

9th Annual

Islamic Finance Summit

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Mukhtar Hussain:

Global Head of HSBC Amanah

Deputy Chairman & Chief Executive Officer, HSBC Bank Berhad Malaysia

Islamic Finance in 2010 : Getting the house in order

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Key themes

- Islamic finance industry is at crossroads
- Global financial crisis is an opportunity for Islamic finance to reflect, enhance and innovate
- Four principal themes
 - enhance Risk Management processes
 - Consolidate - size will drive capacity
 - R&D/innovation lies at the heart of the industry
 - recognise importance of Asia and trade flows
- Islamic finance - a journey from adolescence to adulthood
- The Way Ahead

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Introduction

- Islamic finance gained significant global exposure in the last decade
- However, industry now at a crossroad in the midst of the economic crisis
- Represents only c.1-2% of global assets*; however, what's impressive is the industry's phenomenal growth (25%-30% YOY) since 2000 and its forecasted growth
- Growth across both Islamic incumbents and conventional FIs; interest beyond Islamic countries
- Inherent stabilising principles of Islamic finance benefited industry generally
 - Investments in certain sectors and transactions - "real economy"
 - New industry which itself led to lack of financial "over-engineering" and relative avoidance from crisis
- BUT, industry not been unscathed
 - Sukuk defaults – questions about enforceability and precedence – overall negative perception
 - Restrictive investments – over-exposure to certain asset classes (real estate, equities)
 - Size of industry itself – can it fill the vacuum and earn back business confidence?
- **Time to complement the overall guiding principles with lessons learnt, and put the house in order**

* Source: Oliver Wyman

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Economic crisis – what went wrong...

Values vs. valuations – short term focus on maximising financial valuations whilst eroding moral values

Opposite to guiding principles of Islamic finance

- Cheap money encouraging buildup in debt – growth of mortgage and home equity loans
- Banks encouraged by regulatory capital adequacy requirements to sell mortgages – bundling and securitising
- Credit risks overlooked; bankers' compensation linked with short term financial performance
- CDSs/derivatives traded “over the counter”
- Unmonitored and unchecked buildup of exposures

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Islamic banks during economic crisis

IMF analysis – GCC - Islamics vs. conventional banks % growth

	Growth Rate of Assets (Islamic Banks)	Growth Rate of Assets (Banking System) ¹	Islamic Banks' Assets % of Total Assets in 2008	Period
Saudi Arabia ²	33.4	19.0	35.0	2003-2008
Bahrain ³	37.6	9.6	29.9	2000-2008
Kuwait	23.2	14.3	29.0	2002-2008
UAE	59.8	38.1	13.5	2001-2008
Qatar	65.8	31.9	11.5	2002-2008
GCC Average	44.0	22.6	23.8	
Jordan	20.6	11.2	10.3	2001-2008
Yemen	26.5	22.7	30.2	2004-2008

- Islamics less affected overall during 2008 crisis period vs. conventional
- Better poised to withstand additional stress - not permitted to have direct exposure to financial derivatives, which were most hit during crisis

Source: Central banks, banks' financials

1. Including Islamic banks

2. Including Islamic windows

3. Growth rate for retail + wholesale, market share for retail only

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Islamic banks during economic crisis

IMF analysis – GCC – Islamics vs. conventional banks during financial crisis %2008

	Saudi Arabia ¹		Kuwait		UAE		Bahrain		Qatar		GCC Average ²	
	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All
Capital adequacy ratio	22.1	16.0	21.7	16.0	12.8	13.3	24.5	18.1	17.9	15.6	19.8	15.7
Change in profitability (2007-2008)	2.0	-11.8	-42.7	-70.1	0.7	7.9	18.8	-4.6	4.5	21.7	-6.6	-13.9
Change in profitability (H12009-H12008)	2.9	-11.9	-71.9	-65.3	-34.2	-19.5	-46.5	-33.7	0.0	5.1	-29.0	-23.5
Change in profitability (2008 and H12009 compared with 2007) ³	4.3	-7.2	-49.7	-65.8	-0.8	10.0	8.2	-3.2	2.8	25.4	-8.8	-10.2
Return on assets	3.7	2.1	1.6	3.2	1.7	2.2	2.6	1.3	6.6	2.6	3.2	2.3

Sources: National authorities, banks financials, Zawya, IMF

1. Saudi Islamics don't include window operations; 2. simple average except for change in profitability

3. Based on average monthly profitability

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However...interlinked with global markets...

