

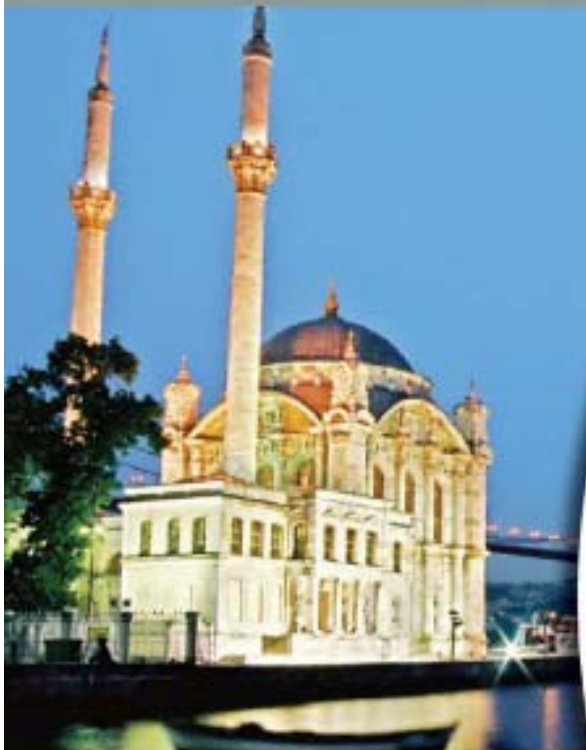
THE INTERNATIONAL



**ISLAMIC FINANCE  
FORUM**

*New Markets*

The Growth Imperative



**Global Economic & Investment Outlook:  
“Confronting The Challenges &  
Unlocking The Opportunities”**

***Baljeet Kaur Grewal  
Managing Director  
Kuwait Finance House***

**13 – 17 October 2008**

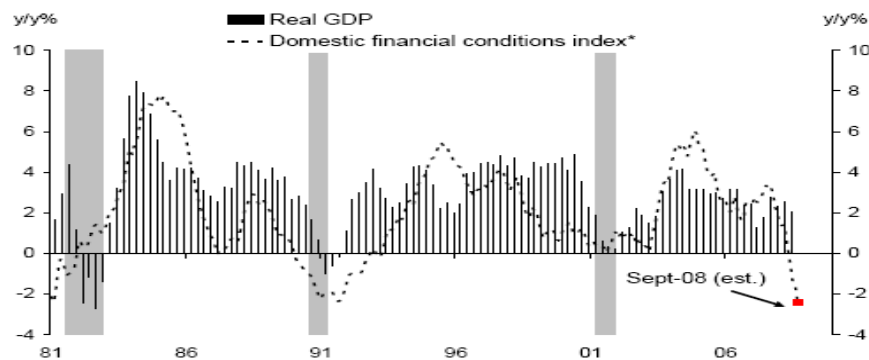
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# SUBPRIME: WHAT HAPPENED & HOW?

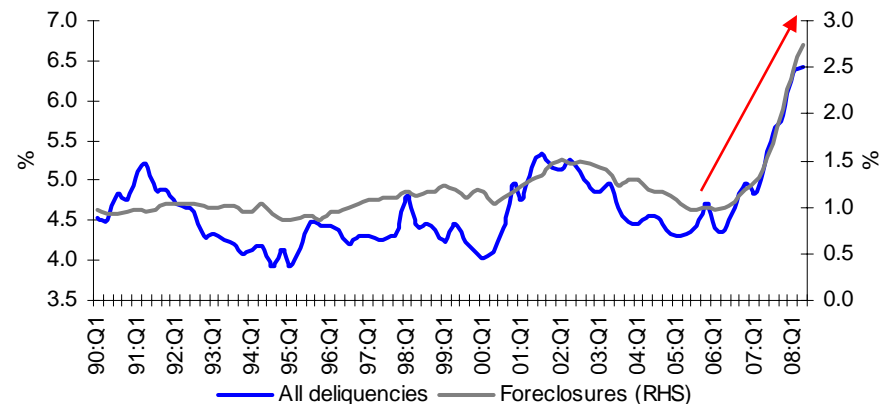
- The subprime mortgage crisis is characterised by the **contraction of liquidity in the global credit markets causing a contagion effect on lending and financing in the banking system**. The downturn in the U.S. housing market, risky lending & borrowing practices, and excessive individual & corporate debt levels have caused multiple adverse effects on the financial system
- The crisis began with the bursting of the US housing bubble and high default rates on "subprime" and Adjustable Rate Mortgages(ARM), beginning in approximately 2005-2006. Prior to that, declining lending standards, an increase in loan incentives such as easy initial terms, and a long-term trend of rising housing prices had encouraged borrowers to assume difficult mortgages in the belief they would be able to quickly refinance at more favorable terms
- Once interest rates began to rise and housing prices started to drop in 2006-2007, refinancing became more difficult. Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and ARM interest rates reset higher. Foreclosures accelerated in the United States in late 2007 and triggered a global financial crisis through 2008. In 2008, nearly 1.7 million U.S. housing properties were subject to foreclosure activity, up 84% from 2006

