ISLAMIC FINANCE

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Grappling with problems of success

The sector is expanding in range and credibility – bringing new strains, says **Roula Khalaf**

Rich oil-pool of liquidity: there is still a growing appetite for sharia-compliant financial products in the wealthy Gulf states Bloomberg

Islamic finance has not escaped unscathed from the global financial turbulence of the past year. As the credit crunch hit, the market for sukuk, or Islamic bonds, took a pause, with new issues postponed and months going by without a single dollar-denominated bond being sold.

Despite the setback, however, the pool of liquidity in the oil-rich states of the Gulf, and the still-growing appetite for financial products that comply with the prohibition on the use of interest, have kept the $800bn Islamic finance industry marching on.

With experts predicting that the slowdown in the sukuk market will be temporary, the menu of Islamic-sanctioned financial instruments has continued to expand. More bankers, lawyers, and advisers have been flocking to the sector, bringing along new ideas and structures that can replicate products available in conventional finance. After Islamic mortgages and Islamic insurance, the industry is now dabbling in hedging products, and experts say derivatives are the next big thing on the horizon.

Perhaps the most powerful sign of progress in recent months has been the establishment, partly with state backing, of large Islamic banks, a trend that should take an industry dominated until now by hundreds of small institutions a step closer to mainstream banking.

In January, Noor Islamic Bank was launched with $1bn in capital by the Dubai government. It started operations through 10 branches but also made clear its ambition for expansion, hoping to lift the share of Islamic banking in the United Arab Emirates to as much as 50 per cent. The industry now represents between 15 per cent and 25 per cent of the banking market across the Gulf.

In April, it was the turn of Saudi Arabia to launch Inma Bank, raising $2.8bn in capital in an initial public offering. Now a group of Gulf investors are looking to launch a $9bn Islamic bank and float it on the Bahrain stock exchange.

"The new banks add a lot of credibility to the market," says Afaq Khan, head of Islamic banking at Standard Chartered Bank. "As big banks come in with sizeable capital they will become mainstream banks in their local economy and can bid for all the big projects."

Nabeel Shoaib, global head of HSBC Amanah, says that despite challenges in the sukuk market, the new banks underline that Islamic finance business is still picking up. "It's a reflection of the potential available. And the oversubscription [of initial public offerings for these banks] is a reflection of the market and the liquidity that is available."

Yet, an industry where every product needs a religious stamp of approval is also starting to face some vital questions.

The most important is the extent to which it can create new products that provide the same service and give the same returns as conventional instruments without deviating from religious tenets.

Over the past year, the industry was jolted by controversy after a leading religious scholar declared that the most popular type of sukuk was not at all in line with principles of sharia, or Islamic law. At stake were structures that included a repurchase undertaking in which issuers promised to pay back the face value of the bond at maturity or in case of default.

For Sheikh Muhammad Taqi Usmani, head of the religious board of the Accounting and Auditing Organisation for Islamic Financial Institutions, the Bahrain-based standards setter, the guaranteed return violated the key principle of Islamic finance, which stipulates sharing in profits and losses. Despite an outcry from the industry, Mr Usmani's views essentially prevailed when the sharia board of the AAOIFI subsequently met to discuss the issue.

Given that the decline in the sukuk market has been blamed primarily on the credit crunch, however, the full impact of the AAIOFI decision has yet to be felt. Although the standards body's views carry weight, they are not binding, and some bankers and issuers are likely to ignore them. Others, however, have gone back to the drawing board, to try to make the sukuk structures more compliant.

"The AAOIFI opinion doesn't impact existing sukuk but going forward some people will ignore the ruling," says one leading Islamic banker. "Others will find ways to adhere to them but impose other contractual obligations."

Some analysts have welcomed the debate as a wake-up call, arguing that it will help standardise religious decisions in an industry that has no unified opinion. Others, however, say the attempt to regulate the market is detrimental, stifling its growth. Customers, they say, want products that can replicate debt instruments but without obviously appearing to deliver guaranteed return.

"What AAIOFI is failing to recognise is that investors and issuers need to have debt," says the Islamic banker.

As the industry grapples with religious interpretation, it is confronting another important issue – a shortage of staff.

There are perhaps up to 100 religious experts who know enough about finance and much of the industry relies on the top 12 scholars within that group. More broadly the fast-growing financial industry, Islamic and conventional, is struggling to keep talent as salaries soar and foreign banks beef up their operations. That is a particular concern in the Gulf.

While AAIOFI is helping to train a generation of younger religious experts, Dubai International Financial Centre and Cass Business School are offering an executive MBA programme in Islamic finance.

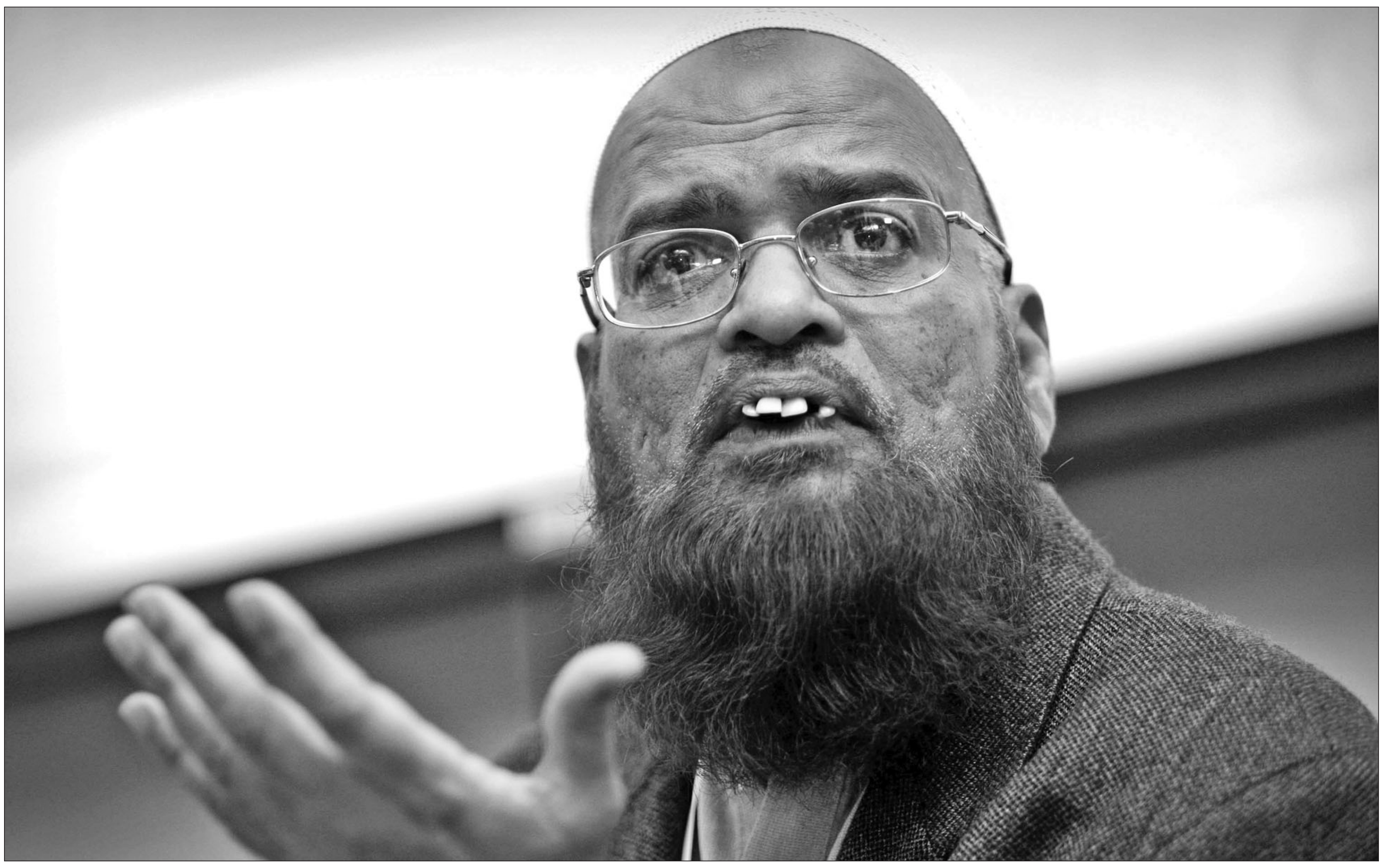
"What's limiting the ability of banks is the right people, the skilled bankers," says Mohammed Amin, head of Islamic finance at PwC. "The industry needs new talent and it needs to re-skill bankers."

