



The Evolution of Islamic Finance



Islamic finance lexicon/1

- **Ijara**: leasing transaction where the purchase of the leased equipment at the end of the rental period is optional
- **Mudaraba**: form of financial partnership where one side provides only capital, while the other only labor and entrepreneurial skills
- **Qardh hasan**: interest-free loan, made for welfare purposes or for bridging short-term funding requirements; the borrower is required to repay only the principal
- **Retakaful**: form of Islamic reinsurance that operates on the takaful model



Islamic finance lexicon/2

- **Riba:** usury
- **Sharia:** Islamic law
- **Sukuk:** Sharia-compliant financial instruments that can be compared to conventional notes
- **Takaful:** form of Islamic cooperative based on the principle of mutual assistance
- **Wakala:** agency contract, which may include in its terms a fee for the agent, who does not participate in the risk of the business

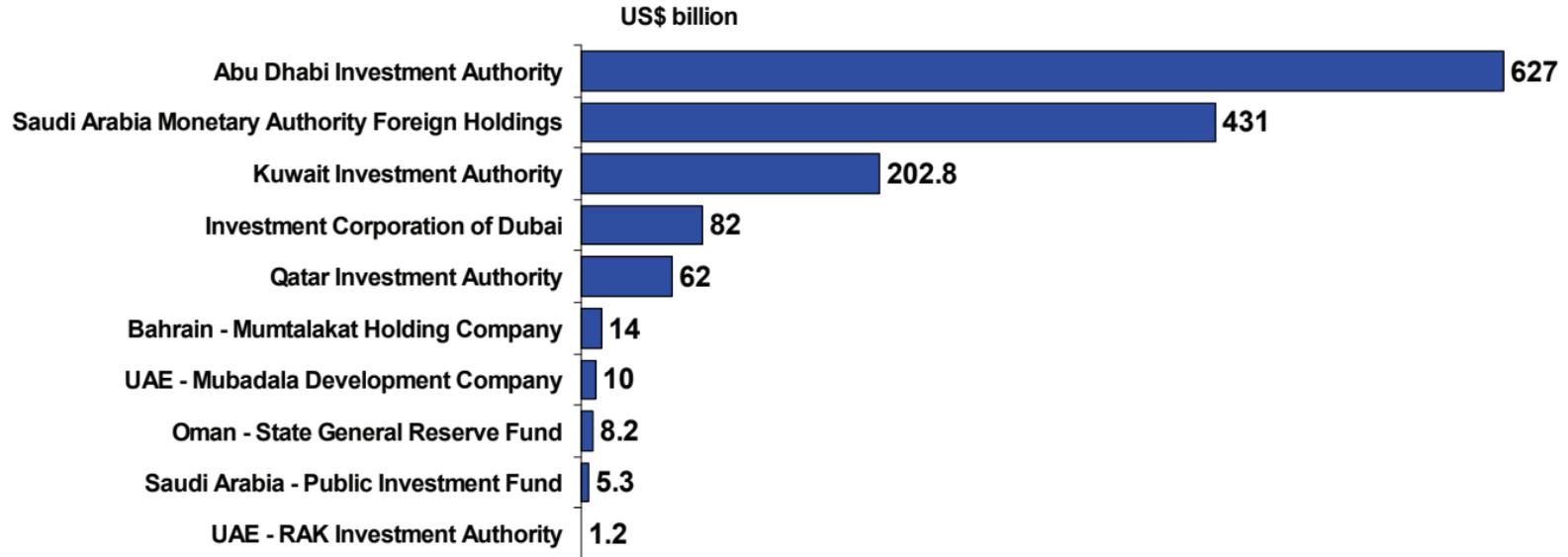


The five pillars of Islamic finance

- **The ban on interest:** Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.
- **The ban on uncertainty or speculation:** Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.
- **The ban on financing certain economic sectors:** Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling—is forbidden.
- **The profit- and loss-sharing principle:** Parties to a financial transaction must share in the risks and rewards attached to it.
- **The asset-backing principle:** Each financial transaction must refer to a tangible, identifiable underlying asset.

