



# Drumming up support for Islamic finance

As traditional lenders have been felled by the global financial and economic crisis, Islamic financiers have been drumming up support for Islamic finance. Islamic finance does not allow excessive leverage, the main culprit that shook the very foundation of global banking. Had the world banked mostly on Islamic principles, it would have been a much safer place for everybody. **Ritwika Chaudhuri** speaks to industry experts.

**T**here are plenty of arguments in favour of Islamic finance, other than that it does not allow excessive leverage. One of the most quoted is the asset-backed nature of its transactions that goes against the very principle of complex derivatives, which were responsible for the housing market collapse in the US that started the global financial crisis.

Of course, the issue is not that simple. Modern banking uses complex risk management techniques and has regulations that bar irresponsible lending. Yet, there was a crisis, and it led to systemic problems that became

endemic. To speak simplistically, it was indomitable human greed that triggered the crisis. Checks and balances, including regulations, were circumvented by people who wanted to become rich quickly. But more importantly for this article, the global crisis did not spare Islamic banking, as these institutions too lent to entities that defaulted and took significant hits. Their asset concentration in real estate and equities did not help either, as both asset classes weighed heavily in their books and became pariahs for investors. Eventually, the balance sheets of Islamic financiers also gasped for recapitalisation.

## In favour of Islamic finance

Exponents of Islamic finance argue that unlike traditional banking, the former carries a risk profile with less exposure to market volatility. Since it is not structured through embedded speculative ingredients, Islamic finance is safer and less risky when compared to other products available in the markets, they say.

Many experts feel that Islamic finance is more comparable to traditional banking, as its transactions are backed by assets. That cash flow should stem from tangible rather than notional assets is an important

distinguishing factor that stands out in favour of Islamic finance, especially after a market collapse happened because of lending without substance.

Explains Hussain Al Qemzi, group CEO of Noor Islamic Bank: "Islamic finance does not rely on unsecured debts. Besides, the Shari'ah principles mean that there is a review and oversight process with the ethical foundations of Islamic law. In practical terms, all Islamic financial transactions must have an underlying economic activity."

In Islamic finance, one cannot take excessive risk, which means that the value of the financial transaction cannot exceed the value of the underlying income stream. Therefore, Islamic banks avoid overleveraging or speculative activity not based on the underlying value activity.

Mohamed Damak, credit analyst at Standard & Poor's, explains that to date Islamic banks have been less impacted because they do not have any exposure to structured investment products, as these are based on interest. They are, however, feeling the pressure of a less supportive operating environment. Besides, most Islamic product offerings are made of plain vanilla products, Damak adds.

Another important differentiation of Islamic finance is that it is based on the idea of sharing both profit and risk with customers. Hence, risk management and governance practices are strong in Islamic finance, according to Sohail Jaffer, partner for international business development, FWU International.

"From an ethical perspective, the Shari'ah board has customers' best interests at heart, ensuring that principles of transparency, full disclosure, fairness and profit sharing are applied," he says.

So effectively, although risk still exists, it is limited and shared among investors, reducing it even further.

### Scar from the global crisis

Despite being considered much safer and more ethical in comparison to conventional finance, Islamic finance has not emerged unscathed from the global financial and economic crisis.

Most experts name excessive risk taking by Islamic financiers in real estate in the

S&P 500 vs. S&P 500 Shari'ah					
Portfolio Statistics*:					
Index performance	Quarter	YTD	12 month	3 year	5 year
S&P Shari'ah 500	12.74%	4.59%	-22.78%	-2.67%	1.07%
S&P 500	15.93%	3.16%	-26.21%	-8.22%	-2.24%

Middle East as the primary reason for their predicament. Balance sheets of banks and funds that were heavily invested in real estate were affected considerably when the region's property market took a tumble.

Qemzi quotes a recent industry report when he says that Islamic banks in the GCC lost nearly 45 per cent of their market capitalisation since the peak of the oil price in 2008, versus a loss of 39 per cent of their conventional counterparts. However, the rebound has also been marginally higher for Islamic banks, as their market capitalisation climbed 11 per cent compared to a 10 per cent rise for conventional banks.

Even while Islamic institutions were not as impacted by the initial shocks resulting from CDOs, CLOs and subprime lending, as their exposure to these types of assets were very limited, the resulting banking and liquidity crisis impacted everyone.

"Islamic finance has proven more resilient, but faces many of the same vulnerabilities as conventional finance resulting from liquidity contraction and eroding asset values," says Qemzi.