Inside this issue

Clarification of rules does market a favour

SUKUK MARKET

A scholar's blow to bonds is likely to turn out to be a favour, says **David Oakley**



Sheikh Muhammad Taqi Usmani has shone a helpful light on bonds that are acceptable to scholars Bloomberg

In November last year Sheikh Muhammad Taqi Usmani, a religious scholar not widely known outside the Middle East, sent shockwaves through the Islamic financial world with a statement that threatened to bring the fast-growing sukuk market to a standstill.

Mr Usmani, head of the religious board of the leading body that sets standards for Islamic financial products, said 85 per cent of sukuk, or sharia-compliant bonds, had broken two key principles of Islamic law.

He was specifically referring to two types of bond structures that began to dominate the market towards the end of 2006. These structures are known as musharaka, an Islamic joint partnership, and mudaraba, a form of trust financing.

Significantly, between November and February not one sizeable international, or dollar-denominated, sukuk was issued, suggesting his statement may have permanently damaged a market that has grown dramatically since 2002 when the first Islamic bond was issued by the government of Malaysia.

However, most bankers and lawyers involved in the industry believe that the head of the religious board of the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) may turn out to have done the market a big favour by clarifying now rather than later what bonds are acceptable in the eyes of mainstream scholars. Mr Usmani also made it clear that his guidance was for future reference and would not affect the existing $80bn of outstanding sukuk.

Danie Marx, managing director, treasury and capital markets, at the European Islamic Investment Bank, a London-based Islamic bank, says: "This is a positive development as it prevents the market from going down a particular avenue that is not universally perceived to be in the spirit of sharia."

Most bankers also believe the stall in growth is mainly because of the credit crisis.

Despite the compliance controversy and dislocations in the conventional financial system, $2.5bn of international Islamic bonds have been issued this year – respectable, even though just half that of the same period a year ago.

In recent weeks, the market has started to pick up. Two notable issues came from the Bahrain government and the Bahrain-based Villamar Sukuk Company.

But, in a sign of the changing landscape, these two bonds were ijara structures, which Mr Usmani had not criticised.

Mr Usmani said the musharaka and mudaraba structures were breaking the rules because they offered investors a repurchase undertaking where the issuer promises to pay back the face value of the bond when it matures or in the event of a default.

This looks like a guaranteed return, which goes against the spirit of Islamic finance where interest is banned and buyers should share risk and profit. These financial deals were also criticised as they did not always transfer the assets from the borrower to the lender, again raising a question-mark over who was taking the risk in the transaction.

Ijara structures, which involve a sale and leaseback arrangement, escaped the criticism because they use an asset, usually a building, to raise money.

The building is placed in a special-purpose vehicle by the owner for a set amount, say $100m. The SPV will raise the $100m from investors to finance a business project. The SPV will then lease back the building to the owner for a set monthly fee, which will be paid to the investors.

As these are lease payments, no interest has been used to fund the project – in line with sharia law. As a building does not usually lose its value, the investors are in effect guaranteed their principal payment at par on maturity, although no explicit guarantee is made.

In the case of a musharaka, where one partner, usually a bank, puts the money into the venture and another, usually a company, puts in assets, such as a plot of land to be developed, the principal payment on maturity is guaranteed at par even though the investment may fall below face value. This was the point objected to by Mr Usmani.

With a mudaraba, where a group of investors appoints an agent to manage or develop the land or some other project, the principal payment is also guaranteed at par.

Roger Wedderburn-Day, a partner at law firm Allen & Overy, says: "The scholars are insisting that investors should be exposed to the risks associated with the performance of the underlying assets forming part of the investment. This means that a pre-determined, or guaranteed, price for those assets should be avoided and so a balance is struck between risk and reward."

The debate started to intensify only last year as the musharaka and mudaraba structures became more popular. Before 2005, the only structure used was the ijara. By the end of 2007, the majority of outstanding bonds were mudaraba or musharaka.

> 'There are scholars who do not want certain characteristics, such as guaranteed payments'

The rise in use of the musharaka and mudaraba structures was because bankers wanted more flexible forms of finance that did not rely on an asset or building, which limited issuers to those with property.

Neil Miller, a partner at law firm Norton Rose, says: "On the one hand, there are bankers that want to create instruments that have the character of debt, and on the other hand there are scholars who do not want to see certain characteristics, such as guaranteed payments, that have crept into the new structures because the economic paradigm they seek requires more equitable profit and loss sharing."

So where does this leave the market?

Jawad Ali, a partner in the law firm King & Spalding based in Dubai and London, says: "The Islamic finance and sukuk markets will continue to grow. There are over $1,000bn worth of infrastructure projects planned in the Gulf over the next decade. A big portion of these projects will be seeking sharia-compliant funding. I have no doubt the issues surrounding the sukuk market will be dealt with to facilitate financing these mega projects."

UBS sees a strong performance from the the Islamic bank it set up then brought back into the fold

UBS, one of the world's biggest banks, has not had a good year. The Swiss bank has recorded nearly $20bn in writedowns this year and plans to shed 5,500 jobs because of the credit crisis.

Yet one area of the bank continues to grow – the Islamic financing arm. Since 2002, when it first moved into this fast-growing arena, the bank has expanded operations, creating new products and attracting more business, even in the face of the worst financial crisis for decades.

Idayu Zainuddin, the head of the global sharia solutions team, says: "We are seeing growing interest from investors in Islamic finance across a range of equities, fixed income, corporate finance, real estate, private equity, structured products and foreign exchange."

Catharine Furrer-Lech, chair of the UBS Group Islamic Finance Committee, adds: "We are able to draw on our strength as a global bank to develop and distribute our products through our origination, structuring and marketing teams.

"We are able to develop Islamic products by leveraging the capabilities of our different teams across UBS, whether that is with the commodities agricultural team or the equity structuring team."

The bank, which employs 80,000 people worldwide, launched Noriba Bank as an Islamic bank in Bahrain in 2002, targeting private investors in the Middle East and south-east Asia.

In 2006, after four years of strong growth, helped by the increasing wealth in the Middle East on the back of the soaring price of oil, Noriba was integrated into UBS itself.

Ms Furrer-Lech says: "As our Islamic business gained momentum, we found that our clients' needs would be better served by an in-house team that could take full advantage of UBS's global strength and capabilities."

Offices were set up in Dubai, seen as a better location than Bahrain in the Middle East because of its dramatic growth, fast-developing financial services sector and more appealing lifestyle to western bankers. Its airport, with connections to the main financial centres around the world, was also a big attraction. The bank's client base and products have evolved rapidly since 2002.

Today its clients include some of the big institutional investors, such as pension funds and asset managers, and they are now drawn from all over the world, not just from the Middle East and Asia.

