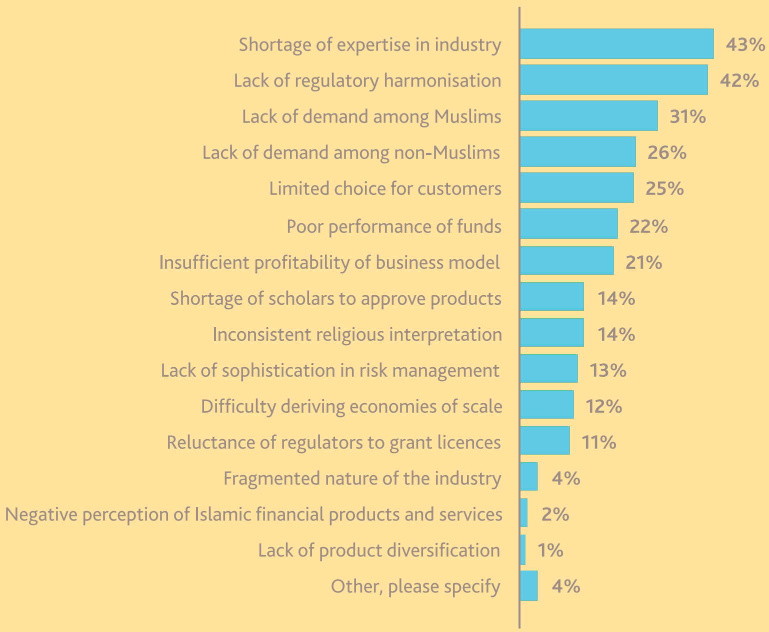
Q. By how much do you expect the global market for Islamic finance to grow over the next three years?



A SHORTAGE OF EXPERTISE IN THE INDUSTRY AND A LACK OF REGULATORY HARMONISATION ARE SEEN AS THE BIGGEST OBSTACLES TO GROWTH, BOTH BEING CITED BY OVER 40 PER CENT OF RESPONDENTS.

Nearly one-third also referred to a lack of demand among Muslims, which could reflect both scepticism on religious grounds, a lack of awareness and concerns about cost-competitiveness. This was less of a concern for respondents in the Middle East (23 per cent) than in Western Europe (30 per cent) where the industry is less established. Demand seems to vary significantly between different Muslim populations, depending on levels of awareness and government support. For instance, Islamic banking is underdeveloped in large North African markets such as Egypt and Algeria, where secular governments have been sceptical about the industry. One-quarter of those surveyed also cited the problem of limited choice for customers. Only 2 per cent, however, saw negative perceptions of the industry as being an obstacle to growth.

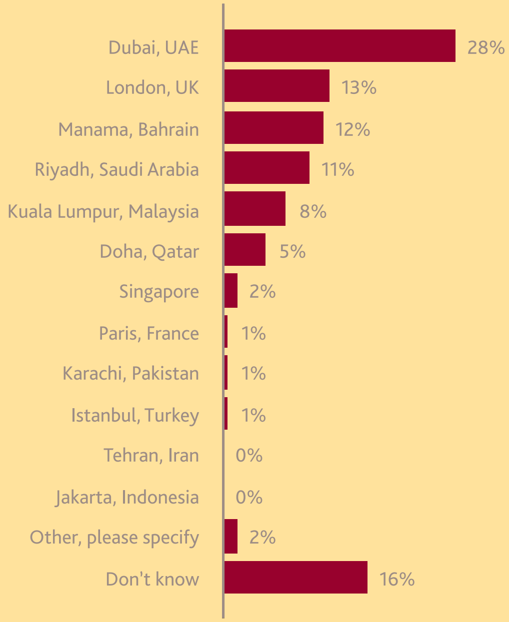
Q. What do you consider to be the main barriers to growth in the Islamic Finance market? Select up to three.