Oil windfall profits transformed GCC Sovereign Wealth Funds into global financial powers

Assets of major GCC Sovereign Wealth Funds (2009 estimate)

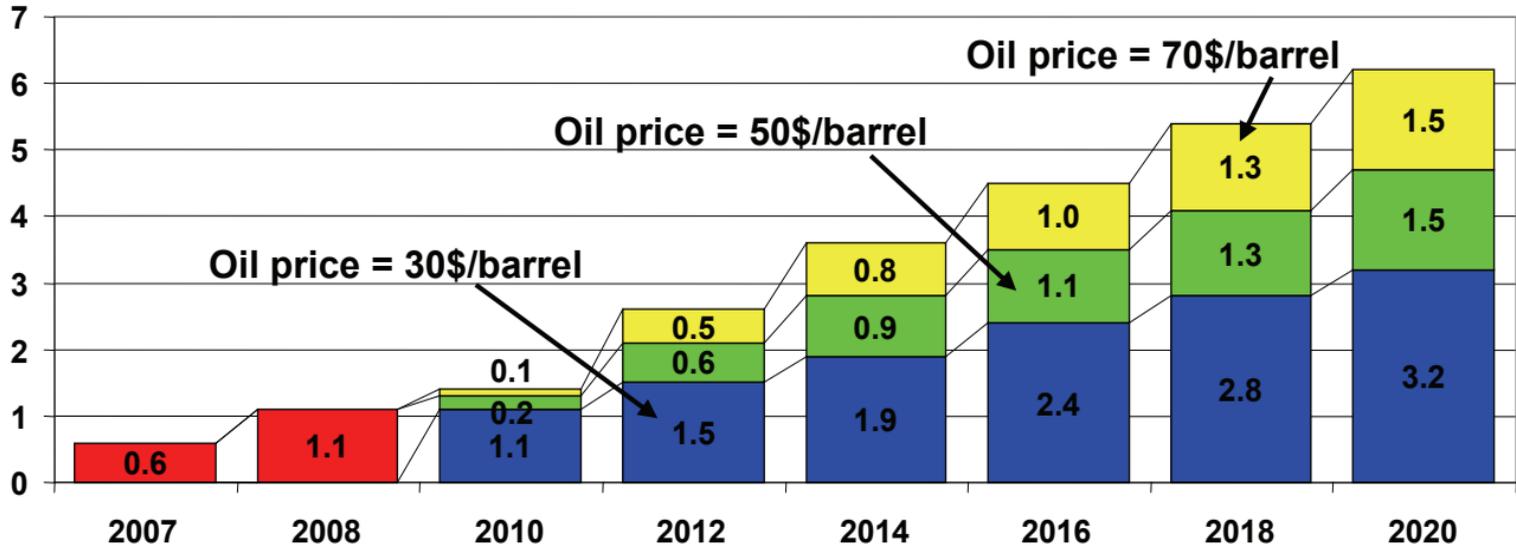


Source: Sovereign Wealth Fund Institute.

Even at lower oil prices, GCC countries' wealth will continue to grow significantly