The bank also helped arrange one of the biggest international Islamic bond deals of the year – a $550m issue of sharia-compliant exchangeable bonds for Khazanah Nasional, the investment arm of the Malaysian government.

Ms Zainuddin says: "The deal highlighted the strength of demand for Islamic financial products. The bond was 13 times over-subscribed, and was launched and priced on the same night."

Products include Islamic cross-border structured debt and equity transactions, sharia-compliant leveraged private equity investments and leveraged real estate transactions. The bank is creating more commodity linked products, too, as investors want exposure to this booming asset class.

More clients and products

Ms Furrer-Lech says: "Our Islamic finance operation has grown and evolved quite dramatically since 2002, when we first started out, in terms of the number of products and services we offer, the regions covered and the number and type of investors we serve.

"We also increasingly rely on the breadth of our distribution networks and marketing teams around the world as more and more institutional and private investors want Islamic financial products. Our core team is based in Dubai, but we can use offices as far afield as Singapore and New York to serve our clients."

Ms Zainuddin says: "We are definitely seeing more and more activity in the Islamic finance space, and we believe this market can continue to grow. There are many more investors who want exposure to Islamic financial products. Islamic finance remains in a healthy state in spite of the credit crisis."

David Oakley

Expansion plan aims high

NOOR ISLAMIC BANK

Farhan Bokhari profiles a new institution in a hurry to grow

Six months after Hussain Al Qemzi led the initiative to launch the United Arab Emirates' Noor Islamic Bank, the institution's chief executive is working on ambitious expansion plans.

He is looking at ideas that range from targeting lower-income customers – by for the first time using post offices to offer Islamic banking – to expanding the bank outside the Gulf to parts of Africa and Asia.

The grand vision of the future for this Islamic bank is in sharp contrast to the days when they were peripheral and catered for only a narrow base of customers.

Several factors have prompted Islamic banks to match international standards.

They range from the large amount of Middle Eastern petrodollars produced by recent rises in the oil price, to customers seeking Islamic services with global standards.

Furthermore, there are plenty of untapped opportunities in the sector.

"We see plenty of areas that are empty. North Africa and central Asia have no presence of Islamic banking. Indonesia and Pakistan have a very small presence of Islamic banking," the chief executive of Noor told the FT.

Mr Qemzi has had a distinguished career as an Islamic banker, with stints including his role in overseeing the conversion of the National Bank of Sharjah, also in the UAE, to an Islamic institution.

Noor, which began taking deposits from customers this year, is 25 per cent owned by the Dubai government, 25 per cent by Sheikh Mohammed bin Rashid Al Maktoum, Dubai's ruler, 5 per cent by the UAE federal government, with the remaining 45 per cent owned by 17 UAE royals and businessmen.

Some of the most prominent names in Dubai's business elite sit on the bank's board.

Mr Qemzi is keen to stress that concepts such as "quality", "creating value for customers" and "creating size" in a competitive environment must all be central to the success of banks entering the Islamic market today.

"There are lots of Islamic banks which don't even carry the Islamic name. Islamic banking could [even] be termed as alternative banking. But the quality has to be the top priority," he says.

To fulfill its plan of expanding outside the UAE, the bank must decide whether its strategy should be to acquire existing banks with a view to converting them to Islamic institutions, or seek new licences to start from scratch.

Mr Qemzi notes that the cost of conversion of a regular bank to an Islamic institution is a factor that would have to be considered.

While Noor seeks to expand, it is also preparing a novel concept.

The bank is launching in the UAE a bank service delivered through post offices to target the 50 per cent of the population that has no formal bank accounts, says Mr Qemzi.

"Post office banks are common around the world. It is time for an Islamic bank to try out this idea. We have signed a contract with the post offices [in the UAE] to create a post bank to cater to the poor."

The idea of setting up a post office bank follows an order from the UAE ministry of labour requiring companies to pay workers by depositing their pay in a bank account, ruling out the option of them being paid in cash.

> 'North Africa and central Asia have no presence of Islamic banking'

The new service is expected to attract custom from low-paid workers, including many expatriates from countries such as India, Pakistan and the Philippines, who represent a significant part of the United Arab Emirates' workforce.

For such workers, the key attraction would be that the charges levied by a post office account would be significantly lower than those levied by traditonal banks.

This joint venture between Noor and the UAE post office is expected to include debit cards, Islamic insurance, credit cards, microfinancing, salary payments, remittances and currency exchange.

The post office and Noor said this year: "We understand that providing banking services to the low-income segment may not be lucrative."

But the post office Islamic bank concept is set to help Noor's profile as an institution willing to offer the type of services covered by conventional banks.

A key challenge for such consumer-based expansion is finding the right talent: it is not easy to recruit bankers who are as comfortable with conventional banking as they are with Islamic concepts.

This is a common problem cited by top executives at Islamic banks, who struggle to retain some of their best staff.

"We are in a situation where so much talent is chasing such few people," says Mr Qemzi.

To ease this situation, he is urging Islamic institutions to create a variety of human resource development programmes, including on-the-job training.

He is also proposing that banks build links with top-quality academic institutions to support research on Islamic banking and finance.

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Pioneer standards body tries to spread the word

MALAYSIA

The IFSB plans to target key finance people, writes **Farhan Bokhari**

Rifaat Ahmed Abdul Karim, is in a self-confident mood. The director-general of the Malaysia-based Islamic Financial Services Board (IFSB), says it has entered a "more meaningful phase" in its existence.

Up to 28 workshops are planned by the board around the world, mainly to translate research into training.

The move is in keeping with its aims: the IFSB was set up five years ago as the Muslim world's first standards body in the Islamic finance industry. It describes itself as "an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry". It does this by issuing standards and guiding principles for the industry, which it broadly defines as including the banking, capital markets and insurance sectors.

The IFSB has pronounced on risk management, capital adequacy, corporate governance, supervisory review processes, transparency and market discipline, recognition of ratings on sharia-compliant financial instruments, and the development of money markets.

Research under way includes examining operations of takaful, or Islamic insurance, and governance of investment funds. The training exercise involves teams from the IFSB teaching courses in countries to key people including central bank officials and financial experts.

The IFSB has set itself the objective of becoming the Islamic world's premier standard-setting body. It aims to be seen as the Islamic world's equivalent to the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors all wrapped into one.

Mr Abdul Karim, a prominent Sudanese economics professor who has built a reputation as a leading scholar on Islamic finance, says the IFSB's could play a central role in the evolution of Islamic finance. "The global structure is there but you have to adapt it to Islamic finance. Otherwise, if we did not have the IFSB, every institution would make its own interpretation."

In some ways, the IFSB's task may be easiest in Malaysia, its home base, which prides itself on hosting the world's largest market for sukuk – Islamic bonds – and where Bank Negara Malaysia, the central bank, has set an ambitious target of raising the proportion of total banking assets under Islamic institutions from 15 per cent now to 20 per cent by 2010.

Much of the demand for its services comes from outside its home country: there are many entrants to the market hopeful of attracting money from Muslim investors in the cash rich Arab world.

Mr Abdul Karim says coming up with high-quality global standards and achieving their adoption is not easy. "Our biggest challenge is the implementation side of our work. We don't have the legal right to impose standards," he says.

Many experts acknowledge the value of IFSB's work but also note that the long-term future of the IFSB's work depends on assuring lenders and borrowers that it achieves globally-accepted standards.

Mr Abdul Karim believes that attitudes are changing. "The industry has grown and has been demand-driven," he says. "The growth has brought about a lot of things. One of the good things is that there are more institutions now."