- **However, Islamics not been immune**
 - Quantitative – real estate exposure, particularly in GCC – Sukuk defaults
 - Qualitative – Uncertainty - enforcement under legal framework etc
 - Perception management - can the industry address its issues promptly and efficiently
- Risk Management framework questioned
 - Credit/liquidity issues faced by individual issuers e.g. TID, Nakheel
 - Structural issues/uncertainty inherent in documentation
 - Failure to react promptly and lack of a clear precedent and line of sight in enforceability
- Reputational risk – industry in growth phase damaged by lack of confidence in robustly responding to issues
- **Why does a sukuk default question the industry when conventional bond defaults are common?**

BUT

- As the Chinese say.... “wei-chi” – Danger *plus* Opportunity
- Immense opportunity remains post the economic crisis, as Islamic finance forecasted to continue to outpace conventional sector
- ...however, need to drive competitiveness and review critical themes surrounding the industry

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Mirror mirror on the wall...to get the house in order...

Risk Management

Risk Management – mere focus on credit risk
Need to identify generic and specific risks and address them
Governance issues

Highly fragmented industry

Most institutions operate in a single country – lack of scale, depth and critical mass
Size vs. conventional industry – capacity and capitalisation

Lack of innovation/ R&D / Talent

Islamic finance sector still maturing – lacks product development and diversification
Lack of human capital

Failure to recognise shift to the East

Asian economy learnt from previous financial crisis
- Developing Asia, although badly hit, did not experience overall decline in GDP but rather a deceleration in growth; subsequent “recovery” faster and more pronounced
Failure to acknowledge that global economy’s drivers are shifting Eastwards

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Risk Management

Risks similar to conventional industry

Credit Risk

Liquidity Risk

Market Risk

Others

- Insurance
- Residual Value
- Pension Fund

Risks related to Islamic finance

Operational Risk

- Operations
- Accounting
- Technology
- Legal
- Compliance

Reputational Risk

Strategic Risk

Shariah Risk

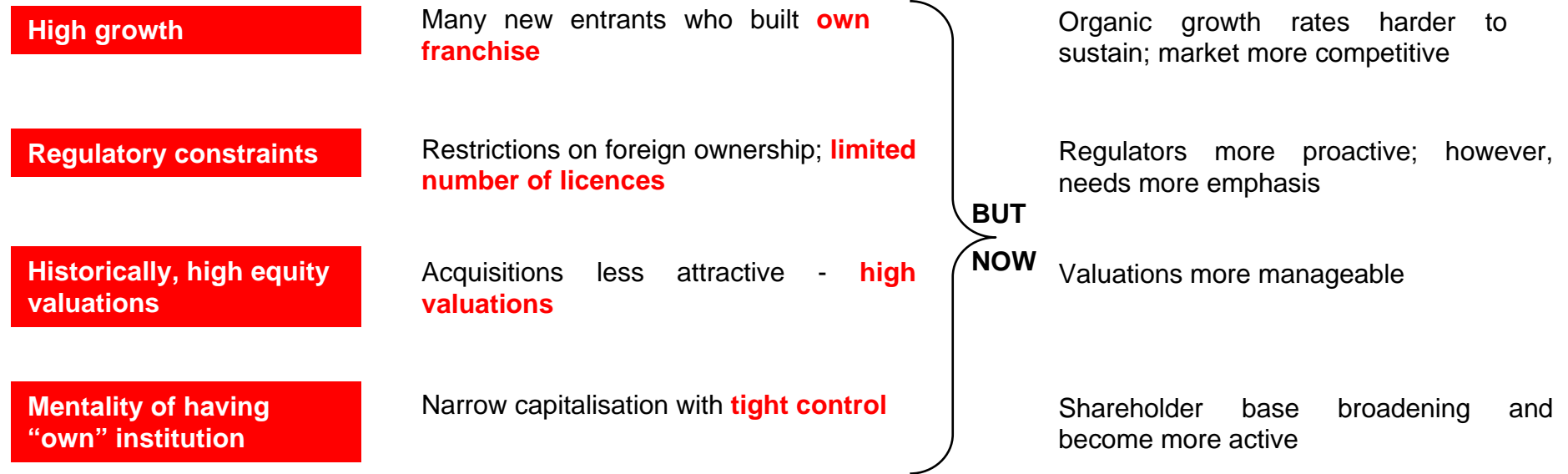
- Specific and varies between each institution
- Risk management for institutions offering both conventional and Islamic services as opposed to “pure-play” institutions
- Current perception issues linked to Islamic finance documentation and enforceability
- Need for careful identification of generic and specific risks within each institution in order to appropriately mitigate/manage the risks
- Frameworks constantly evolving and need to be dynamic - IAS/IFRS, Basel II/III etc.

