

# Back to the Future: The Way Forward for Islamic Finance

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Landmark Hotel, London

23<sup>rd</sup> February 2009



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## “State of the nation – the good”

- Islamic Finance industry continues to grow: estimated US\$ 840 billion in global assets growing 15-20% annually<sup>FN1</sup>
- Growth in the Muslim population estimated to grow by over 20% within the next 8-10 years, to reach 1.6 billion, which represents 21% of the global population<sup>FN2</sup>
- Total assets worldwide estimated to grow to US\$1.6 trillion by 2012 <sup>FN3</sup>
- Islamic banks in Bahrain grew assets by 50% in 2009 to US\$24.6bn<sup>FN4</sup>

FN1 S&P/HSBC

FN2 CORECAP

FN3 OLIVER WYMAN

FN4 CENTRAL BANK OF BAHRAIN



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## “State of the nation – the bad”

- Concentration of assets in real estate and other predominantly illiquid assets
- Instruments and structures (certain sukuk/tawarruq) the source of significant ongoing criticism or tension
- Continuing paucity of good quality human capital
- Still slow movement towards standardisation and harmonisation of standards and agreement on structures
- Legal uncertainties flowing from default situations – asset backed or based?



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## “State of the nation – the ugly”

- Sukuk and other defaults – East Cameron, TID, Global, Saad/Golden belt, Dubai inc.
- Often still poor corporate governance and risk management and a lack of transparency
- Real estate contagion – direct exposure (Dubai, Bahrain, etc.) in lieu of indirect exposure (SIVs, derivatives and sub-prime)
- Lack of meaningful product innovation
- Imitation (conventional finance) is not always the sincerest form of flattery...
- Excessive risk taking for potentially high short-term gains



# Basic principles

- If something is immoral, one cannot profit from it
- **To share reward, one must also share risk**
- One cannot sell what he or she does not own
- In any transaction, one must clearly specify what he or she is buying or selling and one price is being paid



# Return to core values

- At the core of Shari'ah principles that money should be directed to the **real economy** through investing in businesses that offer ethically acceptable products and services
- Returns should be earned through **active involvement and participation in the business risk** in Shari'ah compliant investments
- The stimulation of trade, commerce and industry and the creation of profit through that medium
- The provision and proliferation of investment or development capital



# Growth factors (1)

- Growing requirement, particularly in emerging markets, for core infrastructure assets, especially those that bring social benefits
- Structured products and cash management products are maturing - sophisticated products such as private equity, fixed income (eg sukuk) or hedging products (eg profit rate swaps) are emerging
- PE houses are acknowledged drivers of economic growth and creation and movement of capital
- Insufficient traditional “debt” capital is available to develop the economy and infrastructure – creates opportunities for equity or “quasi” equity



## Growth factors (2)

- Liberalisation of economies
- Updated and improved regulatory environment (eg FDI relaxation, tax equalisation)
- A more overt requirement from Muslims to save and spend in a Shari'ah compliant manner
- A move, particularly at the retail level, towards socially responsible or ethical investment



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## Future focus – project finance

- Genuinely asset based
- Revenues flow from the development and/or exploitation of that asset – steady cashflow
- Ability to participate in assets providing social or economic benefit, eg power and water, schools, hospitals, roads, rail, water treatment, etc.
- Shorter tenors now prevalent more manageable for IFIs
- Returns also much more attractive at current lending levels
- Tried and tested processes for interaction with creditors on multi-source financed projects



# Future focus – private equity, funds and fund/asset management (1)

- An industry still in relative infancy but with scope for rapid and exponential growth
- Start-up (VC) and growing businesses creating a significant funding/capital requirement which is an ideal "home" for risk based, entrepreneurial, long-term capital investment
- Private equity takes a long-term view on investments and aligns the interests of stakeholders, which are also among the key principles of Islamic investment



## Future focus – private equity, funds and fund/asset management (2)

- Move away from reliance upon real estate and leads to investors diversifying their investment strategies
- Provides access for investors to professionally managed pools of assets in which they can't invest directly or through which they can spread risk
- Provides scope for fee-based income based on mudaraba, musharaka or wakala principles
- As a corollary, it encourages the mudarib or wakil to maximise returns through a “carry” or other similar incentive



## Future focus – trade finance, SMEs

- Again, trade finance is asset based and enables financier to exert direct or indirect control over the asset
- Stimulates the economy and increases trade volumes
- SMEs are currently largely ignored by the conventional finance market – plugging a gap



# Future focus – consolidation/new markets?

- Most of the major players are currently global international banks
- Regional and local IFIs have modest balance sheets
- Economies of scale and a filip to aspirations of regional or global presence
- Asia (Japan), Africa, Northern Europe and the United States



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## Future focus – sukuk (1)

- Despite defaults still a growing market with global potential
- Essential liquidity and balance sheet management tool
- Potential for application in infrastructure projects and other social development initiatives
- Need to develop trading platforms and secondary market



## Future focus – sukuk (2)

- Inevitable drift to ijara but musharaka and wakala structures can be used applying limited recourse project/structured finance disciplines
  1. Phased drawdowns against milestones/deadlines
  2. Reserves – at inception and ongoing
  3. Payment cascades
  4. Full security package, including land or tangible assets
  5. Step-in rights
  6. Structured recourse to sponsors (eg SBLCs)



# Conclusion

- Back to basics and core values
- Social benefit or economic stimulus need not mean no/lower profit
- Focus on effective management, due diligence, robust structures and quality assets
- Retail customers - lower absolute returns but growing and stable markets



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