Rafe Haneef, Malaysia-based Managing Director of Fajr Capital, a recently established international Islamic investment management company, says Islamic banks "have to be as competitive as conventional banks. Muslims may not turn to an Islamic institution unless they see value in that decision."

Covering risk puts a premium on growth

INSURANCE

The companies that have piled into this sector face a big challenge, says Andrea Felsted

The development of the Islamic insurance market is at a crossroads. Many big international companies have piled into Islamic insurance over the past few years. But according to Arthur White, partner at Oliver Wyman, companies that have entered the Islamic insurance sector face several challenges in order to advance their businesses to the next stage of development.

"Big international companies have now decided whether they want to be in this market or out of it. Many of the big names have established footholds. The real question now is how do they make it work," says Mr White.

Sameer Abdi, partner in charge of Islamic financial services at Ernst & Young, agrees: "International insurance companies are coming into this market because they see a huge potential for growth, but success will be predicated on a number of critical factors such as market acceptance and scale."

The reason international insurers have flocked to this market is the potential for expansion. The market for insurance that complies with Islamic law, or takaful, is forecast to increase substantially over the next decade.

According to Moody's, global takaful premiums could rise from $2bn in 2005 to $7.4bn in 2015.

Ernst & Young estimates that global takaful premiums could reach $4.3bn in 2010 excluding Iran, and almost $15bn including Iran.

Much of the takaful market is focused on the countries of the Middle East, where historically there has been a low level of insurance penetration. Malaysia also has a mature takaful market.

But according to Simon Harris, team managing director of European insurance at Moody's, as people in Gulf countries and other Muslim nations grow richer and accumulate more assets, they are increasing the extent to which they are insured.

Takaful is expected to play a significant role in these countries. In the Middle East, E&Y points out, demand is high for financial products that comply with Islamic law. And some countries, such as Saudi Arabia, are encouraging individuals to protect themselves by buying insurance.

Indeed, the potential of the insurance market in Middle Eastern countries is underlined by the fact that about 40 companies – including many big international names, often in a joint venture with a local partner – have applied to the Saudi Arabian Monetary Agency for licences to sell insurance under a new regime. Under these rules, insurers must be incorporated in Saudi Arabia and listed on the Riyadh stock exchange.

They must also operate under a co-operative model, whereby profits generated from policyholders are shared with them, usually by granting them a discount when they come to renew their policies.

Saudi Arabia is particularly attractive to insurers because of a combination of low insurance take-up so far, high levels of economic growth and an expanding middle class. In addition, a law requires most expatriate workers to have health and third-party motor liability insurance.

While the Middle East offers the potential for strong growth, even more spectacular expansion could come from offering takaful products to Muslims outside the region – and even to non-Muslims. Indeed, Principle Insurance, the first pure Islamic insurer in the UK, recently received authorisation from the Financial Services Authority.

> 'This is a terrific opportunity to sell a price-competitive ethical product to everyone'

According to Mohammad Khan, a director in PwC's actuarial and insurance management solutions practice, there are about 20m Muslims in Europe. Selling takaful insurance to the UK's 2m Muslims would be a substantial market in itself.

"If you can sell it as an ethical product and price competitively, your market is far far greater," says Mr Khan.

"This is a terrific opportunity to sell a price-competitive ethical product to everyone. You have to market it correctly, but if I walk into the supermarket, and I go to the organic counter, I pay far more for my organic cheese than for my conventional cheese.

"Here, you have a product that is ethically invested, gives you a share of the surplus if the company makes a profit, has an independent body confirming that the company is acting in the right way, and your motor insurance premium is going to be roughly the same."

But the takaful insurance market is not without its challenges.

Mr White says insurers must decide which kind of model to use to share profits. Options include the Wakala model, similar to a mutual where the operator takes fees for service, and the Mudharaba model, a profit-share arrangement between policyholders and operator.

Similarly, insurers need to decide which type of Islamic law they are to comply with: the Malaysian version, which is well-established but viewed as more lenient, or stricter interpretations from Saudi Arabia or Qatar.

Other challenges in the Middle East include how policies are distributed to customers and how to deal with teething problems associated with a rapidly expanding information technology infrastructure.

With the takaful market expanding rapidly in the Middle East, PwC's Mr Khan says another challenge is recruiting sufficient skilled staff.

"Traditionally, insurance has not been at the cutting edge of attracting talent in the region," he says.

To ensure that companies stay ahead, they will need to price their products appropriately, develop and distribute innovative products, and manage claims properly.

All this, says Mr Khan, "requires staff with talent and experience".

Scholars and harmony in short supply

EXPERTS

Sharmila Devi finds opportunities in the lack of standardisation

Barely five years ago, few western investment bankers would have believed that they would be following the fatwas or religious rulings of Muslim scholars, some of whom do not use email of fax.

But the spectacular rise of Islamic finance in the past few years has left many western institutions rushing to acquire the knowledge and expertise necessary to compete – with a resulting scramble for skills.

Bankers' scepticism about the sector is expressed only privately but some Islamic scholars have gone public in their attacks on banks and the judgments of other clerics.

Many analysts say such debate is simply part and parcel of a religion with no clerical hierarchy, and to be expected in a sector as young as Islamic finance.

More of a threat to immediate growth is the shortage of skills – from the religious scholars needed to approve sharia compliance to lawyers, bankers and technical staff needed to implement deals.

Salaries are rising in accordance with the demand, say recruitment consultants.

There are only about 60 Islamic scholars with expert knowledge of finance, while an even smaller group of around 12 are highly sought-after by western institutions.

"The number of internationally accepted scholars is stagnant and there is an acute shortage," says Qudeer Latif, head of Islamic finance at corporate law firm Clifford Chance in Dubai. For one deal, he had to travel to four countries to meet just one Islamic scholar.

It takes about 15 years to train in Islamic jurisprudence and become expert in finance.

But there is a pipeline of people who have started training, says Jamal Dar, an executive at PwC in London.

Mr Dar says the lack of Islamic standardisation offers opportunities for institutions to offer a wide variety of products and instruments to suit all levels of religious sensibility.

"There is agreement on 90 per cent of the sector," he says. It gets complicated in the other 10 per cent with instruments such as derivatives, which affect the cross-border market, not the domestic market."

Malaysia is a long-established Islamic financial centre but has been challenged in recent years by strong growth in the Gulf.

The Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is working hard to develop common, regulatory standards including sharia and training.

"There are more than 16 jurisdictions that follow or consult our standards," says Khairul Nizam, assistant secretary-general at AAOIFI.

"The standards take into consideration all the different Islamic schools of thought – and there is a lot more similarity than difference among the schools."

But AAOIFI standards are not enforceable, and different scholars even within the same jurisdiction are likely to continue on their own paths.

"I've looked at AAOIFI and I think the problem is that, with anything done by a committee, clarity and crispness is sacrificed in getting a consensus," says Henry Thompson, legal counsel at the Bahrain-based Arcapita investment firm.

"It will be hard to have standardisation because each board of scholars at all the different firms will be loth to have their rulings overturned."

Another area where AAOIFI is likely to be ignored is remuneration.

The organisation said scholars should not accept contingency fees and where pay might depend on a deal going ahead as it creates a conflict of interest. Most scholars, however, receive a set fee and observers say a top scholar can earn up to $250,000 on a typical capital markets deal.

Another organisation striving for standardisation is the Central Bank of Bahrain, which examines regulation such as bank adequacy rules to ensure stability.

"We were the first to develop such regulations and we have been promoting them worldwide," says Khalid Hamad, an executive director at the Central Bank of Bahrain.

