

NCB CAPITAL

**How to position Islamic
investment banking for the
upturn?**

What has the crisis taught us?

Dr Jarmo T. Kotilaine
Chief Economist

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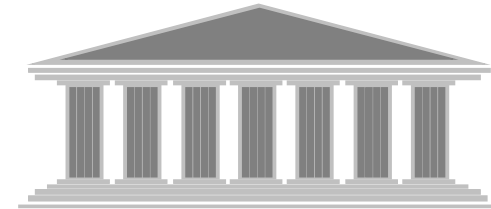
WHERE ARE THE RISKS?

The crisis has revealed structural weaknesses...

- The regional financial sector is narrow and shallow in terms of both the structure of the market and range of instruments available for investments.
- Three principal choices:
 - ✓ Bank deposits / Money market
 - ✓ Equities
 - ✓ Real estate



Investors



Bank deposits / Money market



Equities

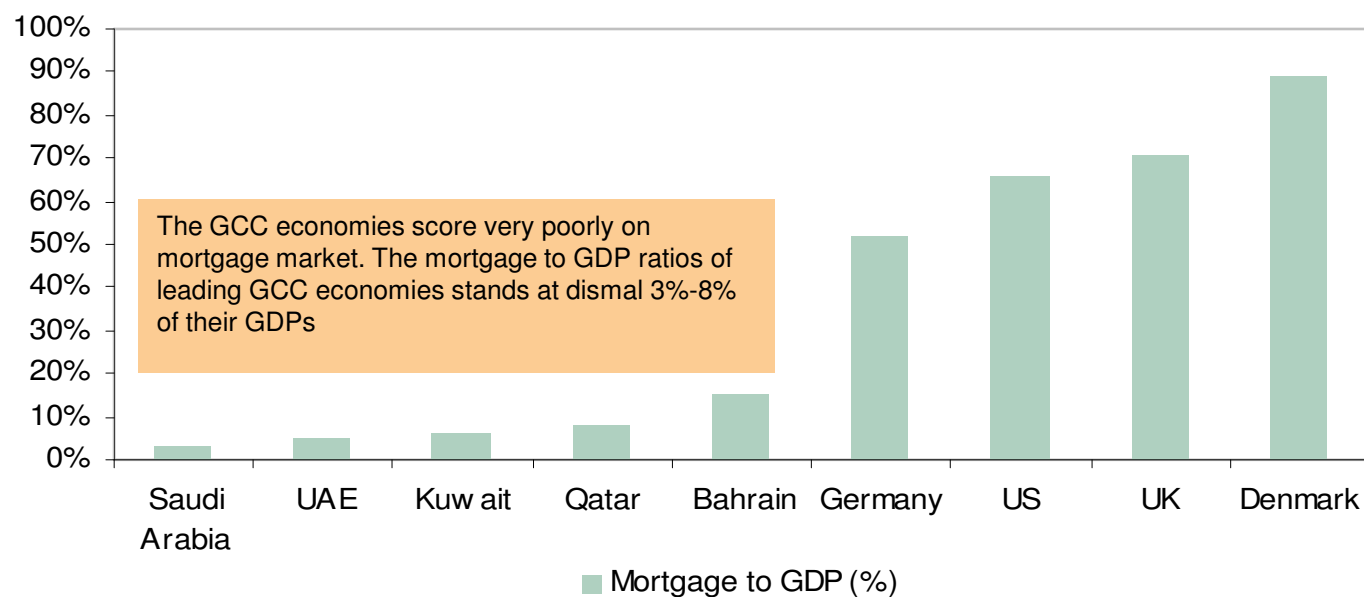


Real estate

...including limited range of options for investors

- The structure of markets, range of instruments, and learnt investor behavior promote myopia.
 - ✓ No proper mortgage markets
 - ✓ Little long-term housing finance
 - ✓ Retail investor-driven, volatile equity markets
 - ✓ Few options and a lack of history of long-term collective saving schemes

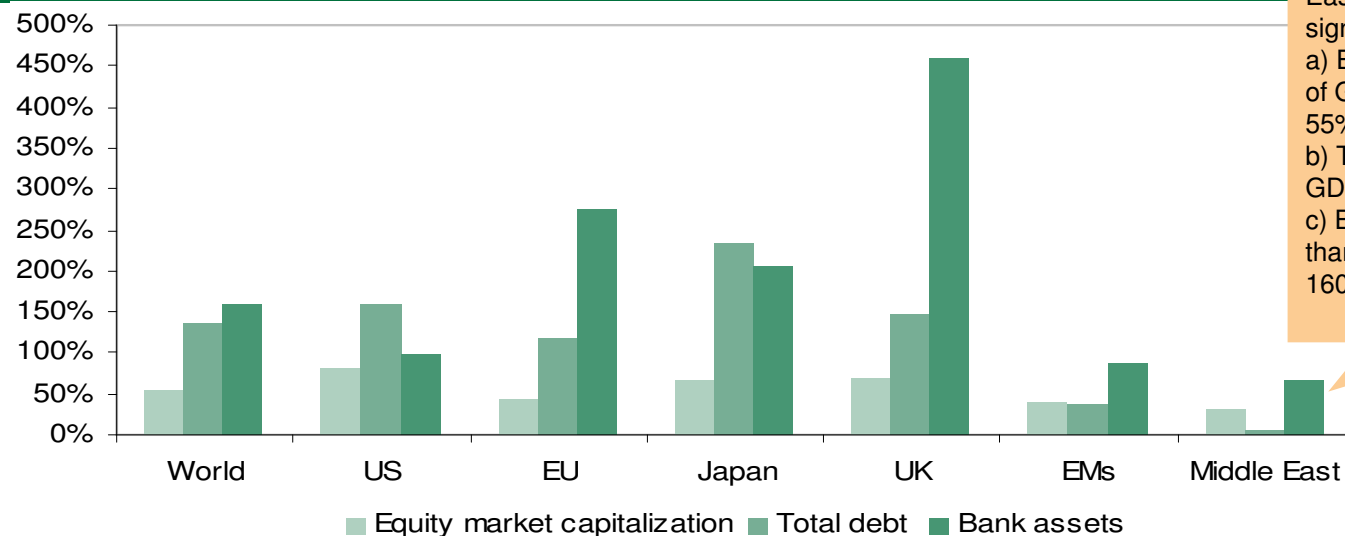
Mortgage-to-GDP ratios of key advanced and emerging GCC economies