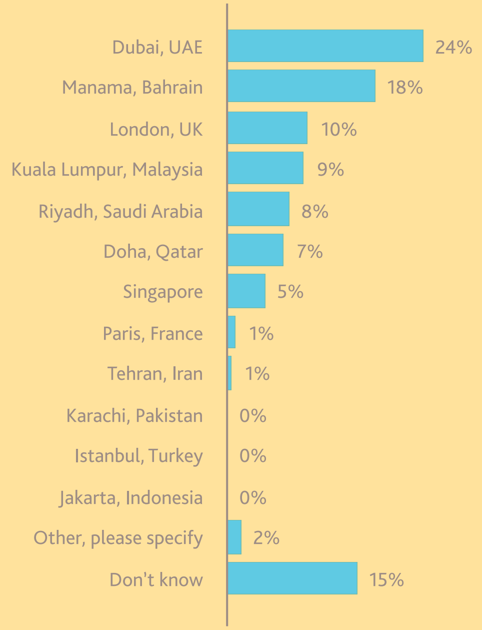
JUST UNDER ONE-THIRD OF RESPONDENTS THOUGHT THAT DUBAI WOULD BE THE LEADING INTERNATIONAL CENTRE FOR ISLAMIC FINANCE ISSUANCE AND INVESTMENT IN 2012, WHILE JUST UNDER ONE-QUARTER SAID IT WOULD BE THE LEADING CENTRE FOR ISLAMIC FINANCE TRADING.

Despite the current weakening of the Dubai economy, a plunge in property prices and financial difficulties at some of its major sharia-compliant lenders, the emirate's recent efforts to attract investment and talent into the financial sector, including the sharia-compliant subsector, still seem to be paying off in terms of perceptions. London was the second most popular choice as the international centre for Islamic finance issuance (13 per cent) and investing (16 per cent). Bahrain – home to the Auditing and Accounting Organisation for Islamic Financial Institutions, which seeks to improve cross-border standardisation of sharia principles – ranked in second place as the centre for Islamic finance trading (18 per cent). Malaysia has been a world leader of Islamic finance and in 2009 has issued more sukuk than the UAE. Yet it was rated as the future international centre for issuance by just 8 per cent of respondents, probably because of an ongoing disagreement between Malaysian scholars and their Gulf counterparts over a number of contracts deemed acceptable in Malaysia but prohibited in the Gulf.

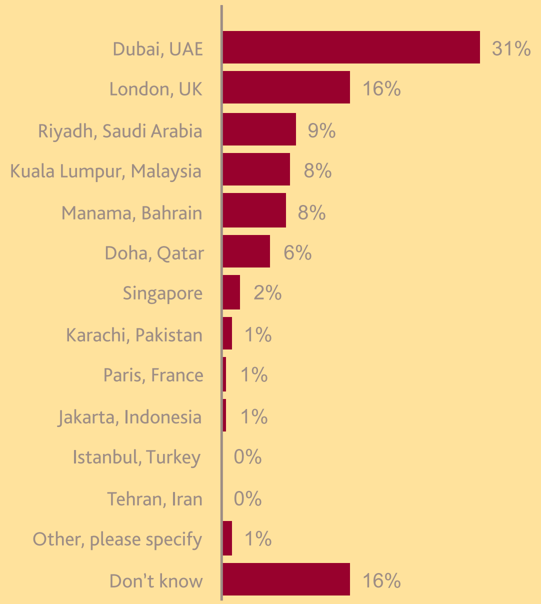
Q. In three years' time, which do you expect to be the leading financial centre for Islamic finance issuance?



Q. In three years' time, which do you expect to be the leading financial centre for Islamic finance trading?



Q. In three years' time, which do you expect to be the leading financial centre for Islamic finance investing?



NEW BUSINESS DEVELOPMENT IS LIKELY TO FOCUS IN PARTICULAR ON SHARIA-COMPLIANT INVESTMENT FUNDS AND WEALTH MANAGEMENT.

When asked what products they planned to introduce in the next three years, just under one-third of respondents opted for funds and the same number again for wealth management, with just over one-quarter saying they were interested in Islamic private equity. This is an area that has developed significantly in the Gulf Arab states in recent years. Perhaps surprisingly, 23 per cent said they were planning to develop Islamic hedge funds, a type of product that has sparked heated theological debate. [1] The findings suggest that the respondents saw particular scope for growth in products tailored to high net worth individuals. In comparison, smaller – albeit still substantial – proportions planned to offer takaful, an Islamic form of insurance (20 per cent), retail bank accounts (18 per cent), and retail loans and mortgages (15 per cent each). Looking at respondents from fully sharia-compliant banks, the vast majority already offered retail services and over 40 per cent were keen to diversify into wealth management and funds, with 38 per cent planning a private equity offering. None currently offer Islamic hedge funds but a strong 29 per cent planned to offer them within three years.