Joe el Fadl, partner in charge of the financial services industry at Deloitte &

Average Portfolio Characteristics*		
	S&P 500	S&P 500 Shari'ah
Market cap (in million US\$)	14.6	13.9
P/E	9.4	7.6
P/CF	1.5	1
P/BV	2.6	1.9
3 year EPS growth	17.4	11.6
3 year sales growth	13	12.2
ROE	22.1	17.5
ROA	10	7.2
LTD/Capital	24.9	34.9
Operating margin	19.3	19.2
Net margin	12.2	9.4
Dividend yield	2.21	2.36

\*As of June 30, 2009. Source: S&P

Touche Middle East, agrees. He says the proof of this resilience is that there have been no instances of failures, insolvency or major scandals among Islamic financial institutions. If there was a dent in the financial performances, it was because of the global slowdown, he argues.

Notwithstanding the financial crisis, Islamic finance has been witnessing robust growth. According to an Ernst & Young and PricewaterhouseCoopers report, Islamic financial services volumes are growing at over 20 per cent per annum, a momentum not shared by the conventional sector.

Other fairly convincing market data suggest that Islamic instruments and investments are outperforming their conventional equivalents. Islamic indices have also tended to post smaller losses during the economic downturn. The S&P 500 Shari'ah Index fell 0.4 per cent from December 31, 2008 to July 7, 2009, while the S&P 500 fell 2.5 per cent during the same period.

Sukuk are another good example. From December 31, 2008 to July 10, 2009, the



Hussain Al Qemzi

HSBC-DIFX Sukuk Index was up 11.55 per cent on total return, while the HSBC-DIFX Middle East conventional bond index was up 9.7 per cent during the same period. Yields on sukuk year-to-date are around 10.5 per cent, while yields on conventional bonds in the Middle East are around 7.9 per cent.

Globally, Shari'ah-compliant assets under management have continued to rise. In the period from 2006-2007, assets under management rose by US\$7 billion. The pace of growth dropped significantly in the period from 2007-2008, but still managed to grow by US\$2 billion. Sukuk issuances dropped to US\$20 billion in 2008, compared to US\$40 billion the previous year. In the same period, conventional bond and equities markets also faced a similar decline in value. Rather than low demand,

Qemzi names uncertainty in regulatory issues, the liquidity crunch and pressure on most asset classes as some of the key factors in the decline of sukuk issuances.

Sukuk, like other debt instruments, are tied to the debt market and are technically exposed to the same market risks. However, because of the relatively smaller volume of related traded papers in the debt market and the available demand from investors with Shari'ah beliefs, they could have been less exposed to volatility. This is normal considering the impact of a more balanced supply and demand in the sukuk market, says Fadl.

### Lessons from the crisis

Any crisis of such magnitude as the one the world has been passing through teaches

a number of things to all and sundry. And Islamic finance is no exception. Among others, experts say, it has taught Islamic financiers the importance of the evaluation of a product's suitability and its careful introduction. It has also taught them that complex structured solutions are to be avoided and that concentration in particular sectors is to be reduced. Diversification is essential, and enhancing corporate governance and risk management practices has become more important today.

Some experts have maintained that had the financial industry been Shari'ah compliant, the world could have averted the crisis. However, such a scenario is practically impossible to imagine.

"In theory, had the Islamic principles of full transparency and disclosure, fairness

## Islamic finance will continue to thrive

Sameer Abdi, head of Islamic finance services at Ernst and Young Middle East, tells **MONEYworks** that Islamic finance has excellent potential.

### Do you believe that the current financial crisis could have been averted to a great extent simply by following Islamic financial practices?

This is a hypothetical question, so the answer needs to be put in the wider perspective of the causes of the financial crisis. Then we also need to understand how the situation might have been different under the Islamic finance system. Even with those caveats in mind, we must remember that it is rarely prudent to make wholesale or fleeting judgments.

Many different underlying factors that have played out over a long period of time contributed to the current financial crisis. Economists first sounded the warning bell about the US housing bubble (and others) as early as 2006. The collapse of the subprime real estate market was the first major domino. Consumer credit levels were at historic highs, as was leverage. Weak regulatory enforcement and frameworks also played a part. These and other factors undermined a finance system that had forgotten prudent principles.