Source: IMF, NCBC Research

Underdeveloped markets and uneven regulatory framework

Key financial market indicators as a % of GDP (in 2008)



On all the parameters, the Middle East financial markets remain significantly underdeveloped.

a) Equity market capitalization at 33% of GDP is less than world average of 55%

b) Total debt outstanding at 5.8% of GDP is below world average of 137%

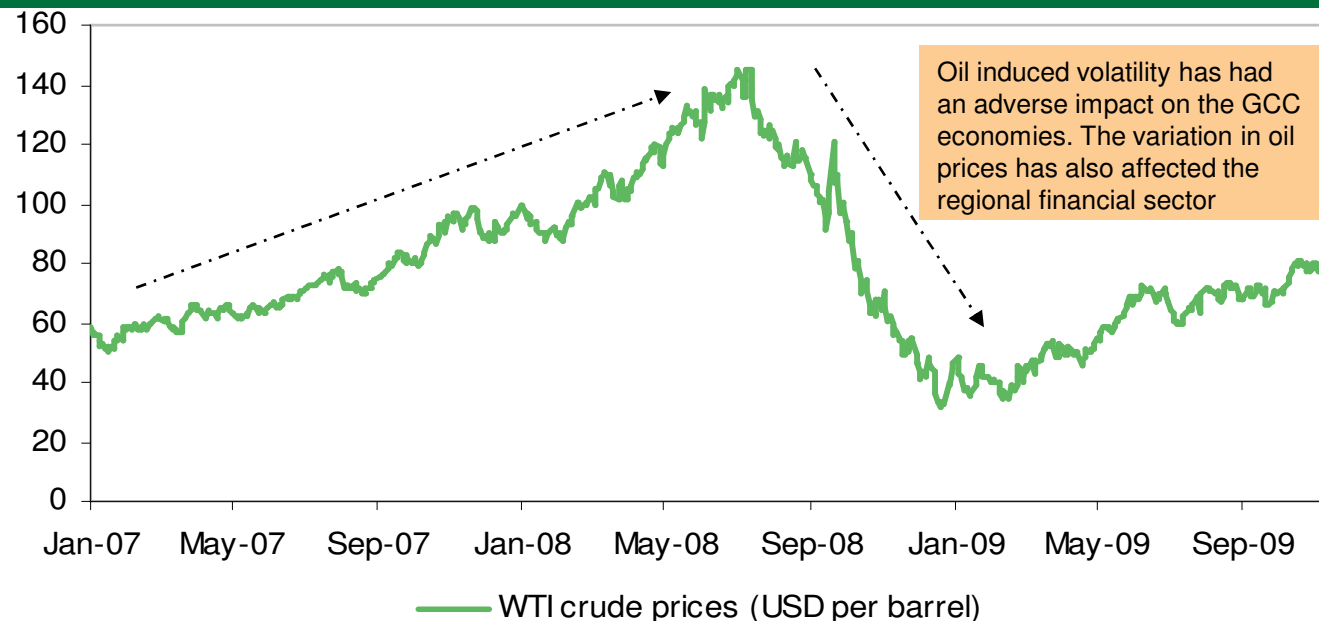
c) Bank assets at 65% of GDP is less than half of the world average of 160%

- Debt capital markets highly underdeveloped. *Source: IMF GFSR October 2009, NCBC Research*
 - ✓ GCC bond markets remain under-developed as debt securities make up just 5% of the Middle Eastern capital market → this deprives the private sector of a potential major source of funding
- Equity market still lacks breadth and depth, participation still remains low compared to other developing and developed nations
- Limited mobilization of capital
 - ✓ Pension funds across the globe account for 32% of the managed global assets and act as a stable source of long term funding
 - ✓ Apart from GOSI of Saudi Arabia, there are no other pension funds of a considerable size which can augment longer term savings and channelize them towards lending for a longer term investments
- Regulation is uneven. There are areas of excellence but also segments which have evolved in a largely unregulated manner

Volatility in oil prices has adversely affected the region

- In the face of economic volatility – driven above all by oil price variations – the regional financial sector has become bubble-prone.
 - ✓ Significant petrodollar inflows, since early 2000, pumped up the revenues of government with the region reporting large current account and budget surpluses
 - ✓ Excess liquidity into the system led to the initiation of several massive development and infrastructural projects in the region
 - ✓ However, the GCC region's dependence on oil has made it extremely susceptible to volatility in oil prices → falling prices have also led to production cuts by the GCC countries – crude oil production is set to decline to 14.9 mbpd in 2009 from 16.1 mbpd in 2008 → this has further negatively impacted the GCC governments' revenues