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Consolidation – historically fragmented industry...

Fragmentation in Islamic finance industry been driven by several factors :



- Islamic assets represent only c.1-2% of global assets
- Size of Islamic banks relative to conventional banks globally - need for depth and scale
 - Consolidated asset values of top 10 Islamic banks < 10% of asset size of RBS which was ranked no. 1 by asset size*

* Source: The Banker, Bankersalmanac

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Consolidation – addressing capacity issues in the industry...

Client offering

Increased convenience and service – access to global branches
Higher quality and more efficient call centres
Wider client base e.g. “Mass affluent” as opposed to only affluent/premier customers

Product offering

Investment products spanning more asset classes and markets
More variety; scale facilitates R&D and improves economics of product development

Risk Management/ Standardisation

Facilitate harmonisation of Shariah and accounting standards
Develop Risk Management strategies and Best Practices

Scale & depth

Enhance Shariah credibility and reach of Islamic institutions
Better capitalisation - Facilitate investment in R&D
Catalyst for change in business model – stronger and more competitive Islamic finance providers

- Industry needs necessary scale to complement conventional industry
- Drive standardisation such that reputational risks are mitigated in future
- Needs to be driven by both industry players and regulators

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HSBC experience on consolidation – few important learnings

Growth

Acquisitions helped HSBC achieve significant growth and gain balanced global footprint