Had the world been following the Islamic system, speculative instruments such as CDOs and CLOs would not have been allowed. Leveraged investments would not have existed, so they could not have blown up. On the other hand, any adjustment in real estate prices would have significantly impacted bank balance sheets because real estate and other assets would have been owned by the banks. Therefore, the financial crisis might have been of a smaller magnitude, but it is unclear whether it could have been averted.

### Why would the magnitude of the crisis have been lesser?

There would have been less structural speculation under an Islamic financial system. *Gharar* [uncertainty] is discouraged in Islamic finance. There would have been less leverage, since *riba* [interest] is prohibited. However, in any game, some players are less risk averse than others. This is as true in golf as it is in finance – and so some investors are prepared to consider higher levels of risk



Sameer Abdi

regardless of whether risk taking is encouraged or prohibited. We saw this with Islamic investors in the Middle East who, with the benefit of hindsight, may have taken on excessive risk when developing real estate.

### Has Islamic banking been more resilient to the crisis?

On first view, Islamic banking has been more resilient than conventional banking. This is not to say that it has been completely immune. Initial shocks resulting from CDOs, CLOs and subprime lending did not immediately impact Islamic banks, as most of them had very limited or no exposure. The resulting banking and

towards the customer and profit sharing among investors been applied, there is a chance that the financial crisis would not have had the same magnitude globally," argues Jaffer.

But Qemzi finds this theory simplistic. He contends that the adoption of Islamic finance would not have been enough to prevent the crisis.

"The current market situation is too complex to be tackled by one system. In addition, Islamic finance is only 35 years in the making. It has not reached the critical mass needed to compete on a level footing with conventional finance, which has a history spanning more than 300 years," he adds.

The financial crisis was triggered by multiple factors, the most significant of

which was the un-regulated introduction of innovation in the repackaging of debt and interest-based securities. And herein lies the difference between Islamic and conventional financial practices. Had the world been following the Islamic system, speculative instruments such as CDOs would not have been allowed. Uncertainty, or *gharar*, is discouraged in Islamic finance. There would have been less leverage as well, since interest, or *riba*, is prohibited. Hence, leveraged investments would not have existed. In fact, the subprime crisis has helped to validate some of the basic principles of Islamic finance – that deals must be backed by tangible assets and that there should be strict control over debt levels.

Fadl points out that Islamic banks and



Joe el Fadl

finance, including sukuk, have been primarily funding domestic projects. On the books of these institutions are tangible

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liquidity crisis has impacted everyone. The drop in real estate and equity markets that occurred as a result of and then contributed to the financial crisis did have a markedly adverse impact on a number of Islamic banks because of their concentration in and exposure to those asset classes.

However, the jury is still out. The impact from the crisis is still permeating through the Middle East's financial systems and all banks have been hit to a greater or lesser extent. A number of local banks have had to be bailed out and protected by host governments.

Islamic banks also face other issues. These include a lack of diversification, the shortage of talent, operational inefficiencies and a lack of standardisation. Islamic banks need to focus on these issues and simultaneously tackle external threats.

#### **Given the current scenario, do you think Islamic finance has the potential to grow faster?**

Islamic finance has excellent potential – not least because it is a smaller, younger industry, which means that it will tend to grow faster regardless. That said, there are other fundamental reasons suggesting that Islamic finance will continue to thrive.

On the corporate banking side, there are still gaping holes in service provision. There is still no equity underwriting, research is limited and Islamic finance institutions do little or no trading. Liquidity management is still an issue, as there are a limited number of products available. On the retail side, a number of liability and asset products have yet to be introduced. Middle and back offices offer significant opportunities for expansion, upgrades and improvement in terms of people, processes and technology.

On a macro level, there is still no global Islamic player that has the scale, balance sheet size and service delivery to match the largest conventional players. I believe this will change because the fundamentals and demographics for Islamic markets are strong in the medium and long term. Basic industries such as infrastructure, education, health and telecoms are rapidly growing in the Islamic markets and require capital. Oil prices, which had plunged, are recovering, and supply and demand ratios are changing, which will lead to increasing levels of regional wealth and liquidity.

Many Muslim countries have young and growing populations. There is an increasing awareness of and preference for Islamic finance, which stems in part from the collapse of the conventional banking system. This can be seen from

the heightened interest in Islamic finance amongst non-Muslim populations in countries like the UK, Malaysia, Italy, Japan, Spain, Malta and the US.