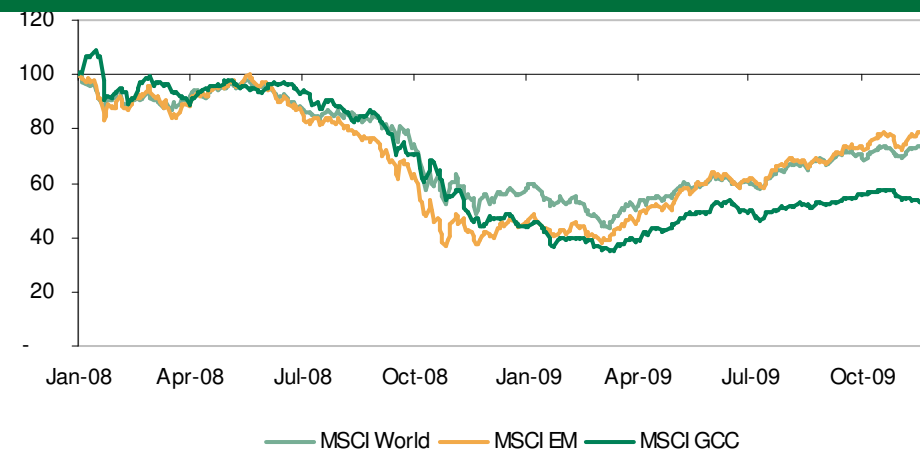
Volatility in oil prices have had a negative impact on GCC economies



Source: Bloomberg, NCBC Research

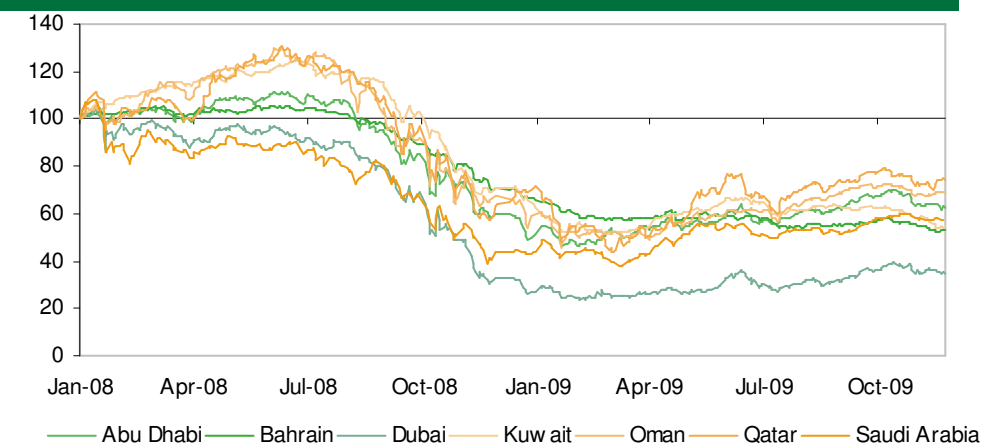
Market volatility the norm

MSCI world, emerging market and GCC indices performance



Source: Bloomberg, NCBC Research

GCC equity market performance



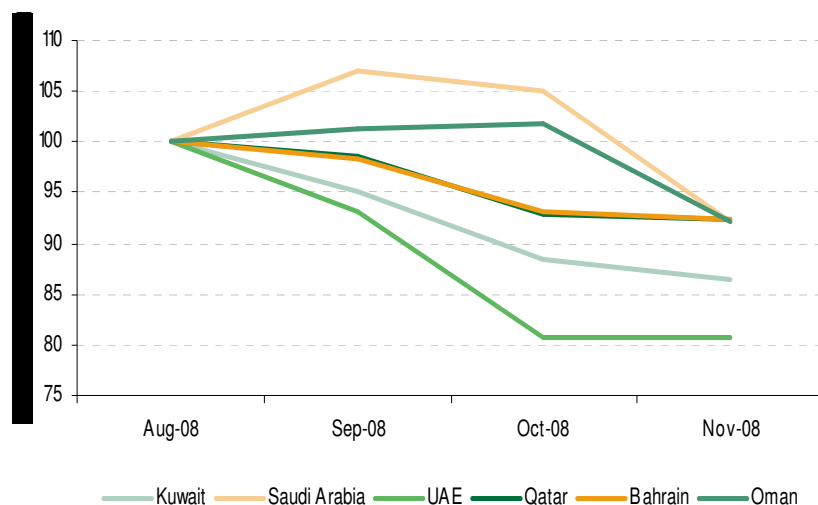
Source: Bloomberg, NCBC Research

- Equity markets globally have exhibited greater amount of volatility since the beginning of the economic crisis
 - ✓ While the MSCI World and Emerging Market indices corrected by 42% and 54% respectively in 2008, the MSCI GCC index declined by 56%
 - ✓ Even in 2009, the YTD performance of GCC index at +20% lags that of the world and emerging market indices of +27% and +72%, respectively

- The performance of the GCC equity markets has been highly uneven with increased volatility becoming the norm
 - ✓ The retail investor-driven bourses have accentuated the volatility
 - ✓ All the regional equity bourses have corrected significantly (-25%-65%) since the beginning of the turmoil
 - ✓ Dubai has been at the forefront with the benchmark DFM losing over 65% since the start of 2008