US' GDP vs. Financing Conditions (1981-Sep 2008)



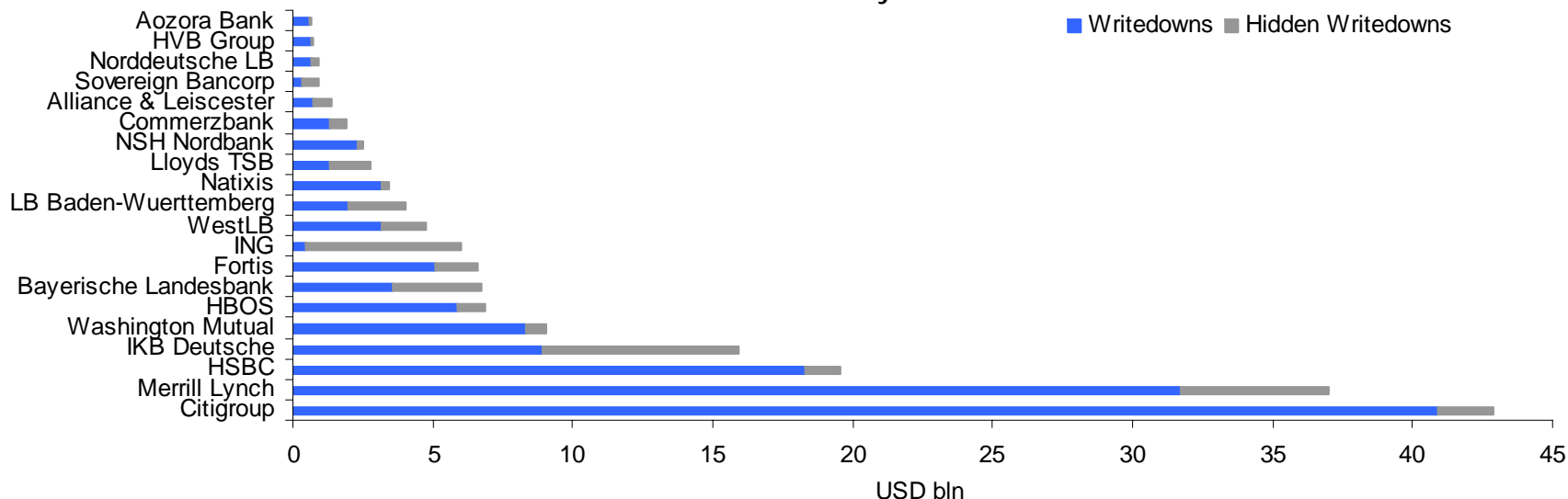
\*Includes M2, bank loans & leases, consumer credit, yield curve, credit spreads & cyclical stocks

US' Delinquencies & Foreclosures as % of Total Loans



# CDO WRITEDOWNS BY FINANCIAL INSTITUTIONS

Writedowns and Credit Losses by Selected Banks



\*Hidden writedowns = additional writedowns expected among major banks that are not reflected on income statements

## Projected Future Losses for Banks/ Institutions

Banks/ Institutions	Total (USD bln)	Job Losses
IKB Deutsche Industriebank	44.2	8,900
Royal Bank of Scotland	13.9	2,780
Credit Suisse Group	10.1	1,565
Deutsche Bank	101	470
Credit Agricole	8.6	500
Barclays	7.5	900
Bayerische Landesbank	6.9	350
<b>Total</b>	<b>101.3</b>	<b>15,465</b>