[1] A few institutions already offer such funds, but scholars have been divided over the issue of short-selling, and contract structures are still evolving.

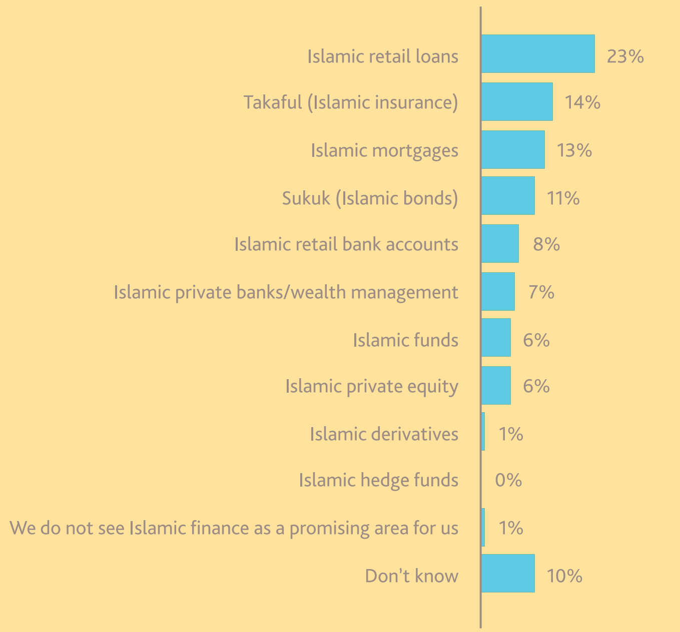
Q. Which of the above Islamic finance products does your institution currently offer and which do you expect it to offer in three years' time?

	Currently		Three years' time		Don't know	
	Yes		Yes		Yes	
Sukuk (Islamic bonds)	31	42 %	18	24 %	31	42 %
Takaful (Islamic insurance)	24	32 %	15	20 %	24	32 %
Islamic mortgages	46	62 %	11	15 %	46	62 %
Islamic funds	36	49 %	22	30 %	36	49 %
Islamic retail bank accounts	42	57 %	13	18 %	42	57 %
Islamic retail loans	38	51 %	11	15 %	38	51 %
Islamic private banking/wealth management	22	30 %	22	30 %	22	30 %
Islamic hedge funds	4	5 %	17	23 %	4	5 %
Islamic derivatives	6	8 %	13	18 %	6	8 %
Islamic private equity	8	11 %	19	26 %	8	11 %
None of the above	1	1 %	1	1 %	1	1 %

THE CORE RETAIL PRODUCTS STILL OFFER THE GREATEST REVENUE POTENTIAL, ACCORDING TO THE MAJORITY OF RESPONDENTS.

Of those surveyed, 23 per cent chose retail loans, 14 per cent Islamic insurance and 13 per cent Islamic mortgages. These results varied significantly by region, reflecting variations in the size and income of the Muslim population and the relative development of the Islamic finance market. For instance, 37 per cent of respondents based in the Asia-Pacific region saw retail loans as offering the greatest revenue potential – more than three times as many as selected any other single option. While 24 per cent of respondents in the Middle East agreed that retail loans would be the most lucrative, sukuk was not far behind, with 20 per cent believing it has the greatest revenue potential. Those based in Western Europe showed more interest in takaful (insurance), selected by 26 per cent of respondents, perhaps reflecting stronger demand for insurance in general, compared with the Middle East, where insurance is not seen as a necessity by most retail customers.

Q. Which of the following Islamic products do you see as offering the most potential as a source of revenue for your organisation?



EXPANSION PLANS ARE CONCENTRATED IN THE MIDDLE EAST, BUT A FEW ARE LOOKING AT NEWER MARKETS.