The region's real estate sector amongst the worst hit globally

Correction in property prices in GCC economies



Country	Residential	Office	Retail
Dubai	High degree of price correction and oversupply	High degree of price correction and oversupply	Low consumer spending and a weak tourism market
Abu Dhabi	Prices stabilizing	Moderate rental correction	Retail rental rates softening with low consumer confidence
Qatar	Prices stabilizing	High degree of rental correction	Retail rental rates softening with low consumer confidence
Kuwait	High degree of price correction	High degree of price correction	Retail rental rates softening with oversupply
Bahrain	Moderate price correction	Moderate rental correction	Rental softening in 2009
Oman	Moderate price correction	Moderate rental correction	Rental softening in 2009

Source: Mazaya real estate, NCBC Research

- The liquidity crisis aggravated by the damaged investor sentiment has led to a severe correction in property prices in the GCC region.
 - ✓ The property market correction has been sharp with Dubai leading the way with a c. 50% drop in prices
- Prices in other GCC countries also showed signs of moderations
 - ✓ Real estate prices in Qatar also fell by more than 40% since September 2008
 - ✓ Apartments and commercial properties in Kuwait reported a decline of 23% by the end of 2008
 - ✓ In Bahrain, Mazaya real estate price index fell by 12% QoQ in 4Q-08

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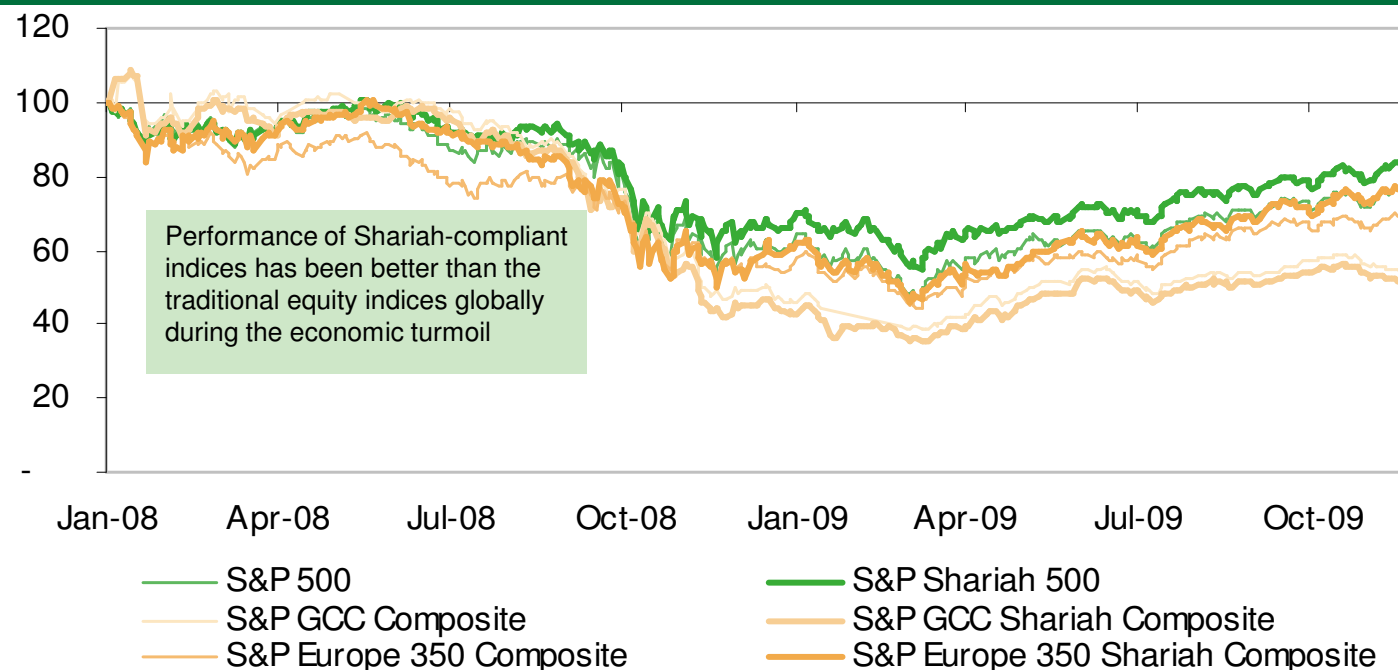
THE WAY FORWARD

WHERE ARE THE RISKS?

Resilience of Shariah-compliant finance

- In general, Shariah-compliant institutions have performed well during the crisis
 - ✓ Islamic capital market seems to have performed well in terms of returns compared to conventional markets and has weathered the current financial crisis relatively better
 - ✓ In 2008, the S&P500, GCC Composite and Europe 350 Composite had worse returns than their Shariah counterparts; Even in 2009, the YTD performance of the Shariah-compliant indices has been better than the conventional indices
- The general perception has been that Islamic finance has done better in the face of the crisis than conventional finance
 - ✓ This is attributed to their inherent ethical and non-speculative nature. The prohibition of riba, gharar, maysir, and haraam activities, provides an inherent security mechanism and keeps the issue of speculation at bay