Projected oil revenues to 2020 for GCC countries

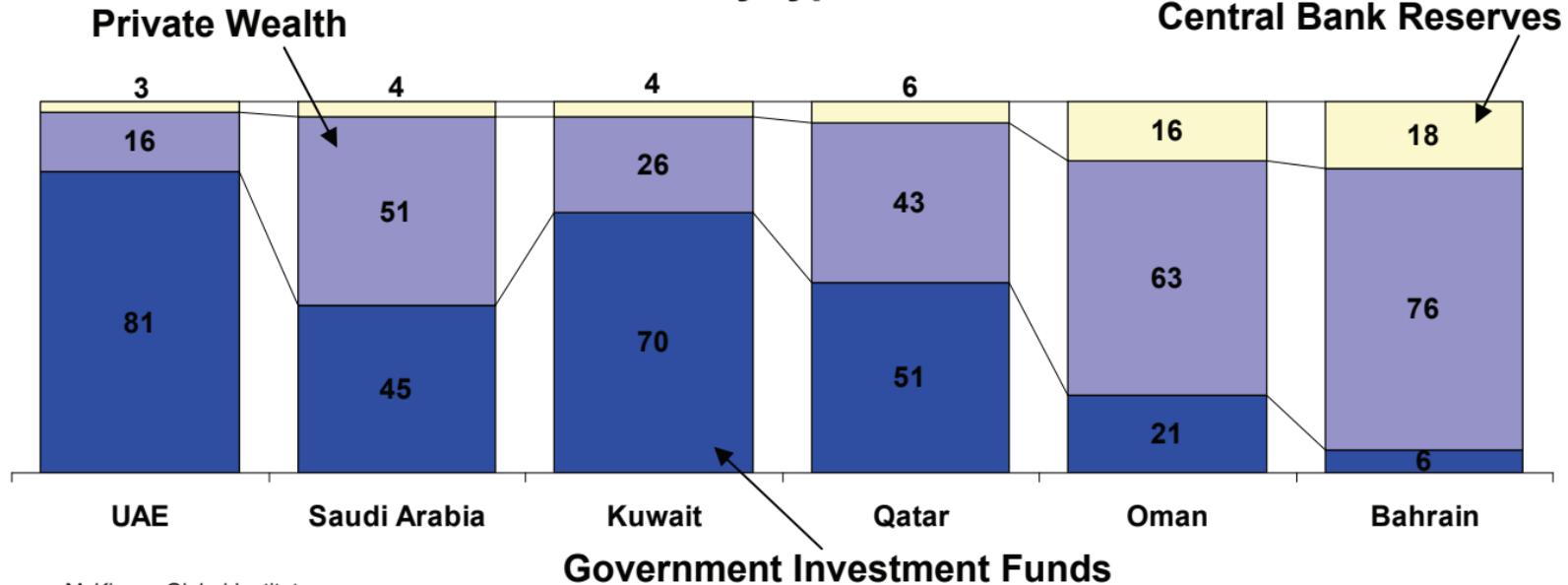
US\$ trillion



Source: McKinsey Global Institute.

Snapshot of GCC countries wealth

GCC assets by type of investor



Source: McKinsey Global Institute.



**Shawn Baldwin, Chairman
Capital Management Group**

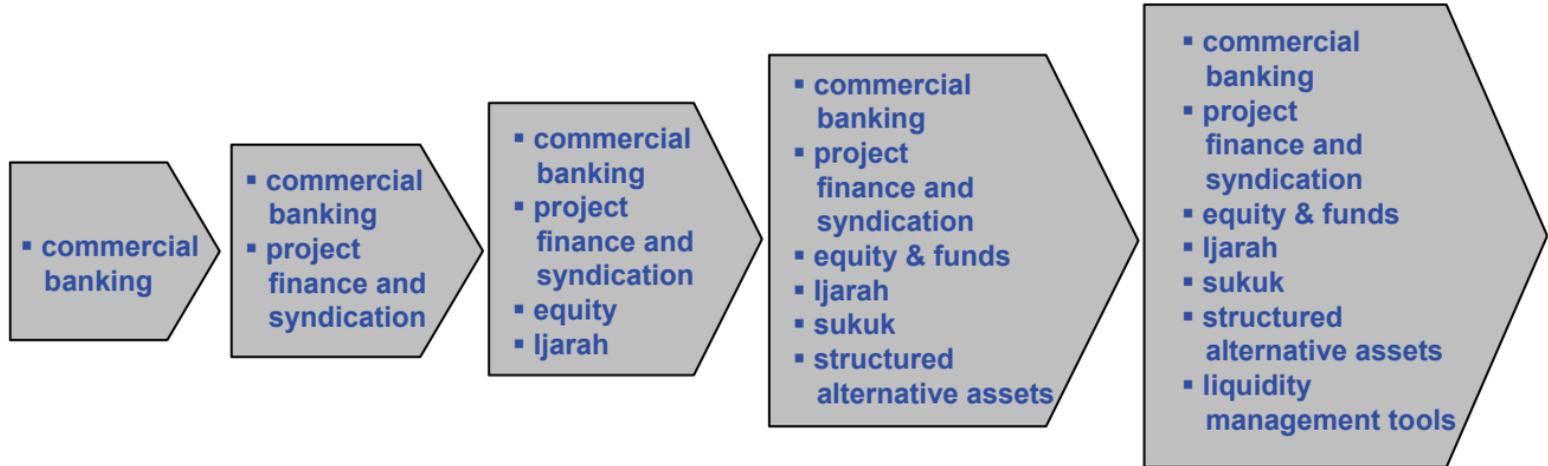
Evolution of the Islamic Finance Industry and Islamic Capital Markets



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- Islamic finance has followed in the wake of innovations in the global financial services industry
- A natural progression of the Islamic finance industry due to:
 - competitive retail offerings
 - sophisticated corporate banking products
 - innovative project finance solutions

Progression of the Islamic finance industry



Global market perspective

- US Equity Market : US\$ 15.1 trillion (30% Global)
- Global Equity Market : US\$ 39.0 trillion (estimated)
- Islamic Equities @ 24% : US\$ 9.36 trillion Potential
- Islamic Financial Assets : US\$ 400 billion (UAE MOF)
- Islamic Money Market : US\$ 30 – 50 billion

US REITS	Market capitalization (US\$ billions)	Malaysian REITS	Market capitalization (US\$ billions)
DJW REIT	252000		1189



Islamic capital market : how big is it?