- The problem is not just limited to the mortgage industry, but has spread to the broader financial industry as financial institutions like banks, asset management companies, insurance companies and pension funds
- Major banks & other FIs globally have reported losses of approx. **USD600bln as of 6<sup>th</sup> Oct 08**, and this continues to increase
- As a spill over effect, mortgage delinquencies and property foreclosure are set to increase further

# IMPACT OF SUBPRIME ON GCC

*The fallout from the US crisis has so far been confined to equity and financial markets in the GCC. However, we caution that there may be potential fallout in financial services, real estate and the overall demand for consumption:*

## 1. Correction in oil prices:

- One of the immediate repercussions of the US crisis on the global market is the sharp decline in oil prices, which have already lost nearly 50% since the USD150 peak in August. A plunge in crude prices means much lower earnings for GCC countries and this could hit their economies, budgets and foreign assets
- The first signs of a correction in oil prices were felt in the stock markets, which have seen a sell off in the last weeks. Government agencies (i.e. KIA, ADIA, QIA) have been reportedly 'supporting' trading activity on their various exchanges
- We expect the price of oil to continue to weaken on worsening recession & economic data and lower consumption numbers from the US. Oil price is at USD93.03 on 2nd Oct, but dipped below USD86pb in intraday trading. Expect further pressure on oil prices (oil price closed USD87.81 per barrel on 6<sup>th</sup> Oct)
- Technical analysis shows first support level for oil price is at USD86.90 per barrel, second support level at USD72.90 per barrel and third support level at USD50.30 per barrel

Crude Oil Price Trend (2007-2008YTD)



# IMPACT OF SUBPRIME ON GCC LIQUIDITY

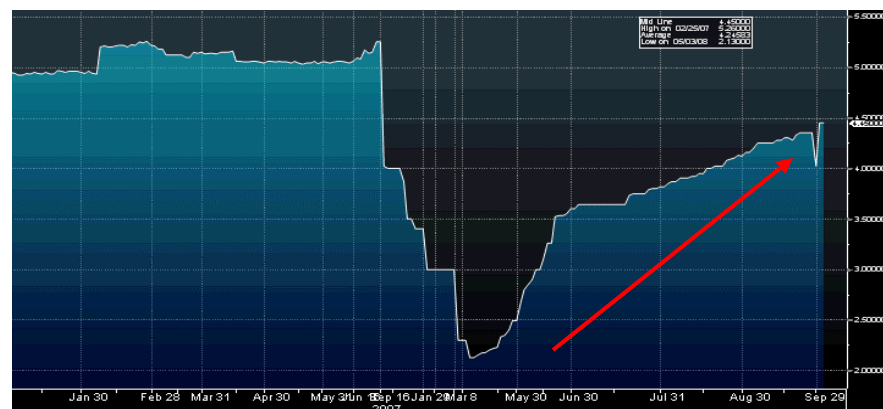
## 2. Liquidity drying up in GCC:

- Cash crunch in the global financial system also means less money for GCC banks and this will stifle their ability to finance projects, thus contributing to a reversal of a steady upward trend in their GDP. Financial markets are already facing liquidity issues in USD funding, which had led to a surge in domestic lending/borrowing
- Eg. Dubai Electricity & Water Authority (DEWA), in June 08, completed a AED2.75bIn (USD749mIn) sukuk priced at 125bps over Eibor. A year ago, DEWA issued a USD1bIn sukuk, priced at 25bps over Libor, reflecting higher dollar funding cost & the preference of local-currency over dollar funding due to global credit crunch
- However, the demand for local currencies is now outstripping supply and the rising cost of borrowing in local currencies may drive issuers to return to dollar financing moving forward, but not in the immediate future
- Latest statistics support this view. In Saudi Arabia, 3m Sibor stands at 4.45%, lifting the spread between 3m Sibor and SAMA key interest rate to 245bps, the highest since Oct 02. Meanwhile, 3m Libor currently stands at 4.32%, meaning that the cost of riyal funding has exceeded dollar funding for the first time since early 06
- Hence, a return to dollar funding is anticipated for corporate loans and bonds in line with rising GCC project financing, *but only when USD liquidity returns, which implies only when the US financial markets get better*

3m Libor Trends (2007-2008YTD)



3m Sibor Trends (2007-2008YTD)