> 'The number of internationally accepted scholars is stagnant'

Qudeer Latif
Head of Islamic finance, Clifford Chance, Dubai

The International Islamic Finance Market (IIFM), also in Bahrain, is working on regulation of Islamic capital and money markets in co-operation with the International Capital Market Association.

"There is a generational issue when it comes to standardisation, with some older people not feeling comfortable giving judgment on complicated instruments," says Ijlal Alavi, IIFM chief executive.

Many analysts hope there will be greater consensus on standards as the sector matures.

"The scholars have made great strides in recent years in establishing rules which have seen the development of mainstream products, such as profit-bearing deposits, mortgage loans and other investment vehicles," says Salim Nathoo, head of Islamic finance for legal firm Allen & Overy.

"Selection of reputable scholars who command the respect of the market is critical in developing some of these newer products."

Property price growth spurs rise in instruments

REAL ESTATE

Companies are looking for ways to capitalise on surging prices, says Sharmila Devi

Nakheel, the Dubai government-owned property developer, might be making a splash in an arcane area of Islamic finance after having defied nature to create palm-shaped islands off the United Arabe Emirates coast.

Nakheel wants to raise Drh1.36bn ($1bn) for housing and infrastructure projects via an initial public offering of two real estate investment trusts (Reits).

These instruments have yet to take off in the Gulf Islamic finance sector but are tipped as the next big thing as more institutions examine ways of managing and capitalising on the recent real estate boom while abiding by Islamic restrictions.

Analysts say Reits are perfectly suited to Islamic finance because they are based on underlying, tangible assets, such as rent on real estate, not on speculation.

"Reits have not yet taken off but it's a question of when," says Qudeer Latif, head of Islamic finance at corporate law firm Clifford Chance in Dubai. "Real estate growth in the last three years has been phenomenal and there are lots of banks who have very high exposure to real estate assets."

Hedging such exposure can be difficult because sharia scholars differ on whether derivatives are permissible.

A Reit is a listed property company that usually does not pay tax on its earnings as long as these are mostly distributed to investors in the form of dividends.

"There's a lot of demand in the market for Islamic solutions," says Jamal Dar, an executive at PwC in London. "It's dependent on the legislative environment in the region."

Malaysia, a long-established Islamic financial centre, several years ago listed the first Islamic Reits, which included hospitals and palm oil estates as assets.

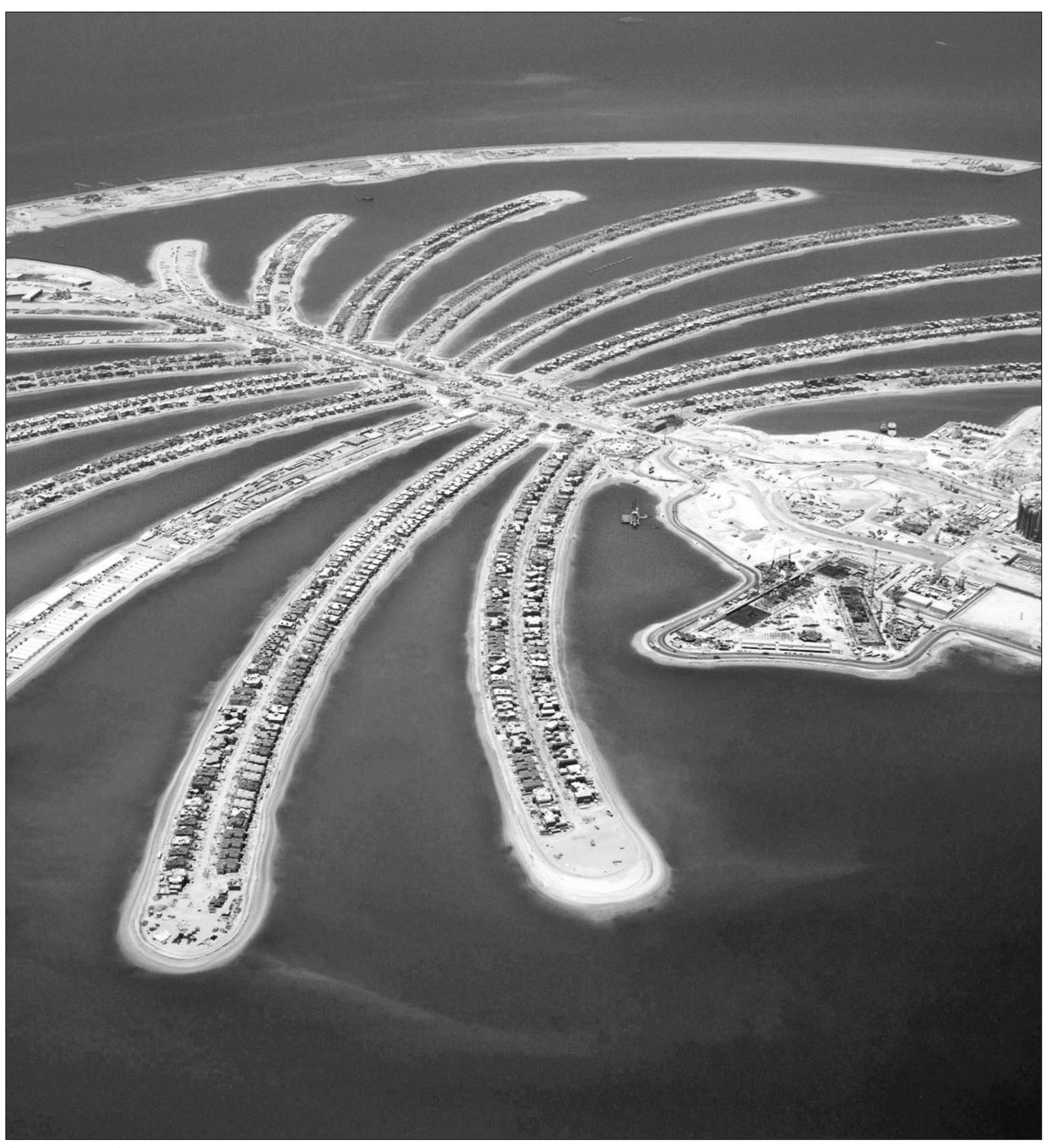
The Dubai International Financial Centre, the free zone opened in 2004 to attract institutions from around the world, is also hoping to create a Reit sector following a revamped regulatory framework.

"We've seen a number of Reits in jurisdictions with a fairly mature real estate market [such as Malaysia]. They aren't just limited to buildings and they can be anything tangible with an income stream – estates, plantations, even a power plant with an off-take by a government entity," says Nik Thani, executive director of Islamic finance at the DIFC.

"As long as there's steady cashflow, and the cashflow is not derived from interest-based income, anything can be monetised. And while sukuk [Islamic bonds] are for institutional investors, Reits can be retailed to everyone thereby providing wider access towards investing in Islamic investment products."

Institutions operating in the DIFC are regulated by the Dubai Financial Services Authority, whose rules contain "hidden gems, particularly for Islamic finance", that have yet to be utilised, says Mr Thani.

But Reits still need another important foundation stone – clear and concise property laws and, in particular, land registration rules. In Dubai, for example, companies operating outside the DIFC's free zone are subject to the regular civil legal framework, which is in the process of being adapted to keep up with the fast-paced economy.



Shored up: Gulf Islamic financial activity is expected to remain linked to real estate AP

"This makes sense for Dubai because there are a lot of massive projects here that are not currently monetised but are income-producing," says Mr Thani.

An updated legal and regulatory framework is needed to boost securitisation in general, not just Reits. Legal issues relating to bankruptcy, insolvency and ownership need to be clarified before investors gain confidence.