- The total worldwide Muslim population is 1.5 billion, representing a sizable 24% of a total world population of 6.3 billion
- Shari'a-compliant assets represent an estimated US\$ 300 billion in banking assets and approximately \$400 billion in the capital market



The Islamic capital market worldwide

- Islamic funds in Global Financial Institutions are estimated at US\$ 1.3 trillion
- The Islamic Financial Market is estimated to reach US\$ 400 billion in size, with an annual growth rate of 12% to 15%
- There are over 300 Islamic Financial Institutions currently operating in about 75 countries worldwide
- More than 100 Islamic Equity Funds are managing assets in excess of US\$ 5 billion
- The annual growth of the Islamic Capital Market is estimated between 15% and 20%



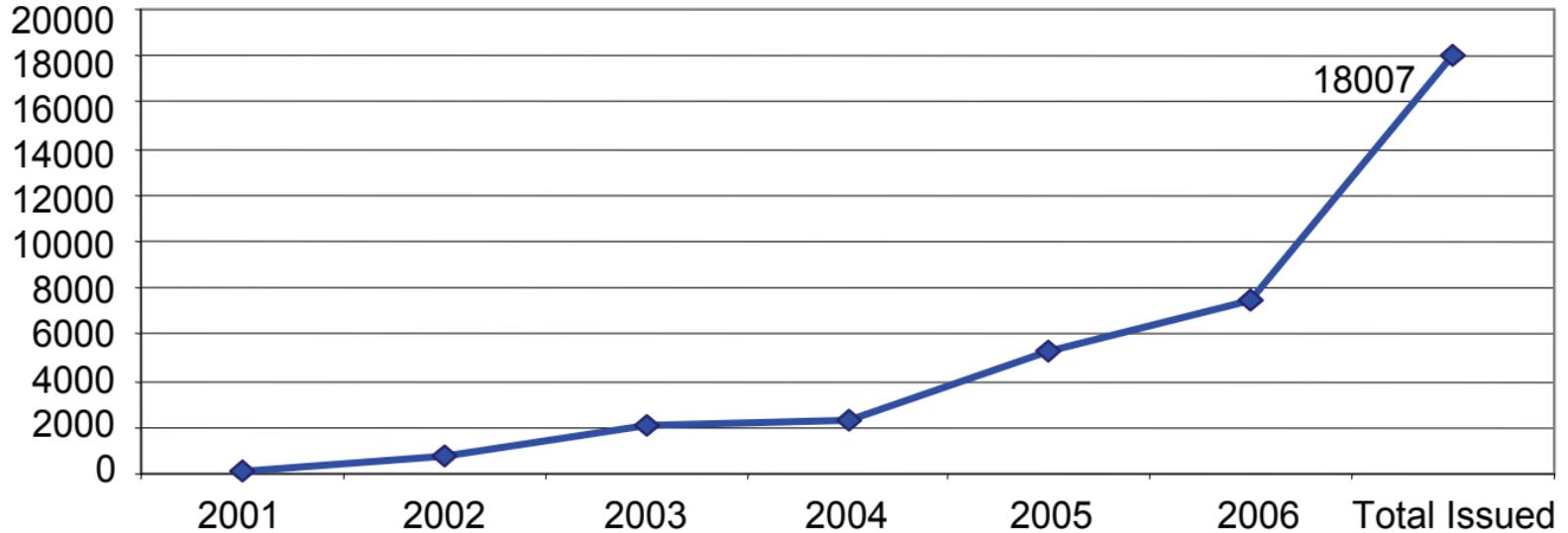
The Islamic capital market in GCC countries

- GCC equity markets are amongst the fastest growing in the world in both value and volume
 - Equity held in Islamic portfolios: US\$ 20 billion
 - Approximately 100 GCC companies planning IPOs in 2006
- Rapidly expanding GCC conventional and Islamic bond market
 - Islamic Bonds – approximately US\$ 9 billion issues announced in 2006
 - Growing at 100% pa in volume
- 150+ Islamic Funds; 65% in equity, 10% in bonds (equivalent) and 25% in cash and hybrid, valued at US \$9.5 billion
 - Over US\$1 billion raised in GCC equity funds between 2005 and 2006

Amount of Sukuk issued since 2001 reached US\$ 18 billion in 2006



Global Sukuk Issuance, 2006 (US\$ Million)