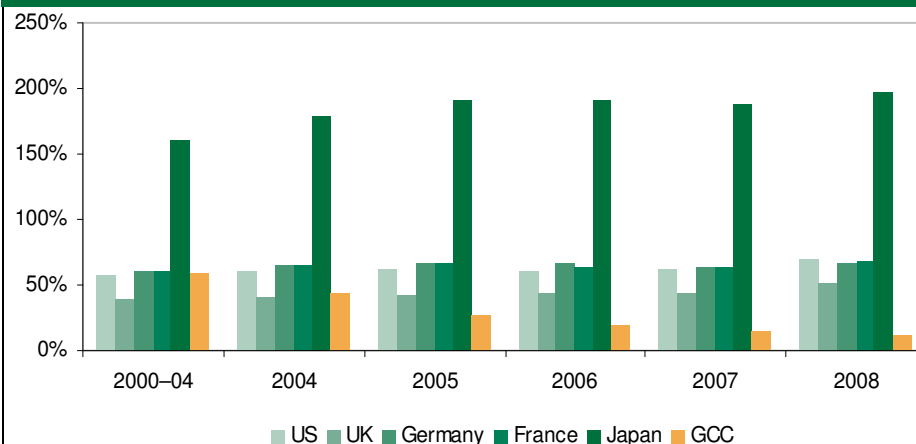
Performance of key S&P conventional and Shariah-compliant indices



Source: Bloomberg, NCBC Research

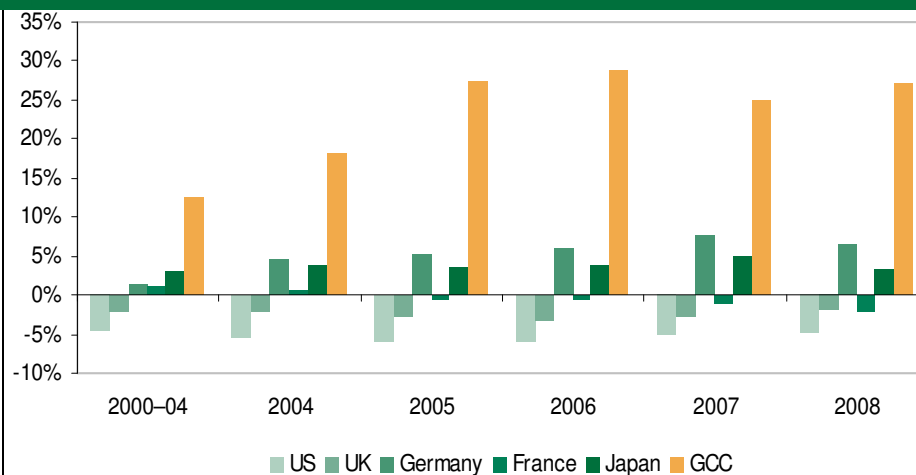
Reasons for strength: Macroeconomic stability

Public debt (as a % of GDP) in key economies



Source: IMF, NCBC Research

Current account balance (as a % of GDP) in key economies



Source: IMF, NCBC Research

- The global crisis has to a significant degree been a **crisis of leverage**

- ✓ The leading western economies were living in an era where debt/finance was easily available, thanks to historical low interest rates
- ✓ Public debt as a % of GDP in leading industrialized nations ranged between 38%-196% in the 2000-08 period
- ✓ In the same period, the **GCC governments reduced the public debt levels from 59% to 12% of GDP**
- ✓ Apart from the government, even the corporate sector and household debt had increased significantly in the build up to the crisis → **During 2000-07, US household debt nearly doubled to USD13.8trn**

- Thanks to the prudential macro economic policies, the GCC economies escaped from the crisis of leverage
- ✓ In the 2000-08 period, **the average current account surplus for the GCC economies was 23% of GDP** compared to a deficit of 5.3% and 2.4% for the US and UK, respectively

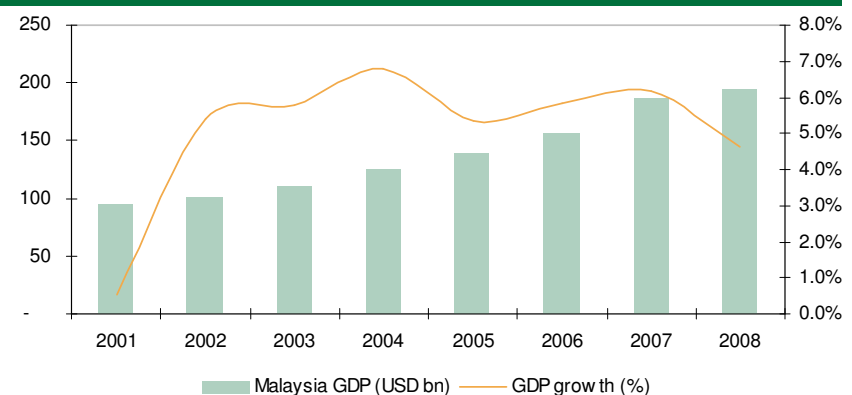
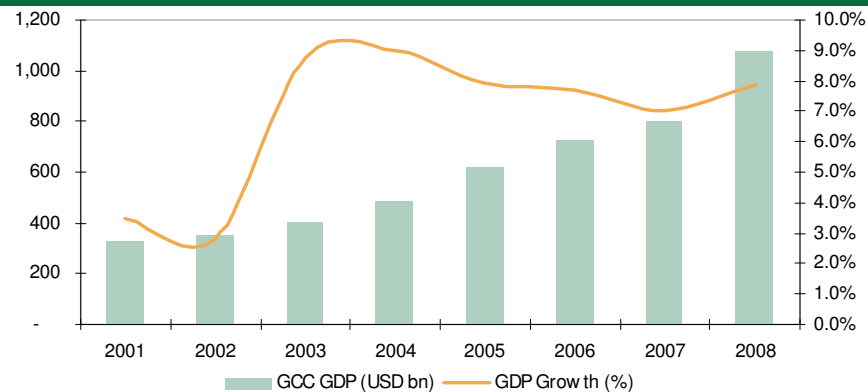
Reasons for strength: Shariah-related