Over one-third of respondents already offer products and services in the six states of the Gulf Co-operation Council (Saudi Arabia, UAE, Kuwait, Qatar, Oman and Bahrain), which have a strong concentration of high net worth individuals and strong economic growth prospects, as well as being centres for Islamic finance innovation.[2] Of those surveyed, 23 per cent planned to start offering services in the Middle East by 2012, with 20 per cent looking at the broader Middle East. Interestingly, the third most popular market for expansion was the UK (19 per cent), reflecting the City of London's success in branding itself as a hub for Islamic finance, thanks to strong government support and changes in relevant tax laws, as well as its traditional business links with the Gulf and sizeable domestic Muslim population. Even when stripping out all respondents currently based in Western Europe, the UK was the second most popular expansion market (16 per cent) after South-east Asia – home to Malaysia, a world centre for Islamic finance and which attracted nearly one-quarter of respondents. (The Middle East was less highly rated, mainly because over one-third of respondents already operated there.)

[2] The UAE-based Dubai Islamic Bank and the Saudi-based multilateral Islamic Development Bank were among the first modern institutions to offer sharia-compliant loans in the 1970s, while Bahrain is home to 26 Islamic banks and is a centre for theological debate and product development.

Q. In which of the regions above does your institution currently offer Islamic finance products, and in which do you expect your institution to offer products in three years' time?

	Currently		Three years' time		Do not operate in this region	
	Yes		Yes		Yes	
Gulf Council states	28	38 %	17	23 %	9	12 %
Other Middle East	23	31 %	15	20 %	11	15 %
UK	17	23 %	14	19 %	7	9 %
Continental Europe	26	35 %	9	12 %	11	15 %
South-east Asia (including Malaysia and Singapore)	16	22 %	12	16 %	7	9 %
North Africa	11	15 %	3	4 %	14	19 %
Sub-Saharan Africa	6	8 %	5	7 %	16	22 %
South Asia (including India and Pakistan)	16	22 %	7	9 %	11	15 %
Central Asia (including Turkey and Iran)	9	12 %	2	3 %	14	19 %
US, Canada and Mexico	13	18 %	2	3 %	11	15 %
Central and South America	6	8 %	1	1 %	11	15 %
None	2	3 %	0	0 %	2	3 %
Don't know	2	3 %	2	3 %	1	1 %

CONCLUSION

The survey suggests that the crisis facing conventional banks has added to the appeal of sharia-compliant alternatives, although there are still significant challenges for the industry to overcome. Respondents showed an appetite for expanding into a diverse range of products and regions, with Western Europe – especially London – now seen as an important target market as well as the more traditional Middle Eastern and Asian locations.

Looking at first-half bank results for 2009, most major Islamic banks have seen falling profits rather than losses this year. They have generally been well protected by high levels of liquidity. There will be pressure, however, on many institutions to re-address their business models and produce a more diversified investment strategy, which is still difficult when there are limited options for long-term sharia-compliant investment. Corporate sukuk issuance has dwindled this year and there is virtually no secondary market activity, although sovereign sukuk issuance is gradually rising, with significant issues by Bahrain and, for the first time this year, Indonesia. As our survey highlights, a lack of cross-border regulatory harmonisation also remains a problem. Yet with so much attention now being paid to the industry in many parts of the world, there is scope for significant developments over the next three years.

CASE STUDIES

Gatehouse Bank
Building a presence in international capital markets

Gatehouse Bank obtained its licence from the Financial Services Authority (FSA) in April 2008 and is a wholly owned subsidiary of The Securities House KSCC, an Islamic investment company incorporated in Kuwait and listed on the Kuwait Stock Exchange. It also had a sister company, Global Securities House (GSH), authorised by the FSA, which looked after the family interests of the major shareholders.

In August 2009, however, Gatehouse Bank and GSH merged into one entity under the Gatehouse Bank brand. GSH was formed with a dual mandate – to commission the bank and to run the family office for the Group, focusing on real estate and asset management. Gatehouse Bank's focus was on Islamic capital markets. The aim was that both would operate separately, but as the year progressed it became clear that the two businesses were doing the same thing.

"We therefore merged the advisory and asset management expertise of GSH with the capital markets experience of Gatehouse Bank into a single entity and to reduce the costs of running two regulated entities," said Richard Thomas, chief executive of Gatehouse Bank.Gatehouse's main lines of business include Islamic capital markets, real estate, institutional wealth management, Islamic treasury business and sharia advisory services. The bank has a full-time in-house sharia advisory team led by Mufti Muhammad Shikder.