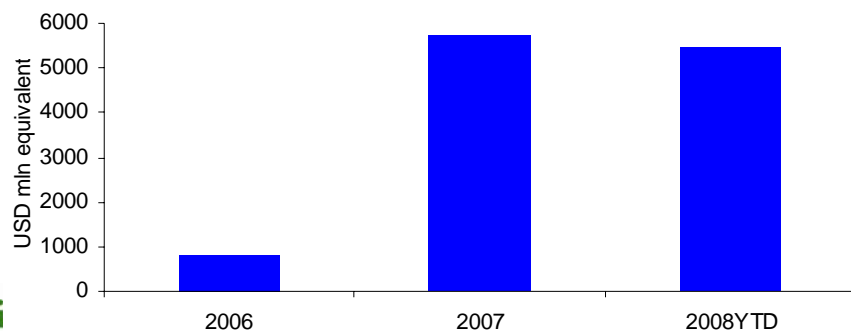


# IMPACT OF SUBPRIME ON SUKUK MARKET

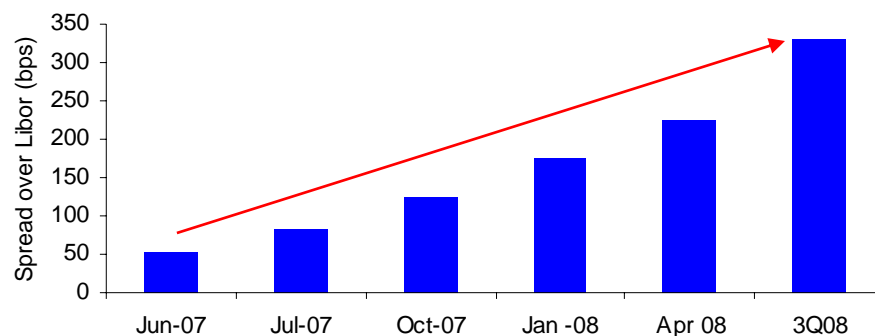
## 3. Tougher Sukuk market

- The weaknesses in global credit markets stemming from the US subprime woes had a bearing on the sukuk market, where new sukuk may have to be either delayed or priced slightly higher to reflect rising debt market volatility as well as the slight drop in investors' demand for the sukuk
  - Dana Gas, the first victim of the subprime turmoil, postponed its USD1bln issue from July 07 to Oct 07 at higher cost
  - Pricing of Ithmaar Bank's USD300mln sukuk was delayed
  - National Bank of Abu Dhabi delayed its USD1.7bln bond programme until conditions improve in global debt markets
  - Amlak Finance delayed its plan to issue USD260mln mortgage-backed Sukuk scheduled for end-07
  - In Malaysia's MISC (national shipping co.) deferred the sale of its planned USD750mln 10-year dollar-denominated bond issue
  - Saudi Basic Industries Corp was forced to lower the senior unsecured bond portion of its financing to buy GE Plastics from around USD2.76bln to USD1.5bln and raise the bank loan portion from USD5.4bln to around USD6.6bln
- **GCC banks that announced subprime-related losses - (1) GIB of USD1bln, and (2) ABC Bank USD640mln**
- The marketability of sukuks has become tough. The same buyers for sukuks, also buy conventional bonds, and as a result, institutional buyers of papers have not been aggressively in the market
- The market also demands higher premium for credit, and sukuks with superior quality. It's a buyers market, and as such we anticipate more sukuk issuers to postpone their issuance until global credit market stabilise

GCC Local Currency Denominated Sukuk (2006-2008YTD)



HSBC-DIFX Islamic Bond Index Trend (Jun 07-3Q08)



# IMPACT OF SUBPRIME ON GCC ECONOMIC SECTORS

## 4. Potential correction in real estate markets

- The liquidity crisis in the US, spilling into GCC markets could lead to a cooling off in property markets, especially in Dubai, and to a lesser extent Bahrain, where the real estate markets are highly leveraged. The same factors that caused the subprime crisis in the US are prevalent in these 2 markets
- In markets like Dubai, where foreign ownership is at its high, and in most instances with foreign funding, the likelihood of real estate distressed assets poses a slight risk to the correcting property market
- As real estate becomes cheaper in the US and home markets, the take-up rates of new launched high-end projects will be under pressure as foreigners consider home markets purchases