- Many investors have been hurt because of the **complexity** of the products they have used and relied on. Shariah-based finance, by contrast, is relatively simple
 - ✓ Reduces risks of mis-selling
 - ✓ Easier to price
- Islamic finance is effectively an example of **principles-based regulation**. Investors can take comfort in a high degree of compliance with certain widely recognized values and principles.
 - ✓ Generally conservative
 - ✓ In-built risk management
- Some of the key characteristics that have helped Islamic finance emerge out of the crisis much more stronger include:
 - ✓ Prohibition of interest (**Riba**) – the Shariah law prohibits the charge of interest on loan or any debt instrument. As a result, any predetermined or guaranteed rate of return on the principal is prohibited in Islamic finance.
 - ✓ Prohibition of activities involving uncertainty (**Gharar**) – activities that involve risk, uncertainty, ambiguity, fraud or deceit are also prohibited under Islamic law.
 - ✓ Prohibition of gambling (**Maisir**) – activities in which the agreement between the participants is such that a loss for one means a gain for the other is also prohibited under Islamic law

Reasons for strength: Non-shariah related

- The main centers of Shariah-compliant finance are countries with **strong regulators**, partly as a result of their success in learning from previous crises
 - ✓ A conservative regulatory approach, inclusive of the macro as well as micro-prudential elements by the monetary authorities, prevented the regional banks from excesses → Monetary authorities in the GCC economies are vested with the responsibility for monetary policy as well as banking supervision.
 - ✓ Malaysia, which was one of the leading casualties of the East-Asian crisis in late 1990s, has been the pioneer in Islamic finance and has built a comprehensive and strong Shariah framework → The country's Islamic Banking Act and Takaful Act were created way back in 1983 and 1984, respectively
 - ✓ Learning from the earlier crises, the country has played a leading role in the development of various Islamic finance products and services including sukuks, equities, units trusts and exchange traded funds
- The strong performance of the GCC and Malaysian economies has given investors **ample opportunities at home**, thereby sparing them from riskier products elsewhere
 - ✓ From around USD300bn at the beginning of this decade, the GCC economies have grown over three-fold to over USD1trn in 2008; the Malaysian economy has grown from USD94bn to USD195bn in the same period

GCC and Malaysian economic growth



Source: IMF, NCBC Research

- ✓ Additionally, the emerging financial markets are underdeveloped and therefore further down the **risk curve** that their Western counterparts. The macroeconomic situation in Islamic countries has been generally solid and **resilient** with growth more being convergence-driven.

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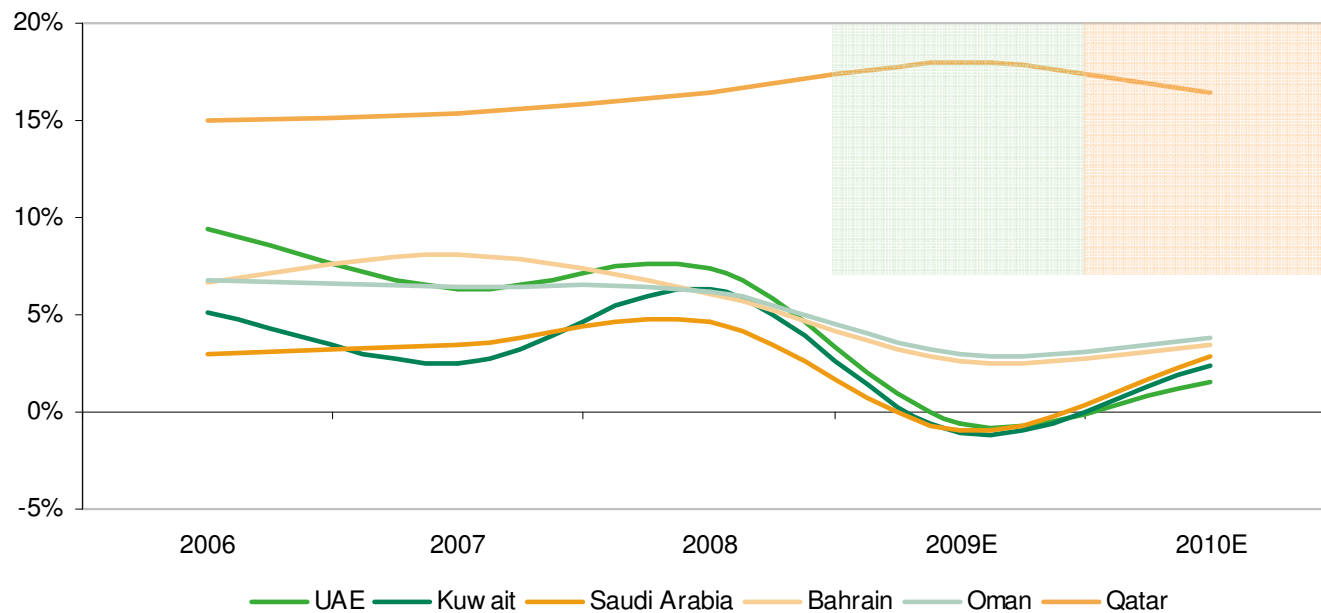
THE WAY FORWARD

WHERE ARE THE RISKS?