Diversity

Geographic diversity provides business resilience, depth and flexibility

Client Offering

Better serve clients with multi-national interests

Brand Value

Global brand assists in capturing synergies; integrated marketing

Risk Management & Best Practices

Leveraging Best Practices and Risk Management strategies

Infrastructure

Better IT systems and common global platforms

Global Talent Pool

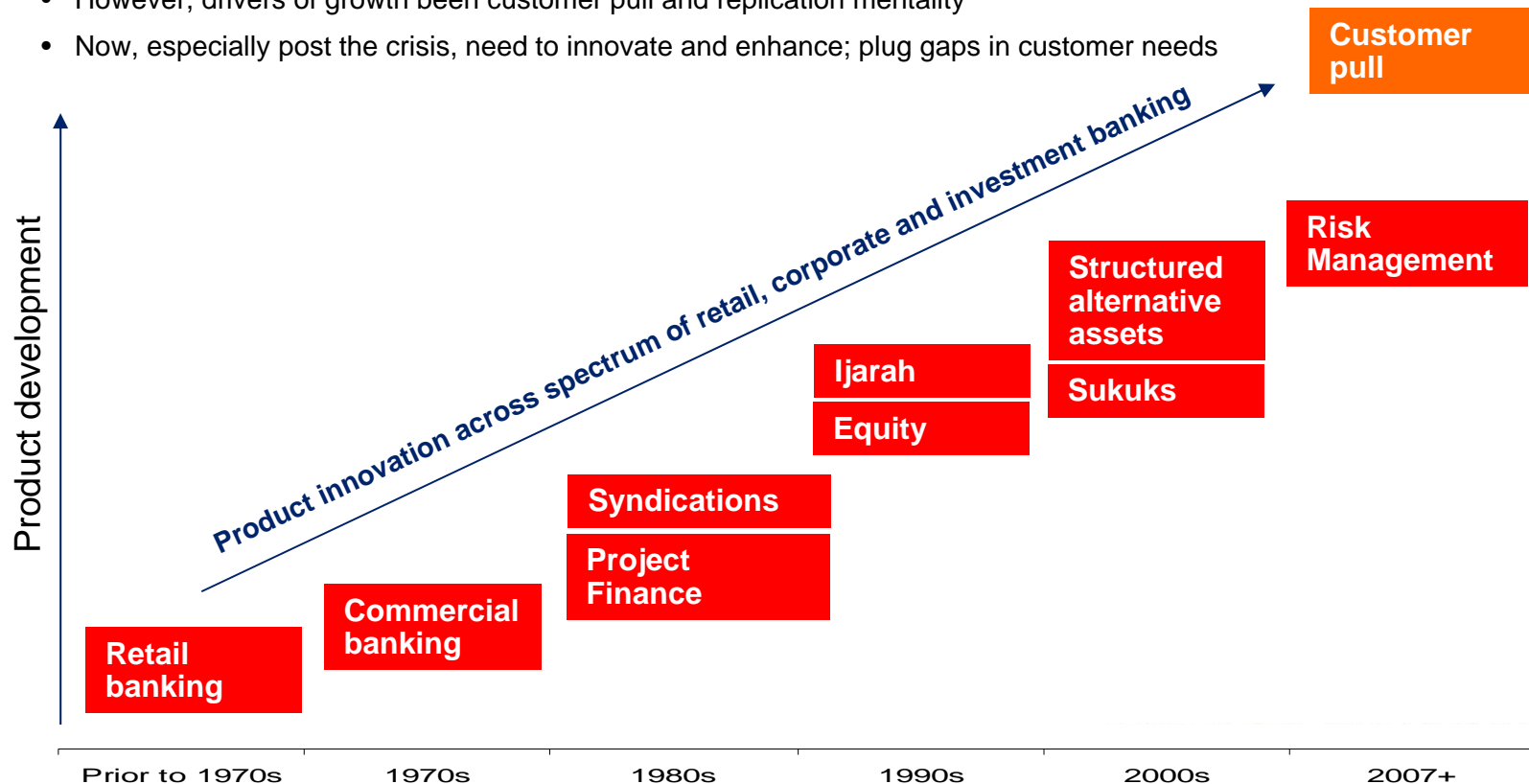
Transfer top talent across globe

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R&D / Innovation

- Industry has developed a comprehensive product offering over past few decades
- However, drivers of growth been customer pull and replication mentality
- Now, especially post the crisis, need to innovate and enhance; plug gaps in customer needs

