Islamic Finance is coming of age:

The Mainstreaming of Islamic Finance

Dr. Nasser Saidi*

Article for Formiche

June 2009

Despite the global economic crisis the Middle East North Africa region has continued to grow in 2008 and 2009. An economic and financial renaissance during 2003-2008 has been accompanied by a surge in Islamic finance. The numbers speak for themselves. Islamic finance has grown by about 15% to 20% in each of the past four years. Since the inception of modern Islamic banking, the number and reach of Islamic financial institutions worldwide has risen from one institution in one country in 1975, to more than 300 institutions operating in more than 75 countries.

Although Islamic banks are concentrated in the Middle East and south-east Asia, they are also niche players in Europe and the US. Islamic banking assets and wealth under management reached US$736 billion in GCC and Asia, and the Sukuk market is expected to issue US$27.5 billion in 2009[1].

For now Islamic finance is a nascent industry, with a small share, about 1%, of the global market, but is benefiting from a number of favourable structural and cyclical drivers: strong growth in the GCC and Emerging Market Economies (EMEs) of Asia, positive demographics of young and rapidly growing populations, and a shift of preferences of savers/investors towards Islamic finance in Muslim countries reflecting, in part, a self-reaffirmation or awakening of cultural and religious identity. In non-Muslim communities and countries, the ongoing global crisis has attracted investors

* Chief Economist, Dubai International Financial Centre Authority and Executive Director of the Hawkamah Institute for Corporate Governance.

[1] Ernst & Young May 2009.

and issuers (including sovereigns) to the perennial principles of ethics, risk sharing and real asset financing which lie at the core of Shari'a compliant finance. As the Vatican's official newspaper Osservatore Romano put it: "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.[2]"

Islamic financial market dynamics are generating growth in breadth and depth: the geographical spread of customers, the number of providers and the range of Shari'a compliant financial services and products is growing as a result of innovation in Islamic finance, through the development of Shari'a compliant mortgages, leasing, securitization, Sukuk and Takaful. The other major factor is that Shari'a products have yielded higher returns compared to conventional assets over the past decade.[3] The expectation is that Islamic finance will continue to grow rapidly in the coming years, with some forecasts[4] putting the potential size of Islamic finance at $4 trillion, over four times its current size over the next decade.

Sukuk is fastest-growing element

Driven by the need to finance large scale investments projects and infrastructure Sukuk or Islamic bonds are the fastest-growing Islamic finance segment, with the Dubai International Financial Centre (DIFC) the main centre for listings, with some 40% of the world's listed issues. The market's estimates of the current pipeline of potential Sukuk issues are in excess of $45 billion. The Sukuk market share of the GCC continued to grow in 2008, up 44.80% from 40% of total value issued by GCC bond market in

[2] http://www.vatican.va/news_services/or/or_quo/text.html, 3 March, 2009.
[3] See Dow-Jones, http://www.djindexes.com/mdsidx/index.cfm?event=showIslamicStats#perf
[4] See S&P, 2008.

2007. The UAE was the second largest market (worldwide) in 2008, raising US$5.3bn from 10 issues**.**

While most of the Sukuk issuance has been dominated by Islamic banks and corporations in previous years, the market structure is changing and we are likely to see multi-jurisdiction issuance from sovereigns such as Japan, the UK, Germany, Hong Kong, Thailand and Australia, as well as supranational issuers. The market has the potential to move from the margins of international finance into the mainstream.

Growing range of Shari'a compliant financial services

But it is not only the Sukuk market that is growing. The growth of Takaful or Shari'a-compliant insurance is far outstripping that of conventional insurance. It has been estimated that $1.7bn was written in takaful premium in 2007 globally, having grown 26% year-on-year between 2004 and 2007[5]. Ernst & Young estimates that the global Takaful market could be as high as US$7.7 billion by the end of 2012, from global Takaful contributions at US$3.4 billion in 2007 (2006: US$2.5 billion)[6].

Given the size of real estate investments in the GCC, Islamic real estate investment trusts, or I-REITs offer retail and institutional investors an instrument allowing them to participate in the strong growth prospects of the Gulf while providing returns that are a better hedge against inflation than other securities, along with international portfolio risk diversification. In recognition of this potential, the DIFC has introduced a legal and regulatory regime that aims to support the development of Islamic REITs and other funds through Collective Investment Vehicles and Investment

[5] Swiss Re Sigma No.5 Report (Feb09)
6 S&P, Islamic Finance Outlook 2009

Trusts allowing international investors' unrestricted access to this promising market.