Growth is likely to resume next year

- Thanks to the aggressive policy responses and improving global economic environment, the GCC economy is likely to rebound to sharp growth in 2010

GCC economic growth forecast



Financial intermediation will normalize

- Apart from reducing the benchmark policy rates, the GCC central bankers along with the government provided support to the financial sector through additional measures

Steps taken by GCC policymakers to deal with the economic slowdown

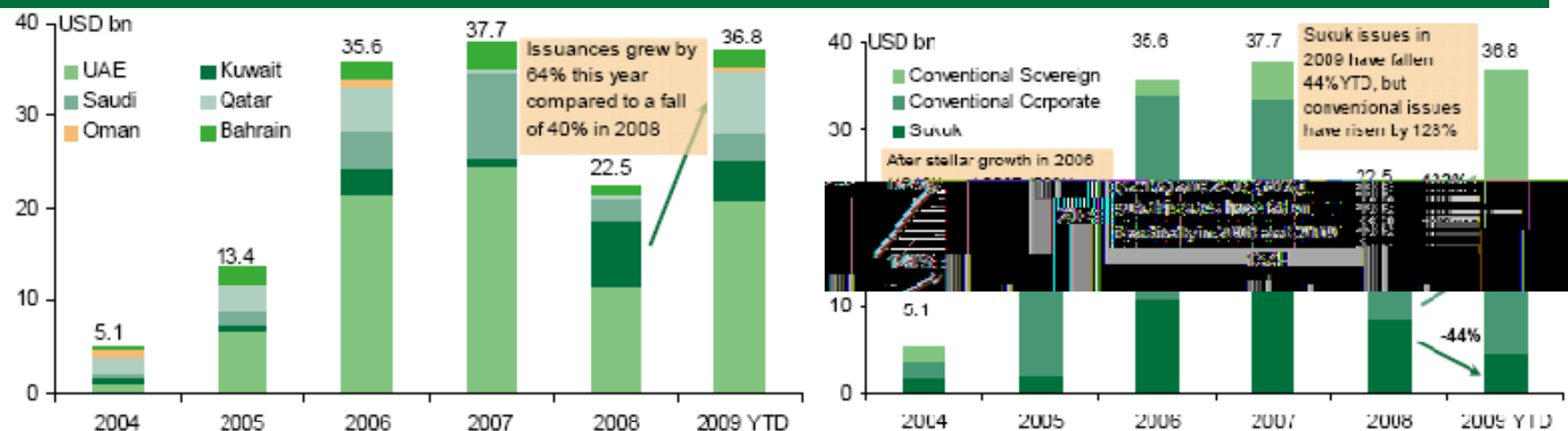
Country	Monetary Easing	Fiscal Stimulus	Deposit Guarantees	Liquidity Support	Capital Injections	Equity Purchases
Saudi Arabia	Yes	Yes	Yes	Yes	No	No
Bahrain	Yes	No	No	Yes	No	No
UAE	Yes	No	Yes	Yes	Yes	No
Qatar	No	No	No	Yes	Yes	Yes
Kuwait	Yes	No	Yes	Yes	Yes	Yes
Oman	Yes	No	No	Yes	No	Yes

Source: IMF Regional Economic Outlook May 2009, NCBC Research

- While the responses have varied from country-to-country, the GCC policymakers have been quick to respond to the economic slowdown
 - ✓ Given the extent of troubles in their financial sectors, Kuwait, Qatar and UAE went a step ahead and recapitalized their banks; Kuwait and Qatar directed the state owned SWFs to pick up stake in the domestic banks
- These initiatives have played a key role in easing the strains of the financial sector and reviving confidence in the economy

Filling the gaps: Debt capital markets

GCC debt market performance

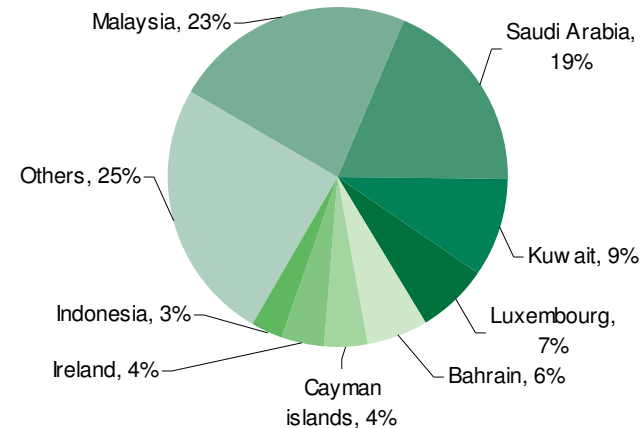
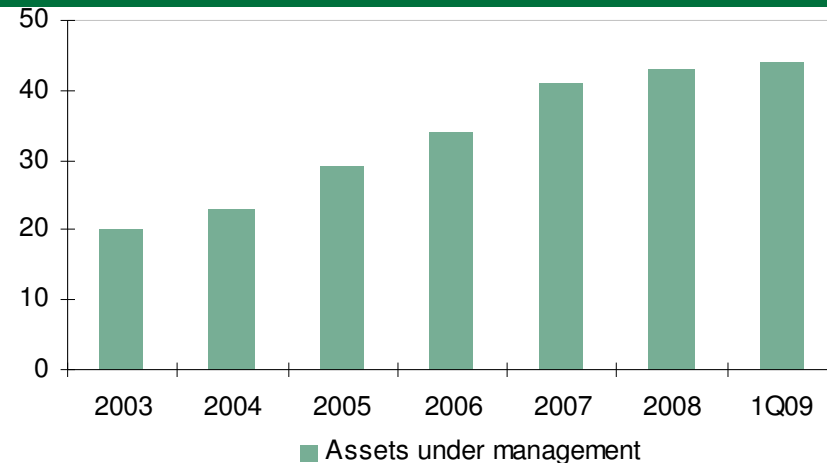