> 'There are a lot of massive projects here that are not currently monetised but are income-producing'

The growth of Islamic securitisation also has been hampered by investor caution following the credit crunch in the US. But many analysts believe the crisis serves to highlight the benefits of Islamic finance and its requirement to be linked to tangible assets.

Securitisation would allow investors to buy bonds directly tied to mortgages, auto loans and other income-producing assets as long as they comply with the Islamic ban on trading debt and lending on interest.

A report released in April by international credit ratings agency Moody's said the future structuring of sukuk was likely to move increasingly towards sharia-compliant securitisation and secured "asset-backed" transactions.

"Thanks to the slow but constant development of securitisation and credit repacking in emerging Muslim countries, asset-backed sukuk, with no explicit guarantee from asset originators, should continue to gain market share but also remain dependent on the dynamics of the global credit markets, especially in securitisation," said the Moody's report Islamic Banks and Sukuk: Growing Fast but Fragmented.

Gulf Islamic financial activity is expected to remain tied to the fortunes of real estate, and analysts see property booming for at least the next couple of years.

"There will probably be a slowdown in the rate of growth of real estate because it can't be 15-20 per cent every year," says Mr Latif. "But there probably won't be a crash given the fact that governments are behind so much of the activity. From a political perspective, they can't allow it to fail."

Agencies struggle to give investors a frame of quality reference

RATINGS

Regulators also need to play their part, says Sharmila Devi

"A fatwa, just like a rating, is an opinion. Investors are constrained neither by ratings nor by fatwas and make decisions from their own perspectives," says Anouar Hassoune, vice-president and senior credit officer at Moody's international ratings agency in Paris.

The growth of analysis and indices tracking Islamic instruments by agencies such as Moody's and Standard & Poor's follows demand from Muslims and non-Muslims alike.

Many potential and even current investors are unclear how best to judge these new Islamic instruments, and have welcomed analysis of their technical features. But these ratings agencies make no attempt to judge the sharia dimension – that aspect is approved by a board of Islamic scholars.

While global investment banks and other institutions can offer standardisation on the commercial and technical aspects of Islamic finance, many differing interpretations of sharia remain. "Fragmentation is a fact of life," says Mr Hassoune.

The ratings agencies, aided by scholars, have had to come up with new methods of analysis in the past couple of years to help to guide the growing number of investors in Islamic finance.

Alka Banerjee, vice-president of index services at Standard & Poor's in New York, says: "It was imperative that we work with an established board of scholars because we don't have credibility in the space of sharia compliance – we were novices. The scrutiny was very intense."

Last year, S&P launched the GCC Shariah series of indices – the name refers to the Gulf Co-operation Council which groups Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

The indices were screened by Ratings Intelligence Partners, a Kuwait-based consulting company whose researchers work with a sharia supervisory board. Companies considered non-compliant include those that deal with alcohol, tobacco, pork, entertainment and financial services.

Companies with debt levels worth more than one-third of their assets are also unacceptable.

Ms Banerjee discovered an interesting statistical fact. No matter the total number of western stocks in any group under consideration, whether 20 or 500, about 50-60 per cent were always found to be Sharia-compliant. "It follows a consistent pattern and follows the normal probability curve," she says.

However, classifying equities according to sharia principles is more straightforward than assessing other instruments, such as sukuk, or Islamic bonds, and Islamic banks.

"Profit-sharing accounts found in Islamic finance don't meet our normal criteria so we have adjusted the framework by which we judge stability," says Paul Coughlin, S&P executive managing director for corporate and government ratings.

> 'The sukuk market in Malaysia is developing very fast and in more depth than in the Middle East'

Islamic banking bans the payment of "riba" which some interpret as interest. Instead of conventional fixed interest rates, payments on sukuk derive from the profits of tangible assets. They can be structured to deliver a fixed annual rate from a profit-sharing investment account (PSIA).

Moody's makes a broad division in its classification of sukuk. The first group benefits from a guarantee from the originator and is called asset-based sukuk.

The second group is sukuk without such an explicit guarantee and is called asset-backed "to reflect the fact that the most critical ratings factor lies in the credit quality of the underlying assets", according to Moody's.

The first type of sukuk has been the subject of controversy, with some Islamic scholars saying they adhere to only the letter and not the spirit of Islamic law.

Moody's discovered an additional advantage to the second type of sukuk. "One of the many benefits of Islamic securitisation transactions giving birth to secured asset-backed Sukuk is the ability of the originator to issue sukuk rated higher than the originator's ... credit ratings," the agency says.

This happened last July when Tamweel, a Dubai-based property finance company, launched the Gulf's first rated Islamic securitisation and transferred legal ownership of residential property and associated financing contracts to investors. Moody's rated the paper Aa2 while Tamweel itself is rated A3.

Analysts and ratings agencies say further growth in securitisation and more sophisticated financing tools in the Gulf will need greater legal and regulatory clarity.

For example, collateral foreclosure, inherent as a risk in property-backed PSIAs, has yet to be tried and tested in the Gulf where real estate has fuelled much of the growth in sukuk.

The Islamic International Ratings Agency in Bahrain conducts analysis of sharia compliance as well as the more usual technical oversight. "We are the only specialised agency doing this," says Jamal Zaidi, chief executive officer.

"The sukuk market in Malaysia is developing very fast and in more depth than in the Middle East because regulatory actions have provided support to the capital markets. Sukuk in Malaysia must have a rating and this provides a level of comfort."

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Thank you for your help

Simon Targett, Associate Director, Financial Times

Q1 How much of this FT Report did you read, or do you expect to have read by the time you have finished with it?

All of it ❑ About a quarter ❑
Most of it ❑ Less than a quarter ❑
About half ❑ Don't know ❑

Q2 Apart from yourself, how many people will read your copy of this FT Report?

None - just myself ❑ 3 to 4 ❑
1 ❑ 5 to 9 ❑
2 ❑ 10+ ❑

Q3a What will you do with the FT Report once you have finished reading it?

Keep the copy for future reference ❑
Pass it on to a colleague ❑
Throw it away ❑
Other/Not sure ❑

Q3b If you intend to refer to this FT Report in the future, where will it be kept?

In your own office ❑
In another office/department ❑
In the company library ❑
At home ❑
Elsewhere ❑

Q4 Overall, how would you rate this FT Report?

Excellent ❑ Fair ❑
Good ❑ Poor ❑

Q5 What is the value to you in reading FT Reports?
Please write in:

Q6 Which, if any of the following FT Reports recently published by the FT did you read or look at? *(Please tick all that apply)*

Arts Collecting (24th May 2008) ❑
Business of Luxury (29th May 2008) ❑
Greece (2nd June 2008) ❑
Youth in the Middle East (2nd June 2008) ❑
Sustainable Banking (3rd June 2008) ❑
Spain (11th June 2008) ❑
Watches & Jewellery (14th June 2008) ❑
South Africa (17th June 2008) ❑
Private Banking (18th June 2008) ❑

Q6a What will you do as a result of reading this FT Report? *(Please tick all that apply)*

Keep it for future reference/clip articles ❑
Keep the whole FT Report ❑
Contact someone in editorial ❑
Contact one of the advertisers ❑
Purchase something ❑
Consider investing ❑
Pick up on an idea ❑
Would consider reading other FT Reports ❑

Q7 Please indicate how strongly you agree or disagree with the following statements about FT Reports...(on a scale of 1 to 5 where 5 is Strongly Agree and 1 is Strongly Disagree).