Growing Sukuk investment opportunities

- Islamic financial institutions are seeking to diversify their portfolio and increase their portfolio of tradable instruments with fixed income profile
- The industry requires Sukuk funds for retail distribution and once the concept becomes more popular, demand for Sukuk issues will most likely surge
- Sukuk is a money market instrument
- Islamic inter-bank or short-term Islamic Finance market can be developed through Sukuks
- Appetite for Sukuk among reserve managers and non-bank financial institutions increasing



Sukuk trend analysis

- According to some estimates, the Sukuk investments in 2005 increased by 35% to approximately US\$ 9 billion as compared at 2004 (US\$ 6.7 billion)
- It is estimated that the amount of outstanding Sukuks reached US\$ 25 billion at the end of 2006 and approximately US\$ 50 billion by the end of 2008
- Bahrain was among the first sovereign countries to issue a Sukuk, opening doors to a whole new asset class for the global financial community. They now issue about 24 Sukuks a year, including a Ijarah Sukuk as well as a short-term Al Salam Sukuk.

General issues limiting secondary market development



- Limited number of issuances constrains active trading of these instruments in the secondary market
- Buy and Hold Strategy by major investors of Sukuks due to lack of alternative instruments in this asset class
- Limited quality assets available for Ijarah securitization
- Limited Corporate Focus - Changing



Regulatory, legal, shari'ah and other issues

- Lack of regulatory support from key jurisdictions
- Lack of initiative in developing a separate legal framework for Sukuks vis-à-vis conventional instruments
- Lack of harmonization in existing Sukuk structures and difference of opinions among various Shari'ah scholars, especially cross-border
- Limited number of qualified personnel well versed in capital market issues both from Shari'ah and commercial perspective
- Few Islamic investment banks, lacking capability in structuring, originating or arranging capital market transactions



Constraints of Sukuk investments

- Secondary market illiquid due to absence of critical mass and market makers
- Limited awareness about these instruments in the western market and some countries member jurisdiction
- No benchmark for portfolio monitoring as available to conventional bonds – Sukuk Index
- Limited supply of universally Shari'ah acceptable Sukuk
- Secondary market tradability of Balance Sheet based Sukuks



Sukuk – Development Requirements

- Typical Sukuk tenors: 3 to 7 years
 - need for shorter-tenor, commercial-paper type Sukuk
 - need for longer-tenor Sukuk (e.g. BMA 10-yr Sukuk)
- Supply of Sukuk in the market currently limited
 - Leads to buy-and-hold investment, as alternatives for investors who wish to dispose of their Sukuk are limited
 - Central Banks borrowing requirements through Sukuk
- More Sukuk Issuers need to come to the market
 - Sovereign funds should initiate in jurisdictions that are new to Sukuk
 - Corporate issuers including project financing should form the bulk of issuers in any market (Example: Dubai Port Sukuks)
 - Use of balance sheet strength rather than real assets requirements



Sukuk – Development of secondary market

- The Sukuk market will be a developed market for liquidity management when
 - There are issues with differing credit qualities and risk profiles
 - There are Sukuks with maturities ranging from short-term to long-term
 - The investor base is broadened to facilitate participation of more investors
 - Infrastructure and IT are in place
- Industry standardization is needed for Sukuk products
 - Format of issuance i.e., structures
 - Listing (e.g. Bahrain, Luxembourg, others)
 - Rating
 - Dual listing recommended to expand reach
- Market Makers & Brokers
 - Well defined role of Lead arrangers
 - To provide bid-offer prices on a continuous basis
 - Role of infrastructure institutions especially IIFM, support to market development bodies



How to move forward?

- Formulation of widely acceptable and appropriate accounting and reporting principles
- Continue innovating structures such as convertible feature
- Establishment of regulatory framework
- Development of infrastructure required for secondary market including refining payment and settlement procedures
- Allocation of funds and resources by the industry and multilateral institutions for Research and Development
- Awareness and understanding drive and widely available information



Future Prospects

- Islamic capital markets have potential to reach several trillion USD
- GCC Surplus to continue for next 4-5 years mainly due to oil demand
- Customer acceptability, both Muslims and Non-Muslims, is increasing
- Increasing trend of companies going public in Islamic capital markets, i.e. IPO's
- Multi-Billion USD infrastructure projects in GCC and OIC Countries



Umar Moghul, Partner
Murtha Cullina, LLP



What is Islamic Finance?

