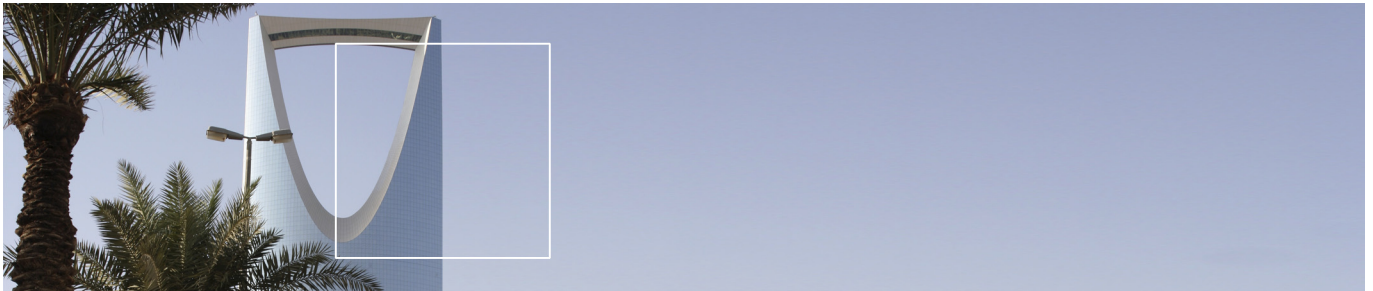


Islamic finance comes of age

Joint opportunities for Western and Arabic financial institutions



With the recent announcement by the Saudi capital market of four IPOs in April 2009, Islamic finance is riding high. The traditional values of Islamic finance are growing in appeal for Western investors seeking a safe haven from the current financial storms. With capital market regulators in the Middle East working hard to improve the region's regulatory system and to offer a wider range of Shariah-compliant investment vehicles, new opportunities are opening up. Arthur D. Little identifies the markets and countries that Western financial institutions should focus on in 2009 if they do not want to miss out.

With the collapse of conventional financial markets, many traumatized investors are seeking a return to conservative and ethical financial practices. Due to its strict ethical principles, strong performance and resilience, Islamic finance¹ is now considered a potential alternative to conventional finance. The credit crisis gives Islamic finance a chance to shine and some Middle East and North Africa (MENA) capital markets are ready to profit from the global downturn.

Despite the shrinking even of the Islamic finance market and exposure to a degree of risk through real estate, MENA markets remain attractive for Western investors. The Gulf Cooperation Council (GCC) markets are expected to recover in the second half of 2009 because of the enormous liquidity reserves they have accumulated in recent years². Other recent developments have also increased the region's appeal: governments have made substantial investment in the education system, regulatory processes have been reorganized and consolidated, accounting standards have been strengthened and better communication and market research have helped increase transparency and efficiency. In addition, Islamic financial institutions have started to introduce innovative and diversified products to attract more investors locally and cross-border.

A recent study by Arthur D. Little takes a closer look at ten capital markets in selected Islamic countries: Kingdom of Saudi Arabia (KSA), Bahrain, Qatar, Kuwait, Oman, United Arab Emirates (UAE), Malaysia, Egypt, Morocco and Tunisia. The study identifies specific opportunities and challenges for each market.

Current state of Islamic finance

The growth in Shariah-compliant assets has been dramatic over the past decade. Current global Islamic finance assets stand at US\$800 billion and could hit US\$4 trillion by 2015. With an annual average growth rate of between 10 and 20%, Islamic finance is among the fastest-growing financial industries³. However, all MENA countries are not performing equally.