## 5. Inflation cooling off

- This crisis has started to depress the swelling liquidity around the world and this will adversely affect the Gulf, where excessive liquidity has been blamed for a sharp rise in inflation rates and a consumption boom
- The decline in liquidity will cool down the boiling economies of the region, reverse a sharp increase in prices, and curb inflation in regional states. We could start seeing inflation come off in the GCC by 1Q09

## 6. Move to Islamic Banking

- A subprime crisis would not occur in an Islamic banking system as subprime mortgages (selling debt on debt) is not Syariah compliant
- Islamic transactions are asset backed, and in structures like Ijarah, Musyarakah etc the assets are ring-fenced around the securitised structure
- Ratings of sukuk take into account the assets in a structure, as such provide a true reflection of risk on each sukuk, in addition to a rating on the issuer
- Islamic banks will only lend to the extent of their deposit base, and do not borrow from the credit market through structured notes / CLOs as these instruments are not Syairah compliant. As such, this has shielded the Islamic industry from the subprime fallout

*Overall, while GCC is in a much better fiscal situation to withstand the global economic crisis, we caution that the threat from a liquidity crunch in USD, a prolonged decline in oil prices and a correction in real estate markets could lead to an economic slowdown, although not as pronounced as the US*

# ISLAMIC BANKING OPPORTUNITIES IN ASIA

## Indonesia

- In 07, Shariah banking assets soared by 30% to IDR30tln or 1.7% of the country's total banking assets, reflecting huge growth potential
- Central bank targets for Islamic banking assets to reach IDR91.6tln or 5.25% of total banking assets by end-08
- Islamic banking in Indonesia is projected to grow at a CAGR of 52% from 2008 to 2010 to IDR11tln (USD13bln), underpinned by large Muslim population, low penetration of Shariah banking & improvement in regulatory framework

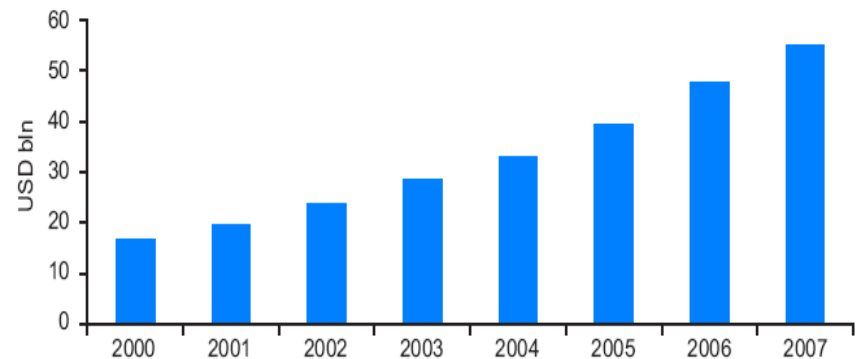
## Thailand

- Programme to develop the Southern Provinces as a hub for halal foods creates opportunities for Islamic banks/ financing (via Mudharabah & Musharakah). Thailand's halal food exports estimated at THB70bln per year (~10% of total imports by Muslim countries)
- The government's 5-year mega infrastructure budget worth USD38.5bln is expected to boost construction-related sectors, hence the potential for **infrastructure & real estate financing**
- **Home financing** is another area to tap. In 07, housing loans granted by commercial banks grew by 9.7% y-o-y
- In 07, only 17% of Thailand's population owns a life insurance policy vs. Japan's 80% and Hong Kong's 70%, this represents a potential for **Takaful market**