According to Mr Thomas, the bank is focusing on three areas. The first is the role of intermediating capital coming out of the Middle East looking for opportunities in the West which may be investment or direct equity. The second is developing facilities for UK and European corporates, to bring the Islamic finance mandate to them. There is also a focus on internationalising the business across non-core markets and non-traditional jurisdictions, particularly Asia, with a focus on Malaysia with its gateway to opportunities in East Asia.

Gatehouse believes that Islamic finance will expand both in terms of geographic growth and product diversification, although this will depend on the capacity of the sector to absorb capital flows and to innovate competitive products.

“We merged the advisory and asset management expertise of GSH with the capital markets experience of Gatehouse Bank into a single entity and to reduce costs, especially in the wake of the financial crisis which has seen a downturn in the Islamic capital markets”

RICHARD THOMAS, CHIEF EXECUTIVE OF GATEHOUSE BANK.

The bank says it faces numerous challenges, including building its presence in the international capital market to compete with the conventional banks. This will require much more co-operation between Islamic banks, not only locally but also internationally. France is seen as an attractive destination for investment capital, especially in property, although the country still has some way to go in developing its Islamic financial infrastructure.

“We have an ambitious French project under way, which tracks and helps with the development of Islamic finance in France,” said Mr Thomas.

Malaysia is another target country, following the further liberalisation of the Malaysian Islamic finance market in April 2009. Gatehouse sees good two-way opportunities in capital markets, real estate and asset management products.

HSBC Amanah UK
Gauging market appetite

The HSBC Group established its dedicated Islamic finance division, HSBC Amanah, in 1998 in the Middle East. Although the headquarters of HSBC Amanah were subsequently moved to London, only to be relocated to Dubai, the HSBC Amanah business in the UK was launched in July 2003.

The bank was established to serve the particular financial needs of Muslim communities, in this case the UK one. HSBC was the first high street bank in the UK to launch a sharia-compliant home financing product; a current account; takaful (Islamic insurance) services; investment products (equity, income, takaful, sukuk (Islamic securities) and real estate funds) and a pension product.

HSBC Amanah is currently undertaking a full review of its business worldwide. The aim is to give a global feel to the Amanah proposition; to leverage economies of scale; and to see how products can be aligned to local markets, including the UK.

"Business is growing," says Amjid Ali, head of HSBC Amanah UK. "We have managed to build a viable and sustainable business and we have seen strong growth in sharia-compliant home finance."

Amanah Private Banking provides Islamic solutions for high net worth individuals globally that are structured by the Wealth Management Group, which develops Islamic funds in various asset classes.

The bank is also considering commercial financing opportunities in the UK. "We are looking at how to support small and medium-sized enterprises in the UK. We have had many enquiries from customers and we are working on a proposal that will be submitted to the senior management for consideration," explains Mr Ali.

It says its biggest challenge is gauging market appetite for Islamic financial products. In fact, Mr Ali believes there has been a degree of misconception in how much the market players understood about the appetite for such products.

"Islamic finance providers are now much clearer about what the needs of their customers are," adds Mr Ali.

> “If you have somebody good who makes a name for himself then he is actively poached by other providers. This is a major difficulty,”
>
> **AMJID ALI, HEAD OF HSBC AMANAH UK.**

“UK Muslims welcome Islamic financial products as long as they feel they are not penalised for wanting to access products based on their faith. For many, as long as the cost is like-for-like, then they are happy to consider sharia-compliant products.”

HSBC Amanah would like to see a more proactive engagement by scholars and Imams in articulating Islamic finance from a religious point of view. Another challenge is the lack of qualified Islamic finance professionals, particularly on the distribution side of the business.

“If you have somebody good who makes a name for himself, then he or she is often actively pursued by other providers. This is a major difficulty,” says Mr Ali.

HSBC Amanah, like any other financial services entity, has reviewed its growth plans following the global financial crisis. The growth aspirations are still there but there is a greater sense of caution and prudence in managing future growth strategies.

HSBC Amanah UK is also looking at the possibility of passporting its sharia-compliant products to other markets in the European Union. But this is not an immediate goal because the emphasis currently remains on consolidating the Amanah proposition in the UK.

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