	Strongly Agree 5	4	3	2	Strongly Disagree 1
They are well written	❑	❑	❑	❑	❑
They are useful to me in my work	❑	❑	❑	❑	❑
They cover a wide range of topics	❑	❑	❑	❑	❑
They provide information I cannot find elsewhere/would not otherwise see	❑	❑	❑	❑	❑
They are better than those produced by other publications	❑	❑	❑	❑	❑
They are more independent and objective than those produced by other orgs	❑	❑	❑	❑	❑
The writing is independent and unbiased	❑	❑	❑	❑	❑
They help keep me informed about trends/development	❑	❑	❑	❑	❑
They are accurate and up to date	❑	❑	❑	❑	❑
They are well laid out and easy to read	❑	❑	❑	❑	❑
They are authoritative and credible	❑	❑	❑	❑	❑
They are useful for both the specialist and the general reader	❑	❑	❑	❑	❑

Q8 How highly do you rate editorial independence and integrity?

Very highly ❑ Not at all ❑
Fairly highly ❑ Don't know ❑
Not very highly ❑

Q9a Which subjects would you be interested in the FT covering?
Please write in:

Q9b Which geographical regions would you be interested in the FT covering?
Please write in:

Q10a How often do you read FT Reports that are not related to the industry you work in?

Almost always ❑ Only occasionally ❑
Quite often ❑ Never ❑

Q10b Do you consider the content of those that you have read that aren't on your industry to be...

Too specialist ❑
Neither too specialist nor too general ❑
Too general ❑

Q11 In which, if any, of the following ways do you use FT Reports?

For a better understanding of countries/regions I do business with ❑
To find out about specific business sectors ❑
To find out more about the industry I work in ❑
To make better informed business decisions ❑
To find new business partners ❑
To understand new technological developments ❑
To learn about new financial instruments and techniques ❑
To incorporate into presentations, reports and other documents ❑
To show to clients, suppliers or other contacts ❑
In preparation for a business trip ❑
In my role as a teacher/lecturer as teaching material ❑
To help make my investment decisions ❑
Other ❑

Q12 Have you ever contacted a company or organisation as a result of seeing an article/advertisement?

Yes - after reading an article ❑
Yes - after seeing an advertisement ❑
No ❑

Q13 How do you generally find out about FT Reports?

Look at Guide to the Week ❑
See advance notices in the paper ❑
Receive advance topic list from FT ❑
Receive advance topic list from another org ❑
Look up on ft.com ❑
Use the FT reports fax back service ❑
Just come across them on day of publication ❑
Editorial contact ❑
Advertising contact ❑
PR contact ❑
Other ❑

Q14 In which of the following ways have you accessed FT Reports?

In print
Copy of FT purchased for this purpose ❑
Copy of FT purchased for overall content ❑
Office/someone elses copy ❑
Library, archive or other source ❑
Purchased/sourced back copy ❑
None of these ❑
Online
Via FT.com search ❑
Via a search engine ❑
Via subscription section of ft.com ❑
Via a downloaded pdf version of FT Reports from FT.com ❑
Via FT Reports video content on FT.com ❑
Via Q&A forums on the FT Reports section on FT.com ❑
Via another online source ❑
None of these ❑

Q15 On how many days do you access FT.com?

6-7 days per week ❑ Several times a month ❑
4-5 days per week ❑ Once a month ❑
2-3 days per week ❑ Less often ❑
Once a week ❑ Never ❑

Q16 If you use FT.com to access FT Reports, how do you use it?

To gain access to the additional web-only articles or data that accompany some FT reports ❑
In place of the print version ❑
In addition to the print version ❑
For archive/reference purposes ❑
Do not use FT.com ❑

Q17 If there were to be more FT Reports material available in web-only form on FT.com, how likely would it be that you would use this content?

Very likely ❑ Not likely at all ❑
Quite likely ❑ Don't know ❑
Not very likely ❑

Q18a In which of these publications do you ever read or look at special supplements or advertising features?

FT ❑ IHT ❑
Economist ❑ The Times (UK only) ❑
Time ❑ Daily Telegraph (UK only) ❑
Euromoney ❑

Q18b Which publication do you think runs the most informative special reports, supplements or advertising features? *(Please tick one)*

FT ❑ IHT ❑
Economist ❑ The Times (UK only) ❑
Time ❑ Daily Telegraph (UK only) ❑
Euromoney ❑

Q18c In which, if any, of these publications do you think the editorial content is influenced by advertisers?

FT ❑ IHT ❑
Economist ❑ The Times (UK only) ❑
Time ❑ Daily Telegraph (UK only) ❑
Euromoney ❑

Q18d Which has the highest quality editorial content?

FT ❑ IHT ❑
Economist ❑ The Times (UK only) ❑
Time ❑ Daily Telegraph (UK only) ❑
Euromoney ❑

About you

Q19 Are you...? Male ❑ Female ❑

Q20 Which group are you in?

Under 25 ❑ 45-54 ❑
25-34 ❑ 55-64 ❑
35-44 ❑ 65+ ❑

Q21a Which of the following best describes your current status?

Employed full-time – 30 hours a week or more ❑
Employed part time – less than 30 hours a week ❑
Studying full-time *(Please go to Q.25)* ❑
Not working - retired *(Please go to Q.25)* ❑
Not working - other reason *(Please go to Q.25)* ❑
Other (please write in) ________ ❑

Q21b Which of the following best describes your occupational status?

Self employed/ Own a business/ Partner in a business ❑
Work for a commercial organisation/ business ❑
Work in an educational establishment ❑
Work in medical establishment ❑
Work in government/ politics/ civil service ❑
Work in charity/ non-profit organisation ❑
Other (please specify) ________ ❑

Q22 Which of the following best describes your job title/working status?

Owner ❑
Partner ❑
CEO/ President/ Chairman/ MD ❑
CFO/ Financial Director/ Treasurer ❑
CIO/ CTO/ CSO IT director/ IT Manager ❑
Other board level director ❑
Senior Management (Department head or equivalent) ❑
Other Managerial level/ executive ❑
Technical specialist ❑
Administration/ clerical ❑
Professional qualified (i.e. Doctor, Teacher, Engineer etc.) ❑
Consultant ❑
Elected representative ❑
Other (Please specify) ________ ❑

Q23 Which of these industry groups best describes the industry you work in?

Manufacturing /Engineering /Energy / Utilities
Energy / Utilities ❑
Oil / Chemicals / Plastics / Pharmaceuticals ❑
IT / Telecommunications / Electronics ❑
Construction / Civil Engineering / Building Materials/ Vehicles / Transport Equipment ❑
Food / Drink / Tobacco / Textiles / Clothing ❑
Other manufacturing / engineering ❑
Finance
Accountancy ❑
Banking/ Corporate Finance/ Fund Management ❑
Insurance ❑
Other finance ❑
Services
IT / Telecommunications services ❑
Advertising / Public Relations / Marketing/ Publishing / Media ❑
Legal / Consultancy services ❑
Travel / Tourism / Entertainment / Leisure Services ❑
Government / Public Sector/ Education / Health ❑
Import / Export / Wholesale / Retail / Logistics ❑
Other services ❑

Q23a Does you job responsibility involve making decisions about the purchase or lease (ie choosing the supplier or brand or authorising the payment) of any of the following type of goods or services?

IT/Telecommunication equipment/systems/services ❑
Other office equipment ❑
Aerospace ❑
Industrial materials/ components ❑
Fuel/Energy ❑
Company vehicles ❑
Business premises/sites ❑
Banking ❑
Investment/Brokerage ❑
Financial/Accounting Services ❑
Legal/management consulting services ❑
Advertising / Marketing / Public relations ❑
Training/Education courses ❑
Recruitment services ❑
Travel services ❑
Logistics ❑
Conferences/Exhibitions ❑
Other business services ❑
Other ❑
Not involved in purchase decision making ❑

Q24 In total, how many people are employed by your organisation worldwide?