#### **Do you see similar growth potential for Takaful as well?**

Takaful has grown very quickly in a very short period of time, but we must remember that it is growing from a very small base. Growth is now being affected by the economic downturn, which is ironically opening a window of opportunity for those Takaful operators who can manage their risks and sustain future growth.

Over the last 10 years, growth has been prompted by basic product ranges, simple distribution channels, the development of regulatory frameworks and the emergence of standardisation. Now we are likely to see increased alliances, mergers and acquisitions, new opportunities from cross-selling and BancTakaful, increasing product innovation, multiple distribution channels and the growth of Takaful in emerging markets.

Future growth will depend on penetration into large population centres, higher per capita income levels, changing social attitudes, growing awareness, economic development and the overall growth of Islamic banking.

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productive assets for corporations or real estate, which are, at best, passing through a recessionary phase now. These assets have not been impaired to the extent of the toxic assets that surfaced on the balance sheets of universal financial institutions, Fadl contends.

### Future growth potential

Islamic finance has a miniscule share of the global financial market at just one per

cent. According to the updated version of the "Guide to Islamic Finance in or from the DIFC" recently published by the Dubai International Financial Centre, the total size of the Islamic banking industry is estimated to be between US\$800 billion and US\$1 trillion and is forecast to grow at a rate of 12-15 per cent per annum.

Islamic finance is growing at a rate of 15-20 per cent per annum. But it still has a lot of catching up to do, as the current

market penetration is just 20 per cent of the Arab population. It is expected that within the next eight to 10 years, the Islamic banking industry will capture half of the savings of the world's 1.6 billion Muslims.

Qemzi says: "The development of the industry over the past three decades has clearly been able to demonstrate the respect and trust that Islamic finance has gained as an alternative and parallel

## Islamic finance fastest growing financial service

David Dew, deputy CEO of HSBC Amanah, speaks to **MONEYworks** about Islamic finance and its potential.

### Do you think that the impact of the current financial crisis would have been lessened by following the principles of Islamic finance?

That is very hard to say. While it is true that the subprime crisis has helped to validate some of the basic principles of Islamic finance – that deals must be backed by tangible assets and that there should be strict control over debt levels – it is also true that the Islamic finance sector has not emerged unscathed from the crisis.

But some of the asset classes that lay at the heart of the global crisis, such as complex derivatives, are impermissible in Islamic finance.

So the answer is "up to a point". We should not be complacent.

### Has Islamic banking been more resilient to the crisis?

Like any market participant in a global crisis of this size, Islamic finance has not been immune. Islamic banks have seen a slowdown in revenues, the same way as their conventional counterparts, and obviously run the same risks of default and non-performing loans.

But despite the slowdown, Islamic finance remains the fastest growing financial service in the world. There is growing acceptance of a broad range of Shari'ah-compliant products and, most importantly, growth in the Islamic finance

sector is being driven almost entirely by customer demand.

### Has HSBC Amanah performed relatively better during this period of turmoil than the group's conventional banking?

We cannot comment on results and performance during our closed period in advance of results.

What we can say is that the demand for Islamic finance is greatest in emerging markets, playing to a natural strength of the HSBC Group, which has an established presence in key growth territories.

We're already a leading provider of Islamic finance to sovereigns, multinationals and institutions and one of the leading sukuk houses. This combined with a global footprint means that HSBC Amanah is well positioned to take advantage of the significant growth opportunities in the Islamic finance market.

### Why is Islamic finance considered to be safer and more ethical?

Shari'ah law sets out a very clear basis for what represents permissible levels of debt, the transparency of structures based on real assets, prohibitions on speculation and the concept of risk sharing with customers. All Islamic financial products must be approved by Shari'ah scholars, who remain independent of the banks.



David Dew

### Is there any evidence to prove that sukuk have been less affected by the crisis than conventional bonds?

There's no doubt that sukuk, like conventional bonds, have been severely tested. After five years of continued growth, 2008 saw a contraction of 50 per cent in the value of issued sukuk, with activity in the second half of 2008 and the first quarter of this year extremely limited.

But the outlook is positive. In recent months, we have seen some significant new issues, notably from Bahrain and Indonesia, and we remain confident that this will herald a re-opening of the market

In just seven years, this asset class has moved from the sidelines to become a key part of the global institutional investor's portfolio, and appetite from a range of investors continues to grow.

system to the traditional interest-based system of banking. This in itself is a significant achievement in such a relatively short duration.”