Shari'a compliant financial product innovation is rapidly growing in other areas, including private equity. Venture capital, hedge funds and infrastructure or project finance are also developing apace. Indeed, the leverage of Shari'a compliant securities and institutions is low, a factor that has provided resilience and protected the nascent Islamic financial markets from recent credit and financial market turmoil triggered by the sub-prime crisis in the US.

The risk sharing constructs of Islamic Private Equity structures are more aligned with the Musharaka mode of finance and provide considerable scope for opportunity in the private equity sphere particularly as the debate for greater alignment to the profit and loss sharing and the participation aspect of Islamic finance continues to make headlines.

Islamic finance increasingly used in infrastructure projects

The total cost of infrastructure projects planned or underway in the Gulf countries is currently estimated at some 1.8 USD trillion. Given the planned expansion plans of many of the GCC economies and the commitment to invest in infrastructure, including transportation networks, public utilities, housing, health and educational systems, infrastructure funding through Shari'a compliant finance is clearly a highly attractive source for such investments.

Given the ease with which capital market products transcend geographical borders, Shari'a compliant financing projects which originate in one country can source investors globally. The current infrastructure projects in the MENA and the Asia regions are an unprecedented opportunity to create an Islamic financial market. Infrastructure should be financed through the financial markets and no longer rely on oil & gas revenue.

DIFC's Role in International Islamic Finance

DIFC is building and developing bond markets, conventional and Islamic, essential for the financing of the corporate sector and government. Corporations need to diversify their sources of finance from their reliance on equity. Governments require long term finance for infrastructure and long gestation projects. The international trading and listing standards applied in the DIFC with the availability of global players and abundant liquidity means that international financial institutions, such as the World Bank, IFC, the EIB/EBRD, ADB, AfDB and the Islamic Development Bank can issue bonds and Sukuk and tap regional sources of finance through the DIFC.

The DIFC believes that the regulation of Islamic Finance should be aligned with the regulation of conventional finance to the maximum extent consistent with Shari'a requirements. A level playing field and convergence of standards is required. In our view, that is the surest and quickest way for Islamic communities to participate to their full advantage in mainstream international finance and capital markets. In the regulatory context, that means applying internationally accepted standards and principles, with variations only as required to reflect Shari'a compliance.

The other critical part of our approach to regulating Islamic Finance has been to step back from the direct regulation of Shari'a products. Our focus is on the adequacy of the systems and controls that firms maintain for all their compliance obligations, be they conventional or Shari'a. In short, we are not there to regulate religious features of Islamic products but rather to ensure that those features are addressed by others under adequate systems and controls. We require Islamic Firms (and also conventional firms operating an Islamic window) to appoint a Shari'a Supervisory Board, which must comprise suitably qualified scholars and operate under approved policies and procedures. Our approach provides flexibility and is a practical response to the circumstances that currently prevail in our region and the absence of an agreed global standard..

DIFC regulation thus ensures conformity to international standards such as risk and capital adequacy as set out by Basel, while adhering to Islamic finance industry guidelines and applications as set out by AAOIFI with regards to the accounting treatment of Islamic transactions.

Moving forward

The DIFC/DFSA is working with regional and international regulatory bodies and entering into cooperation and information-sharing arrangements with other regulators and counterparties, including Mutual Recognition models to facilitate the cross-border flow of Islamic funds. This is a step in the direction of streamlining and harmonizing laws and regulations relating to Islamic finance. The ultimate objective should be an ***Islamic Financial Passport***, an IFP, to facilitate cross-border trade in Islamic Finance Securities (IFSs) and the mutual recognition and establishment of IFIs.

At an international level, bilateral or multi-lateral trade and investment free trade agreements (TIFAs) and the GATS should include specific mutual recognition clauses relating conventional and Islamic finance. Similarly, Double Taxation Agreements (DTAs) should also be negotiated to include provisions concerning the taxation of Islamic financial products, services and securities, to remove tax discrimination, and establish a level tax playing field.

The time is ripe for action on two broad fronts: the mainstreaming of Islamic financial services and products, and the integration of Shari'a compliant securities into international markets, to become an internationally recognised asset class. The egalitarian nature of Islamic finance, investment disclosure, corporate governance and risk-sharing characteristics are an antidote to the uncertainties generated by the ongoing global financial crisis. Islamic finance has come of age and is a viable and credible alternative to conventional financing. DIFC's strategy is to help create the enabling environment for the establishment of a sound, well-functioning Islamic financial system and achieve banking and financial deepening. Islamic finance is now part of the international financial architecture of markets and products. Italy should join the ranks of countries –including the UK, France, Singapore and Japan- by removing tax, legal and regulatory barriers to Islamic finance and consider issuing a Government of Italy Sukuk; the latter would be well received by the markets.