1-9 ❑
10-49 ❑
50-99 ❑
100-249 ❑
250-499 ❑
500-999 ❑
1,000-2,499 ❑
2,500-4,999 ❑
5,000-9,999 ❑
10,000+ ❑
Don't Know ❑

Q25 What country or region do you live in?

UK ❑
Elsewhere in Europe ❑
USA ❑
Canada ❑
Hong Kong ❑
Singapore ❑
Japan ❑
Russia ❑
Korea ❑
Malaysia ❑
India ❑
Other (please write in) ________ ❑

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FOLD 5
(Tuck in to flap A)

FOLD 2

FOLD 3

FOLD 1

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Address ....

....

....

Postcode .... Country ....

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Islamic Finance

UK leads in sowing seeds for a sector


End of Ramadan in central London: the financial centre has also hosted its own ceremony Getty

LONDON

Shyamantha Asokan says the City has stolen a march on many of its global rivals

One Friday night in 2006, London's financial traders shunned the flashy wine bars for a room furnished with white cloths and devoid of alcohol.

The City was hosting a ceremony to break the Muslim fast of Ramadan. Part of Mansion House, usually used for meetings with finance ministers, had been converted to a prayer room for the night.

The event was widely interpreted as a sign of London's eagerness to establish itself as a hub of Islamic finance. This aim had been explicitly stated by the then chancellor, Gordon Brown, who had that year spoken of his ambition to make the UK "the global centre" for the sector.

Almost two years on from that speech, the City is well on the way to becoming a thriving centre for Islamic finance. There are four licensed wholesale Islamic banks – the only ones in the EU – and 21 conventional banks offering Islamic services. London's newest Islamic bank, Gatehouse, received its licence in late April. Principle Insurance, the first independent company fully compliant with Islamic law in the UK, launched at the start of May.

The London Stock Exchange has admitted 16 sukuk, or sharia-compliant bonds, to its markets, raising £5.5bn. The UAE company Tabreed issued the first LSE-listed sukuk, for £109m, in July 2006. The Kingdom of Bahrain registered the first sovereign sukuk in London, for £176m, this March.

"If you want to talk to anyone about Islamic finance, and you're not in the Middle East or Far East, you come to London," says Humphrey Percy, head of Bank of London and the Middle East, which was licensed last year.

"It has the right timezone for dealing with Asia and the Middle East, a huge talent pool, and a concentration of diverse markets – the stock exchange, futures, metal, oil. Also, the government and the Bank of England have supported Islamic finance."

> 'This isn't an altruistic gesture. This is a way of keeping the City at the forefront'

The UK government has been introducing legislation to nurture Islamic finance since 2003. Sharia, or Islamic law, forbids interest on the grounds that money should measure rather than create value. An Islamic investment thus often uses several purchases and sales to create a comparable increase.

During the past five years, finance acts have contained laws that try to ensure that Sharia-compliant transactions are not exposed to multiple stamp duty or ineligible for the tax breaks granted to certain kinds of interest in the UK.

The government gives two reasons for its zeal: to aid the integration of Britain's 2m Muslims, and to maintain London's position as a global business centre.

"This isn't just an altruistic gesture [for Muslim investors]," says Richard Thomas, who chairs the government's advisory board on Islamic finance. "This is a way of keeping the City at the forefront,

"This area is growing rapidly and these new banks draw activity to the UK. That money could go to Bahrain, but we would like it to come to London."

Islamic banking assets have been growing at a rate of just under 20 per cent, according to Moody's, the rating agency. The sector still accounts for just 1 per cent of global banking assets.

London has so far had little competition to become the west's centre for Islamic finance. New York, the only possible contender, struggles with its timezone and remains ambivalent about the sector after the September 2001 terrorist attacks.

"US politicians still confuse Islamic finance with terrorist finance," says Mohammed Amin, who oversees Islamic finance projects at PwC.

Meanwhile, in Asia, countries such as Japan, Hong Kong and Indonesia have started to show an interest in the sector.

But the UK still has work to do. Some sharia-compliant transactions are more heavily stung by value-added tax than conventional equivalents, but this area of legislation is EU-wide and difficult to modify.

City executives are also calling for the UK to issue sovereign sukuk as an alternative to government bonds – it is thought this step will be announced in next year's finance act.

The UK cannot yet boast an Islamic finance sector as sophisticated as that of Malaysia or Bahrain, often considered leaders in the field. But it has made impressive progress in a few years.

As David Testa, head of Gatehouse, said when the bank received its British licence: "What with the problems of Northern Rock and the crackdown on non-doms [non-domiciled foreigners], this really is one area where the City got it right."

The next frontier

Guest Column
AFAQ KHAN

The recent development of Islamic derivative products is making it possible for sharia-compliant finance to address risk-management.

From its modest beginnings in the mid-1970s as a local, specialised product, Islamic banking has grown into a globally recognised alternative. It has amassed assets of more than $900bn and achieved growth rates far outpacing the conventional market.

The past decade has seen significant developments, with rapid growth in the number of Islamic financial institutions and expansion in product offerings and geographic footprint.

Governments from Malaysia and Pakistan to the UK have introduced regulations that allow Islamic banks to operate on equal terms with conventional institutions in these jurisdictions.

An example of this is the tradable sukuk – it provides liquidity, improved disclosure via a regulated rating process, and allowed issuers more flexibility in raising long-term capital at floating rates, as well as enabling market-based pricing of Islamic assets.

Meanwhile, the Islamic product investor base has expanded from local banks to global banks, private bank customers, asset managers and, increasingly, private investors. This has allowed issuers the opportunity to tap into new sources of capital and increase investment and innovation in products.

Islamic finance houses in many jurisdictions now deliver complete retail, corporate and indeed investment banking services.

While the development in the primary Islamic finance market has been rapid, sharia-compliant risk management for Islamic industries has evolved at a slower pace.

The rate of change is now accelerating, for three reasons.

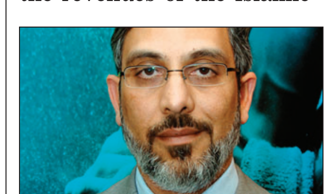
First, as Islamic industry becomes part of national, regional and international economies, it is exposed to the same vagaries of a market-based economy. This means Islamic financial institutions must have the tools to manage this risk.

Second, customers are increasingly demanding end-to-end solutions in a sharia-compliant manner, rather than going to the Islamic industry only for capital-raising.

Third, as Islamic financial institutions expand outside their national borders to participate in some of the fastest-growing economies of the world, they need more sophisticated tools to manage the associated risks of diversified portfolios and global customer servicing.

While derivatives may seem out of line with a ban on profit through speculative means, hedging to mitigate risk or fixing the cost of production is allowed.

These types of Islamic derivatives may provide answers to many of the industry's risk needs and therefore are being aggressively pursued as a key risk-management tool. They should also improve the revenues of the Islamic banks, as they enable them to offer customers a broader range of services.



> 'Islamic derivatives may provide answers to many of the industry's risk needs'
>
> **Afaq Khan**
> Standard Chartered Saadiq

It would help maximise the potential of these products if standard documentation existed for Islamic hedging products -– and banks are working with global industry bodies to this end.

Further ahead, Islamic hedging solutions should enable the industry to expand into such areas as asset management, private equity, principal finance activities and commodity finance.

In a couple of years' time, I believe that we will look back on today as a rapid period of innovation in the Islamic finance industry marking a milestone in its development and its impact across the world.

Afaq Khan is chief executive of Standard Chartered Saadiq