- Substantive Principles – The “What”
 - Business of Target/ Nature of the Asset
 - The unlawful – alcohol, tobacco, pornography, conventional banks and insurance companies, defense, etc.
- Procedural Principles – The “How”
 - *Riba*; exploitation/ oppression
 - *Gharar*; risk/ disclosure/ transparency

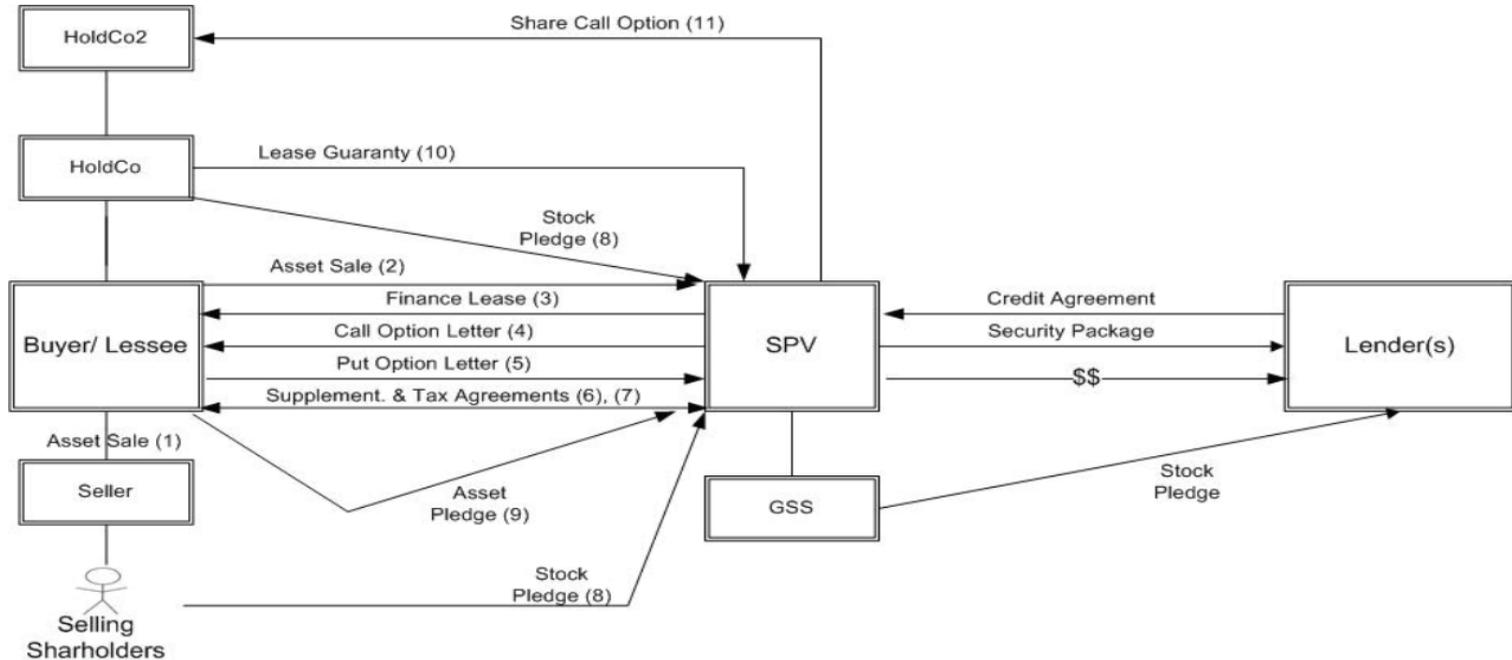


US Laws & Islamic Laws

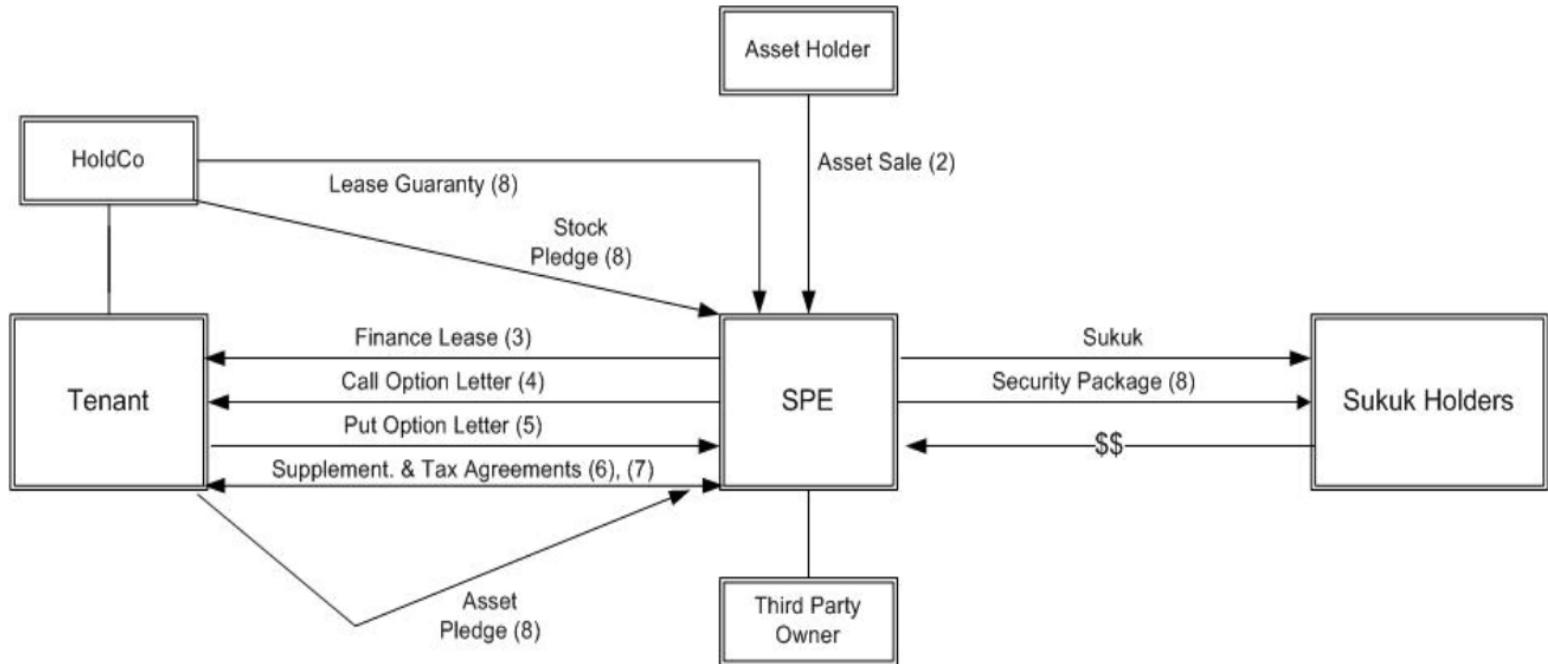
- Islamic laws not wholly inconsistent with U.S. laws (*e.g.*, contractual integrity – fairness, protecting mutual assent)
- But, the challenge in structuring lies with...
 - Bank regulations; OCC letter rulings
 - Tax laws – transaction characterization and regulation accommodation
 - Prevailing customs and expectations



Ijarah – Acquisition Financing Structure



Sukuk al-Ijarah





Aamir A. Rehman, Head of Strategy
Fajr Capital Limited



Islamic Finance: The Rise of a New Global Player



- I. **Ethical Underpinnings of Islamic Finance**
- II. Evolution of the Islamic Finance Sector
- III. Industry Landscape – a Snapshot
- IV. Key Challenges and the Path Ahead