## China

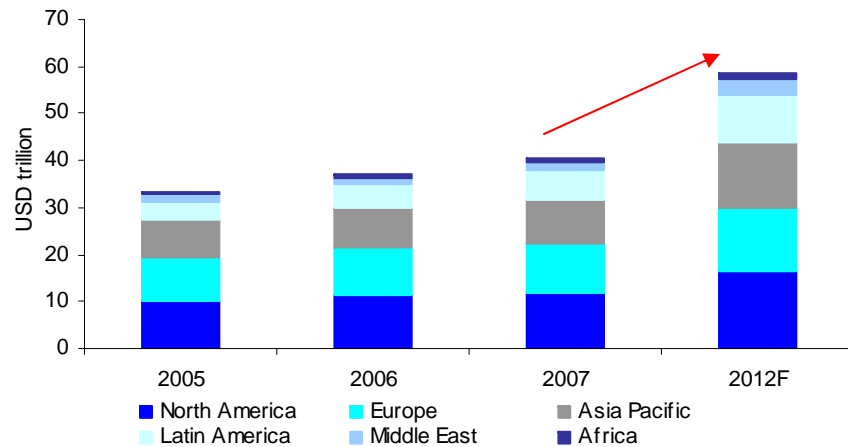
- China's total banking assets grew 25.8% to USD7.3tln in 07. Total deposits rose by 15.2% to USD55bln in 07. A large base for Shariah-compliant **retail banking**
- Opportunities for Islamic banking also include the **debit card industry and rural banking services**
- During 2004-06, housing loans granted grew by CAGR of 19.86%. The country's large population & favourable demographics offer potential for **Islamic home financing**
- China has the world's 5th largest number of households with more than USD1mln in liquid assets. The number of wealthy families with financial assets worth USD100,000 to USD1mln are also expected to increase from 3.25 million in 2007 to 6.4 million by 2011, forming a market for **Islamic wealth management**

China's Banking Sector: Deposits Growth Trend

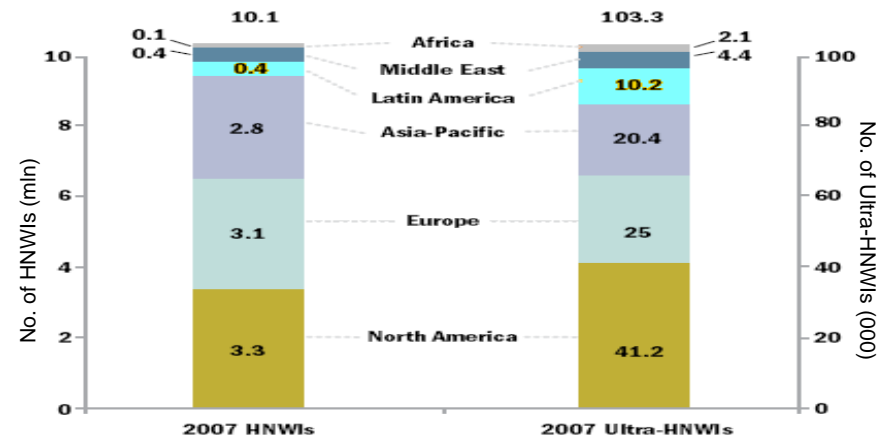


# HNWI GROWTH OUTLOOK

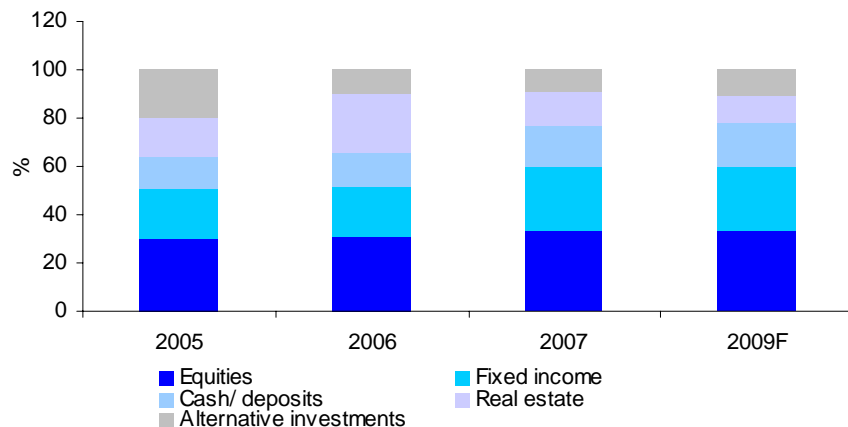
HNWI Financial Wealth Forecast by Region (2004-2007)



Geographic Distribution of HNWIs & Ultra-HNWIs (07)



HNWIs Allocation of Financial Assets (2005-2009F)