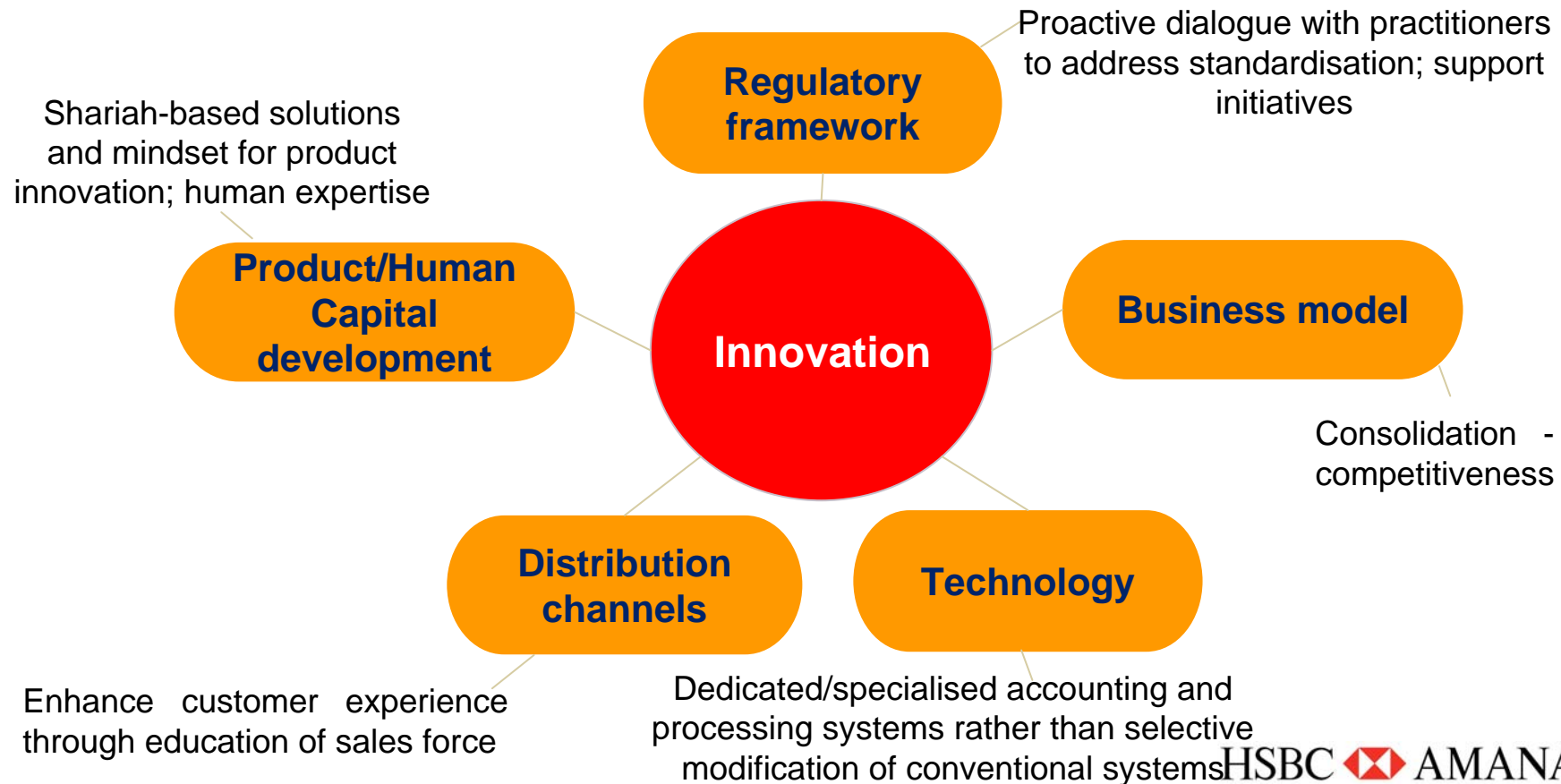


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Holistic innovation needed across multiple dimensions



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Next generation Islamic banking...?

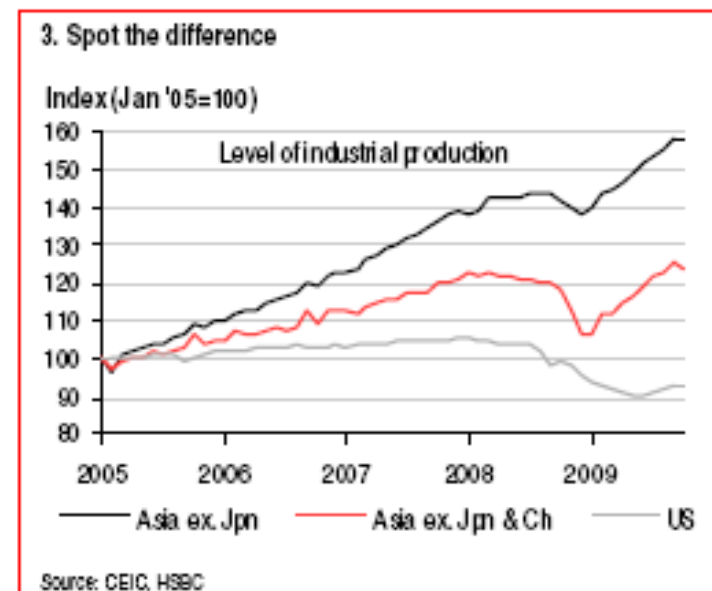
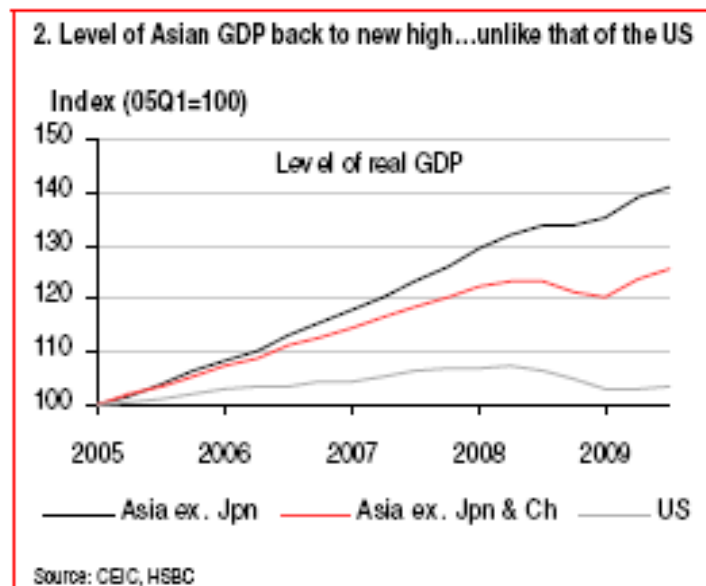
- Address lack of liquidity management products for IFIs
 - Liquidity risk management
 - Interbank positions
 - Commodity finance
- Fixed income products
 - Sukuks – shift from debt-based to equity-based
- Derivative products – protect risks as opposed to speculative
- Fund products – commodities, niche sectors, sukuk funds to pool liquidity
- Standardisation of documentation – address enforceability/structural issues; e.g. template OTC Islamic derivative contract
- Need key enablers to facilitate innovation
 - Dedicated people
 - Committed sponsorship
 - Regulators, industry practitioners and Shariah scholars
- **BUT, innovate while preserving distinctiveness of Islamic finance**