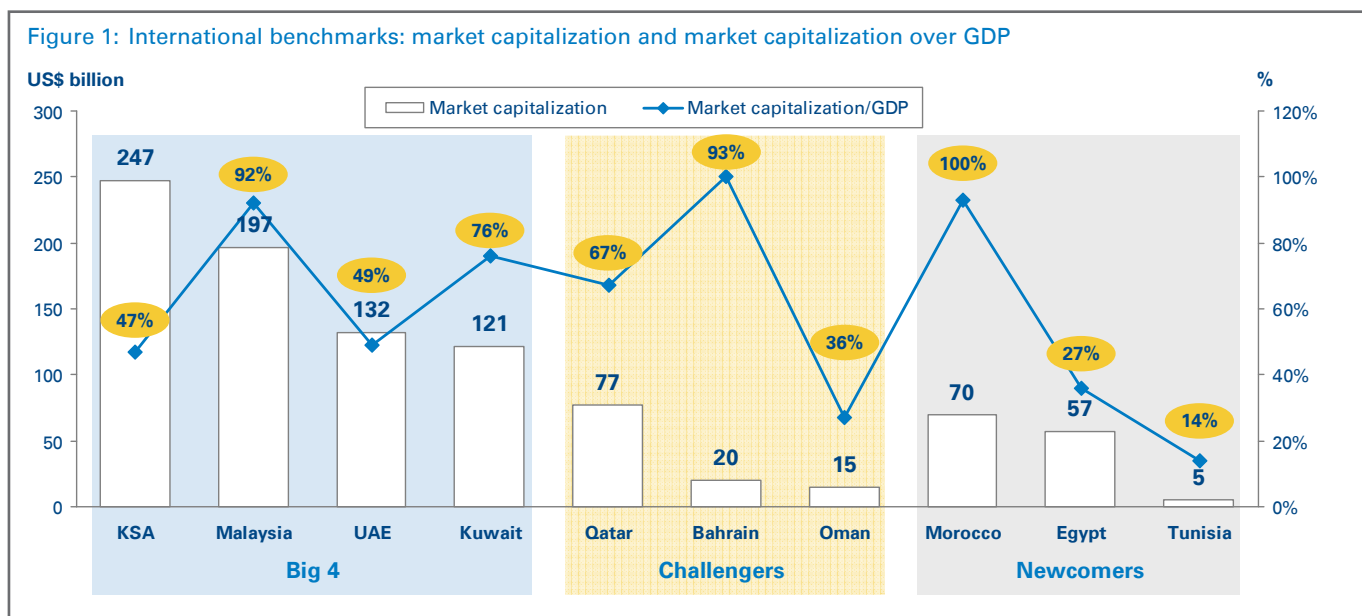
Based on an analysis of market capitalization, market capitalization over GDP ratio (see figure 1 overleaf) and share of Islamic assets in total assets, the countries included in the study can be divided into three groups: the big 4, the challengers and the newcomers.

The "big 4" group contains the KSA, Kuwait, Malaysia and the UAE. Capital markets in these countries are highly developed. The market capitalization is high as is the share of Islamic assets. For instance, in Malaysia and Kuwait the market capitalization over GDP ratio is 92% and 76% respectively. KSA, by far the largest Arabic capital market, also has the largest concentration of Islamic finance assets (40%), followed by Kuwait (21%) and the UAE (20%)¹. Other distinguishing features of these markets are the initiatives by governments and financial institutions to promote financial education and to offer a broader range of financial products.

¹ Islamic banking includes here the full banking system and banking activities that are either consistent with Sharia (Islamic law) or are practiced in Islamic economic systems.

² MENA report, 2009

³ Research bulletin no. 11, Gulf One Investment Bank, October 2008



Qatar, Bahrain and Oman are credible **challengers to the big 4**. With a market capitalization over GDP ratio of 100% and a 15% concentration of Islamic finance assets, Bahrain has repositioned itself strongly in the global ranking. Business diversification in its finance industry is still very low. This might change soon, though, since Bahraini Bank Al Baraka recently announced that it would co-found the world's largest pure sharia conform bank with a starting capital of US\$10 billion by year end. In 2008, Qatar had the fastest-growing economy in the Middle East. Qatar's market capitalization is over US\$77 billion and its market capitalization over GDP ratio is high, but the share of Islamic finance assets is only 5% of total assets. Oman's capital market is relatively small in terms of market capitalization. Thanks to governmental incentives, it is nonetheless attractive. The Oman securities market is very accessible to foreign investors and the financial services industry is well regulated.

The **"newcomers"** are Egypt, Morocco and Tunisia. In 2007 Morocco and Tunisia moved to authorize Islamic finance while Egypt recognized the value of Islamic banking products in 2008. Morocco dominates the newcomers group in terms of market capitalization and market capitalization over GDP ratio. However, with a 2% concentration of Islamic finance assets, Egypt has the most developed Islamic finance industry. While the Egyptian government is launching the policies and measures required to create an appropriate investment climate and the Tunisian government is starting to encourage the inflow of investment, Moroccan authorities remain vigilant. In Morocco, for instance, Islamic banks are considered by some to be tied to Islamic political parties. Licenses have consequently been refused.