But there are a number of issues that need to be addressed if Islamic finance is to keep its growth momentum intact. More resources need to be employed towards research and development, the establishment of robust equity and secondary markets, the development and attraction of human talent and strong governance and risk management practices. These need to be aligned towards recognising and managing the specific risks inherent within Islamic products, transactions and structures, alongside investing in technology to meet the needs and demands of the new economic and financial order. The future growth and development of Islamic finance also largely depends on the degree of innovations in the market and some standardisation of Shari’ah principles.

Fadl emphasises that Islamic banks should place more investment in the quality of services offered and focus more on efficiency. There might be some consolidation of business in the marketplace in the years ahead, he adds.

Jaffer notes: “The potential of Islamic finance is huge, provided that all the cards are played right. Most importantly, Islamic banks need to have a wider presence globally. Within banking in order of importance, I would say that retail banking, Takaful



Mohamed Damak

**Islamic finance industry snapshots**

Banking industry	-The total size of the Islamic banking industry is currently estimated to be between US\$800 billion and US\$1 trillion and is estimated to have a global potential of US\$4 trillion -Growth rate is 15-20 per cent per annum -Within the next 8-10 years, the Islamic banking industry is estimated to capture half of the savings of the world’s 1.6 billion Muslims
Funds	Assets under management in Islamic funds are estimated to be between US\$50 billion and US\$70 billion
Sukuk	-The total value of sukuk to date is US\$88 billion, of which US\$13 billion is listed on NASDAQ Dubai -44 per cent of the total sukuk issued in the world originated from the GCC in 2007
Takaful	-Global Takaful contributions are currently estimated to be approximately US\$4.3 billion and estimated to reach US\$7.4 billion by 2015
World Muslim population	-Middle East and North Africa: 204 million -Southeast Asia: 211 million in Malaysia and Indonesia -Subcontinent: 439 million in India, Pakistan and Bangladesh -Other: 16 million in UK, US, Germany and France

• Figures courtesy of HSBC Amanah, S&P, EurekaHedge Data 2007, Islamic finance news, ICMIF, IFIS and Grail Research  
Source: Guide to Islamic Finance in or from the DIFC

**Principles and prohibitions in Islamic finance**

Principles of profit and loss sharing	Islamic finance requires participation and sharing of profit and potential losses in financial enterprises
Prohibition of riba	Riba, translated as an ‘excess’ or ‘unjust increment’, is classified in two forms: <b>Riba Al Fadl:</b> Expressed as excess compensation or an unequal exchange or sale of goods, usually relating to the exchange or sale of specified commodities including silver, gold, barley, wheat, salt and dates <b>Riba Al Nasiyah:</b> Described as any excess over the principal amount paid that is charged for the delay in repayment (associated with prohibition of interest)
Avoidance of speculation (maisr) and uncertainty (gharar)	Transactions have to be real, based on identifiable assets and transparent contractual terms, and not based on uncertainty and speculation
Prohibition on dealing in items that are haram and the requirement to deal with only halal items	These haram items include riba, pork, pornography, tobacco, alcohol, conventional financial services, speculation and uncertainty
Requirement for fair and transparent dealings	To make sure that all parties are aware of their respective rights and obligations, Islam requires that commercial dealings are fair and transparent

Source: Guide to Islamic Finance in or from the DIFC

[Bancatakaful], investment banking and asset management are the most potent sectors for the future growth of Islamic finance.”

As for the capital market, unless governments allow for a domestic market to flourish like in Malaysia and in Saudi Arabia, its potential remains limited.

Experts say that some branches of Islamic finance are likely to grow faster than others. One such segment is Takaful, which all the experts believe has immense potential. Growth in Takaful is far outstripping the conventional sector. Today, the global average annual premium growth rate stands at 2.5 per cent. In comparison, the Takaful market segment is growing at 20 per cent a year in

the wider Middle East. In the GCC, Takaful premiums are increasing by a phenomenal 40 per cent a year.

Currently, there are 60 Takaful companies operating in 23 countries worldwide, generating Takaful premiums estimated in excess of US\$2 billion and representing only nine per cent of the global insurance market. However, recent projections show that the industry could be worth as much as US\$7.4 billion by 2015.

“Takaful in Asia has been growing at a staggering pace (98 per cent over three years) and Moody’s predicts that this industry, concentrated mainly in the GCC and Asia, will be worth US\$7 billion in 2015, which represents a year-on-year 20 per cent growth versus 2.5 per cent for the conventional sector,” says Jaffer.