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East – East: Asia entered self-sustaining expansion cycle

Emerging markets leading global recovery – Level of Asian GDP and Industrial production back to new high... unlike that of the US

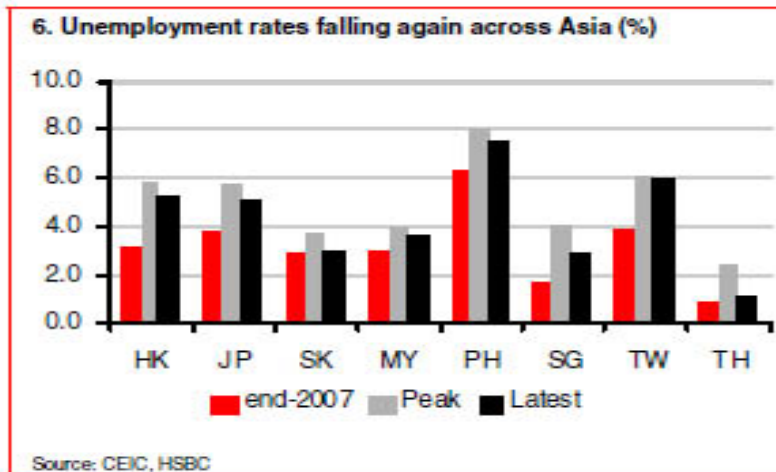


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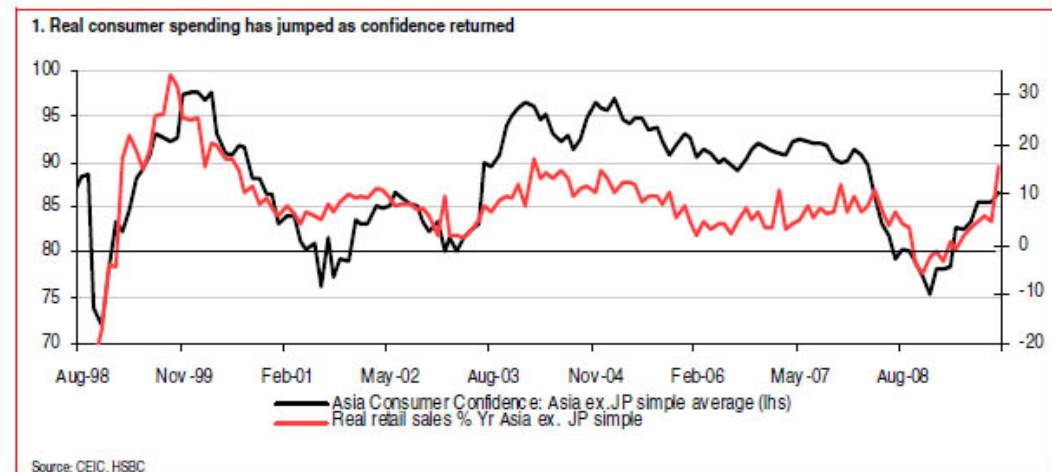


East – East: Asia entered self-sustaining expansion cycle

Unemployment rates have started to fall



The Asian consumer is back



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Asian Opportunity

Asia to contribute largest share of global GDP, surpassing EU and US by 2016¹

Asian consumers to become biggest incremental spenders, overtaking US and European consumers by 2013²

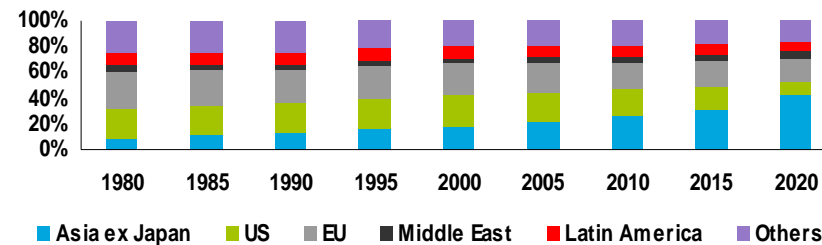
Asian intra-regional trade growing significantly faster than world trade overall²

Notes:

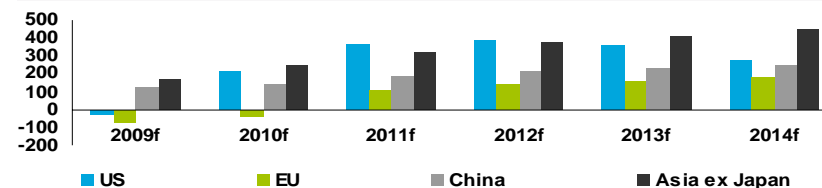
(1) Source: IMF

(2) Source: HSBC Global Research

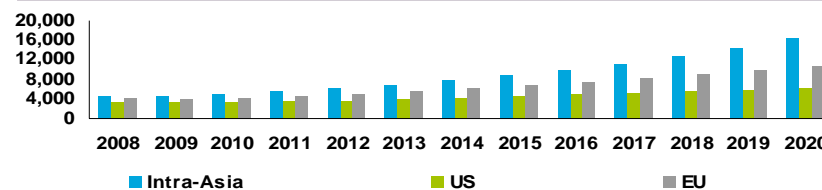
World GDP forecast, based on PPP, % of total



Incremental spending, US\$bn



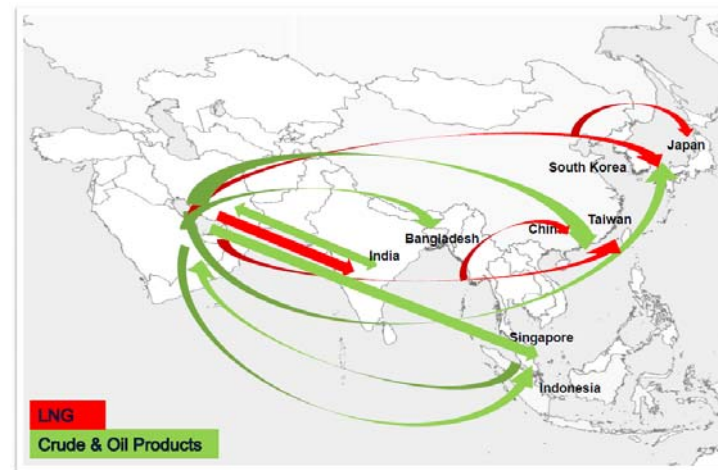
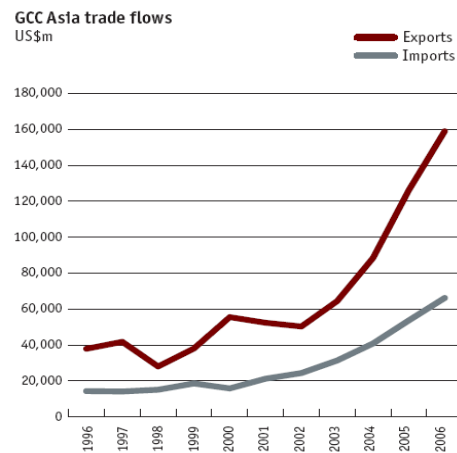
World trade forecast, US\$bn



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Middle East – Asia trade



Total trade between Asia and Middle East quadrupled in volume between 1996 and 2006

Web of diplomatic, economic and political ties and preferences

Energy trade been backbone of relations

Islamic finance concentrated in MENA and Asia; however, penetration remains low relative to Muslim population and opportunity remains to expand within these markets

EAST- EAST FLOWS ITSELF AN OPPORTUNITY FOR ISLAMIC FINANCE

Source: Economic Intelligence Unit, PFC Energy presentation May 2009

* International Energy Agency, McKinsey

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“Shaping Islamic Finance Together” - regulator driving excellence...

Bank Negara Malaysia initiative encapsulates more than 3 decades of expertise and experience to encompass:

- MIFC
- financial and market regulatory bodies
- Government ministries and agencies
- financial institutions / Bursa Malaysia
- human capital development institutions; INCEIF
- professional services companies