Figure 2 shows the current state of development of each of the analyzed capital markets, including comparison with other global capital markets.

Opportunities for market players

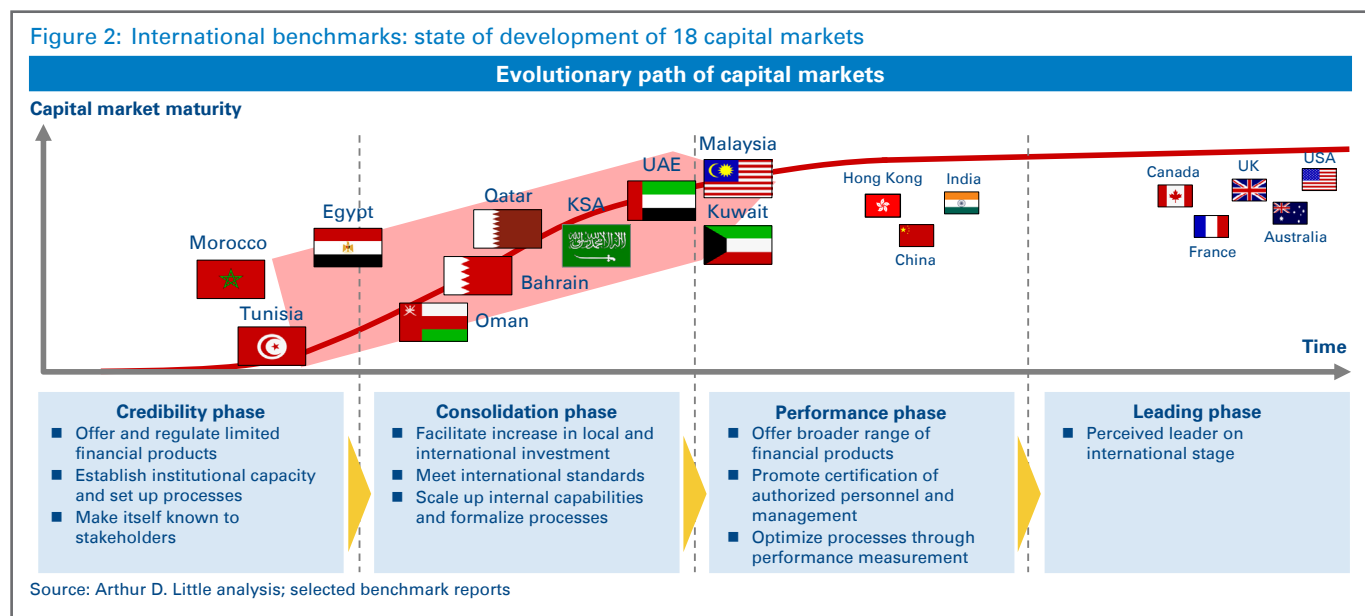
Islamic bonds (sukuk) are still the most popular and rapidly growing type of Islamic finance product but the sharp decline in the sukuk market in 2008 has eroded investors' confidence and they are now looking for other opportunities. There are a wide range of alternative opportunities in the GCC countries and Malaysia, while the range of options in Egypt, Morocco and Tunisia is narrower.

GCC countries and Malaysia

In the GCC countries and Malaysia **syndicated lending** performed particularly well in 2008. As the sukuk market contracted, investors turned to syndications. Real opportunities exist in this market because there are no truly established leaders.

Enormous opportunities also exist in the **project finance** sector. According to the Gulf One research bulletin issued in October 2008, the GCC region alone has a gap in infrastructure financing worth over US\$1 trillion over the next 5 - 10 years. Islamic project finance deals accounted for less than 10% of all GCC project finance deals in 2007 but they could reach US\$25 billion by 2012, accounting for 25% of the total project finance market. Furthermore to build confidence, enhance the creditworthiness of Shariah-compliant projects and attract foreign investors to the Islamic project finance industry, some governments have started to provide financial guarantees, including guarantee accounts. For example, the UAE government has appointed Dubai Islamic Bank as an official escrow account agent.

In addition, the **refinancing and equity market** for specialized financial players, such as **leasing companies**, is of interest to Islamic financiers. Funding in this market is currently limited and asset-based financing principles comply with Shariah.



The KSA capital market offers mainly equity. Swaps have just been introduced but other debt and investment products are not currently available. The first area in line for development is the **mutual funds** business; a fast-expanding population creates the perfect ground for the growth of an effective pension system, which will be crucial for mutual fund businesses.