Source: Bloomberg, Zawya, NCB Research; 2009 YTD indicates till 3Q09

- **Rising high.** New debt issuances in the GCC touched USD36.9bn by end of 3Q09, up 64% over 2008
- **Sovereign financing needs.** GCC sovereigns led the way in 2009 by raising USD20bn worth of conventional debt during 1Q09–3Q09.
- **Infrastructure funding.** Sukuks are a good means to fund some of the USD2.2tn of infrastructure projects underway or planned in the Gulf region
- **Benchmark pricing.** An active government debt market with regular sovereign bond issuance covering all maturities creates a yield curve which can serve as a benchmark to price other market instruments. Dubai, Abu Dhabi, Qatar, Kuwait, SABIC, SECO
- **Exchange traded Sukuk and bond market.** Saudi Arabia launched its first Sukuk and bond market on 13 June, 2009. Similar moves across other nations could herald a new era for the GCC debt markets

Filling the gaps: Asset management

Growth in Islamic asset management industry and domicile of new funds launched



Source: IIFR 2009, Ernst & Young, NCBC Research

- The Islamic asset management industry has come a long way since 1968 when the first Islamic fund Dana Al-Aiman was launched in Malaysia
- Growing awareness rising popularity of investments in majority-Muslim countries has supported the asset management industry's expansion
 - ✓ The **global Islamic funds industry registered a 19.7% CAGR in asset under management (AUM) in the 2003-07** period while the conventional global funds industry registered a CAGR of 17.0% in AUM in the same period → Even during the economic turmoil, Islamic mutual funds' assets under management reported a steady YoY growth of 4.9% in 2008 to reach USD43bn
- However, to fill the existing gap, the Islamic asset management industry needs to do more to attract a higher number of investors. Some of these initiatives include:
 - ✓ Increase the availability of products
 - ✓ Create a true advisory culture
 - ✓ Foster a long-term horizon

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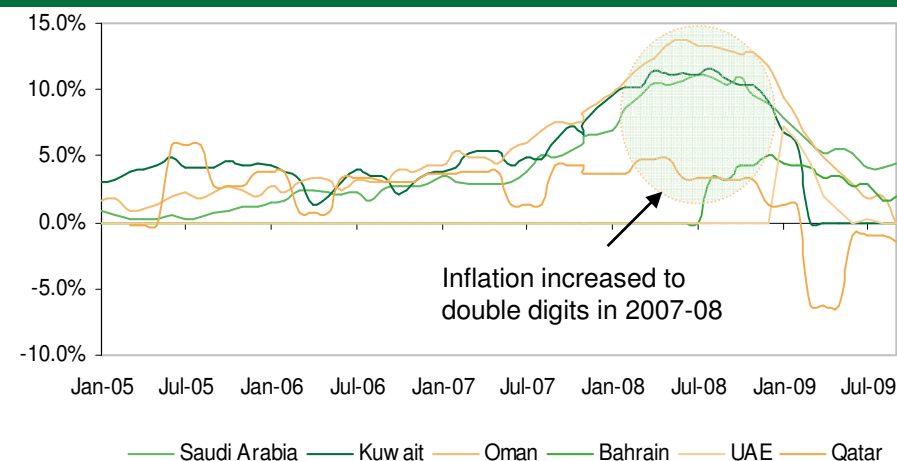
Many products underdeveloped

- During the over three decades of existence, Islamic finance products and services have expanded to cover almost all arrays of conventional product and services offerings
- However they largely lag their conventional counterpart due to following factors
 - ✓ **Differences in Shariah interpretation.** Interpretations and understanding of the Shariah principles differ between shariah scholars depending upon which Islamic schools of thought they represent. Convergence of shariah principles and interpretations is very important to facilitate new product development and ensure awareness between the investors globally
 - ✓ **Lack of standardization.** Various jurisdictions have their individual monitoring shariah committees and regulatory approaches, which makes approval process a lengthy one, thereby considerably delaying the development of new products
 - ✓ **Thin secondary and Islamic interbank market.** Underdeveloped secondary and Islamic interbank market expose the banks to significant asset-liability mismatch as they struggle to efficiently manage their short-term liquidity

The challenge of macroeconomic stability

- The extraordinary oil-driven boom since 2003 not only increased the overall liquidity levels in the GCC economies but also fueled a remarkably robust and broad-based take-off in economic activity.
 - ✓ Financial sector liberalization, along with the increasing openness to foreign financial flows, further boosted the liquidity situation.
- The excess liquidity found its way into various asset categories across the spectrum – commodities, equities and real estate – resulting in a run-off in prices and broad based inflationary pressure
- As a result, the GCC economies have become increasingly obviously bubble-prone

Asset bubble and higher inflation during boom years



Source: Bloomberg, NCBC Research

- On the other hand, the ensuing collapse in asset prices during the economic turmoil brought a new set of challenges for policymakers → the sudden fall in asset values created a deflationary environment
- As a result, the key challenge is to maintain macroeconomic stability that prevents formation of asset bubbles

Regulatory challenges

- Minimize the unregulated fringe
- Enable the growth of new areas
- Foster transparency
- Minimize market fragmentation
 - ✓ Market hubs
 - ✓ Regulatory standards
 - ✓ Documentation
 - ✓ Convention: while not everything can / should be regulated, harmonization is possible through widely accepted market practices

Thank You

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