Bring players, talents, investors and issuers together

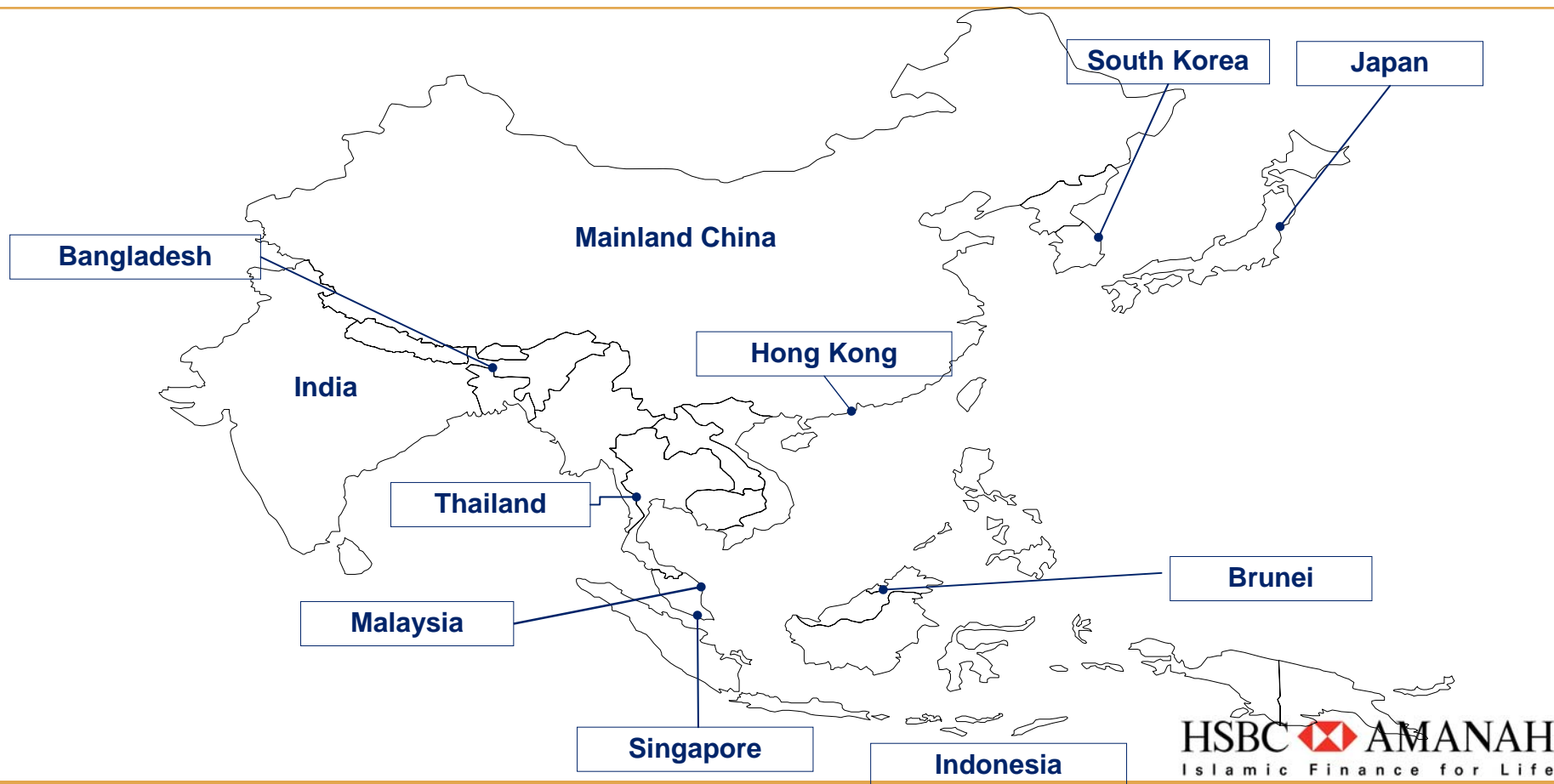
Regulator promoting innovation and taking lead in enabling industry to grow via various initiatives

e.g recent Petronas transaction another testimony; marks new era of bond/sukuk issuance in country and globally - Malaysia/Asia leading global sukuk market over next few years

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Growth in interest across Asia...



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Islamic Finance – Getting the house in order

- Islamic finance industry at a crossroad – progressed but at a cost
- “Inbuilt” risk mitigation system of Islamic principles and ethics have capped the extent of financial distress of IFIs during the economic crisis
- However, suffered loss of credibility and trust in financial system
- Need to affirm status within Islamic countries and reinforce role in the global economy
- Need to affirm Five pillars of Islamic Finance...get back to basics to accentuate advantages, competitiveness and ethics
- Need complementary robust Infrastructure/Risk Management policies
- Emerging markets leading recovery – consolidate to bring these markets together to achieve depth and scale, and drive future R&D/innovation
- Standardise such that we are better equipped to withstand the next crisis and address any credibility issues
- Participants in this room have a major role to play

Reinforce sense of pride/legacy and reputation, and work collectively