In Bahrain, the central bank is playing a leading role in introducing innovative and diversified products. These include many **structures used in conventional finance** which have been modified to comply with Shariah principles.

According to Standard & Poor's, the Qatari insurance sector presents good long-term prospects, especially in **health insurance**.

In Malaysia, the Securities Commission has introduced the "Guidelines on Wholesale Funds" which give licensed fund managers greater flexibility to provide innovative products, including those that incorporate **alternative investments** strategies.

In parallel with these developments in different countries, some well-established banks are re-inventing their commercial banking business and focusing on **Small and Medium Enterprises (SMEs)**. In KSA, the Ministry of Commerce sees the potential for a Small Cap Market for around 800 SMEs in the next two to three years. Some market players also show great interest in **Shariah-compliant IPOs**.

Despite the bursting of the real estate bubble, Dubai has two advantages over other MENA capital markets and can therefore be expected to recover more quickly. First, Dubai is the most global market in the MENA region. Second, Dubai has already experienced astronomical growth. Thus, the UAE **real estate** market is expected to start recovering in 2011.

Egypt, Morocco and Tunisia

In Egypt, Morocco and Tunisia, Islamic finance is perceived as an opportunity for creating capital and fostering economic development. As a result, there are opportunities in **project financing** for major real estate, industry and tourism projects.

Challenges for MENA capital markets

Islamic finance has made tremendous progress in recent years. However, the MENA capital markets still face many challenges.

Islamic finance is not immune from risk. Its fragmented nature and its high concentration on a narrow range of sectors make it **vulnerable to sector-specific shocks**. For example, the current global financial crisis has disproportionately affected the real estate industry and thus destabilized the UAE capital market. The instability in oil prices could also create a liquidity shortage, particularly in KSA, Bahrain, Qatar and the UAE.

As most GCC countries do not have strong inflation-fighting and macroeconomic stability systems, there are growing **inflationary pressures** in this region. In 2008, Saudi Arabia, Oman and UAE experienced a big jump in inflation.

Despite huge efforts, the **legal, institutional and regulatory environment** in which Islamic finance operates is still weak and problematic in most MENA countries. In Bahrain, Oman, the UAE, Egypt, Morocco and Tunisia, regulatory processes must be strengthened in order to increase transparency in the market.

Additionally, Islamic finance is promising but not yet popular in Tunisia due to a **lack of information**. In Morocco, there is a higher tax on Shariah-compliant financial products than on conventional ones because some associate Islamic banks with Islamic political parties.

Recommendations for Western institutions

Western private banks and wealth managers need to gain credibility by offering **strong research reports** on Arabic local markets thereby helping to increase transparency in those markets.

Another option for Western institutions is to step up **collaborations** with their counterparts in the Islamic world with a view to launching Islamic alternative investments products. Many reputable international players, such as Deutsche Bank, HSBC and Barclays Capital, have already initiated such partnerships.

Western institutions could also offer local players and authorities **exchange programs** for financial market specialists in various business areas in order to speed up market development.

Islamic Finance warming up again in April 2009

- The recent appointment of H.E. Muhammad Al-Jasser as Chairman of the Saudi Arabian Monetary Agency (SAMA) is expected to boost Islamic financial services in KSA, including an increase in international license applications.
- In cooperation with the World Gold Council (WGC) and the Dubai Multi Commodities Center (DMCC) a Shariah-compliant tradable security backed by gold, the first of its kind, will be traded on the NASDAQ Dubai stock exchange in mid 2009. This security will capitalize on the rush into gold and the increasing popularity of the Islamic finance market.
- The Islamic Development Bank (IDB) plans to increase its lending this year by 15% to US\$4.5 billion. This will include raising funds from an as yet unspecified Shariah-compliant bond issue (sukuk) in the agricultural sector.
- SABB Takaful Insurance, a member of HSBC Group and traded on the Tadawul in KSA, has recently been named "Best takaful provider" by Euromoney and has entered a partnership with Saudi Arabian Airlines to provide Shariah-compliant travel insurance. In addition, the Capital Market Authority (CMA) of KSA has recently approved four further insurance IPOs, one of which specializes in takaful insurance. Similarly, many Malaysian and Indonesian takaful players are now reaching out to the key Islamic banking players in the Middle East.

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