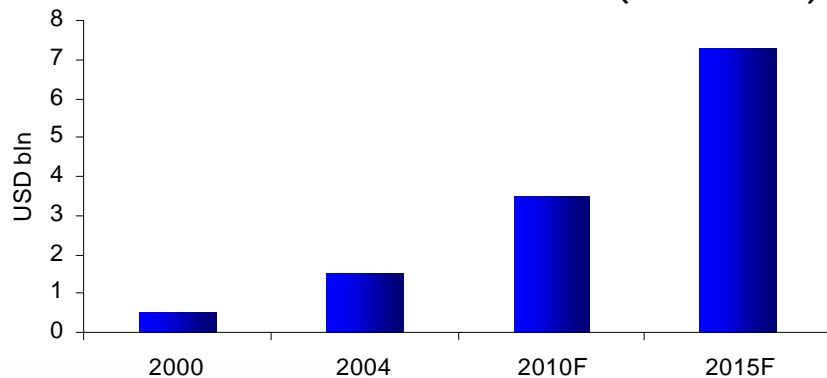
- In 2007, total HNWI wealth grew by **9.4% to USD40.7tln**, while the number of HNWIs rose by 6.0% to 10.1mIn
- Ultra-HNWIs posted the highest gains of any wealth band, both in population, up 8.8%, and total assets, up 14.5%
- By 2012, global HNWI wealth is projected to reach **USD59.1bIn, rising by 7.7% per annum**
- HNWIs allocation of financial assets in 07: equities, bonds, cash/ deposits, real estate, alternative assets
- Increasing trend towards alternative investments such as structured products, foreign currencies, commodities, private equity, venture capital

# TAKAFUL CONTRIBUTIONS WORLDWIDE

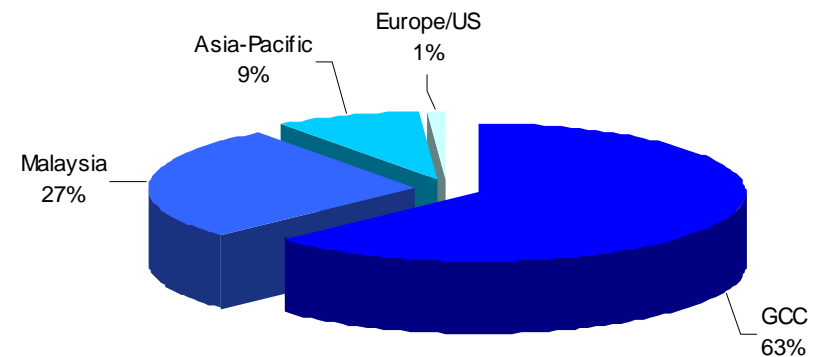
## Factors fuelling the growth of Takaful worldwide:

- **Growing demand for Shariah compliant products.** Existing Islamic banking customers are looking for an ever-broader range of Islamic financial instruments
- **Reduction of state-sponsored welfare benefits.** There is a growing trend towards the gradual reduction of state welfare benefits. This encourages Takaful operators to start analysing and targeting the respective needs of the different customer segments
- **Abundant liquidity.** Sustained high oil prices are contributing to the growing class of affluent individuals, thus encouraging this new class to give more thought to other aspects such as savings, investment and protection in the form of insurance
- **Increasing levels of FDI.** Higher levels of FDI in the infrastructure & real estate sectors are expected to contribute to higher premiums written in GCC
- **Growing government & regulatory support.** Supportive authorities create a conducive environment for takaful to grow and thrive
- **Growth of retakaful capacity.** International re-insurers are allowed to operate in local markets
- **New distribution channels.** Takaful operators offer product lines via internet or hooking up with a bank

Global Takaful Contribution Trend (2000-2015F)



Global Takaful Contribution by Region (2007)



# FACTORS DRIVING ISLAMIC FINANCE GROWTH

We are optimistic on the growth prospects of Islamic finance globally, given the following factors:

- ✓ Robust economic landscape in the GCC and Asia, coupled with rising wealth and strengthening demand for Shariah-compliant investments point to immense potential for further growth of the industry
- ✓ Encouraging demographics and the proactive measures taken by jurisdictions worldwide to promote the development of Islamic finance
- ✓ Industry growth will be strengthened further by improvements in the Islamic finance industry architecture, development of government-backed Islamic financial centres as well as greater awareness and global technological development
- ✓ Government-linked/ top tier companies in the Middle East and emerging Asia (financial, real estate, oil & gas and transport sectors) are looking for funds on the back of massive infrastructure and construction projects in the regions
- ✓ By 2020, the total Muslim population would have increased to an estimated 2.5 billion from 1.5 billion currently

# KFH GLOBAL INVESTMENT RESEARCH



THANK YOU