Islamic finance principles include core basic tenets

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

Wealth is a trust, held with conditions

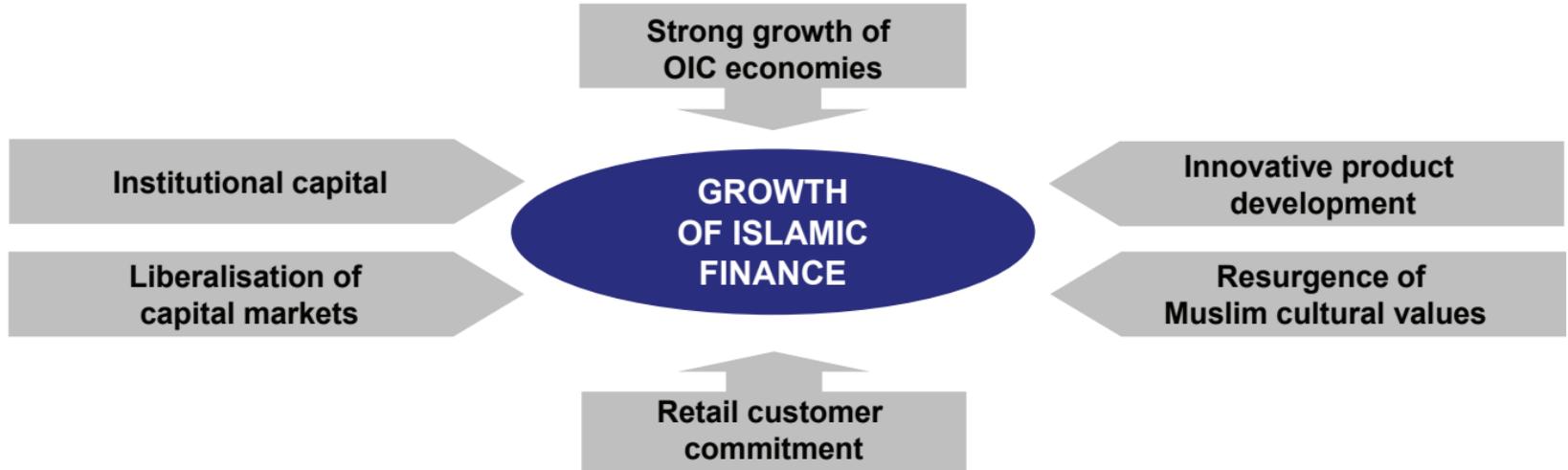
Islamic finance is more than financial contracts



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A confluence of factors is driving Islamic finance ahead

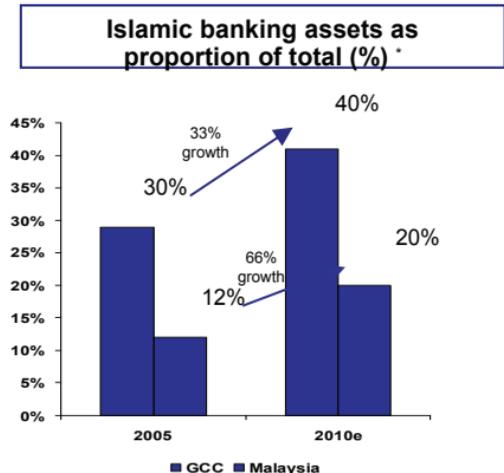


Industry is driven by fundamental factors



Industry has advanced from niche to critical mass

- Islamic finance is a 40 year old industry
 - **Mitghamr Savings Associations (1963)**
 - **Tabung Hajji Malaysia (1967)**
 - **Islamic Development Bank (1974) & Dubai Islamic Bank (1975)**
- Industry is a market-driven proposition
 - **Retail customers historically the backbone of the industry**
 - **Tipping point in retail sector: Saudi Arabia, UAE, Bahrain and Kuwait**
 - **Self-regulating organisations, Standards bodies and Research and Training Institutes**
- Market size estimated at USD 750 billion globally¹
 - **Growing at 15 to 20% per annum¹**
 - **Within 8-10 years, industry estimated to capture half the savings of the 1.6 billion Muslim world²**
- Industry has global scale
 - **More than 300 Islamic banks worldwide operating in over 75 countries³**
 - **GCC accounts for two-thirds of global Islamic assets***
 - **Malaysia leading industry maturity and sophistication**
 - **Islamic Development Bank: largest pan-OIC financial institution**



Source:1: S&P Report (31 Aug 2006); 2: IIR Middle East (Apr 2006); 3 Bursa Malaysia "The Islamic Capital Market" 2005; * HSBC analysis

Industry is fragmented and is gradually evolving and internationalising

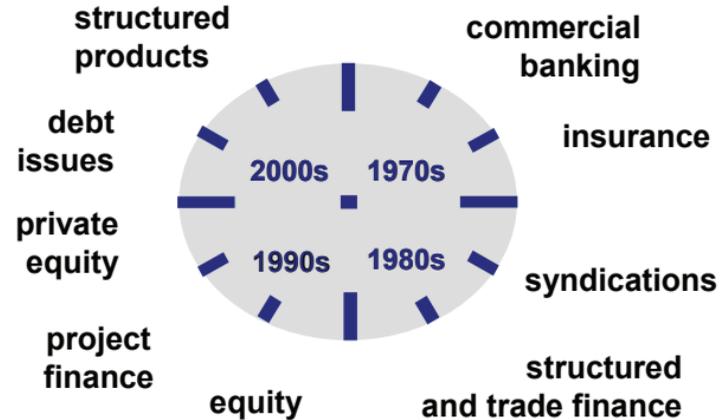


Industry has developed comprehensive product offerings over its young history

Development of industry

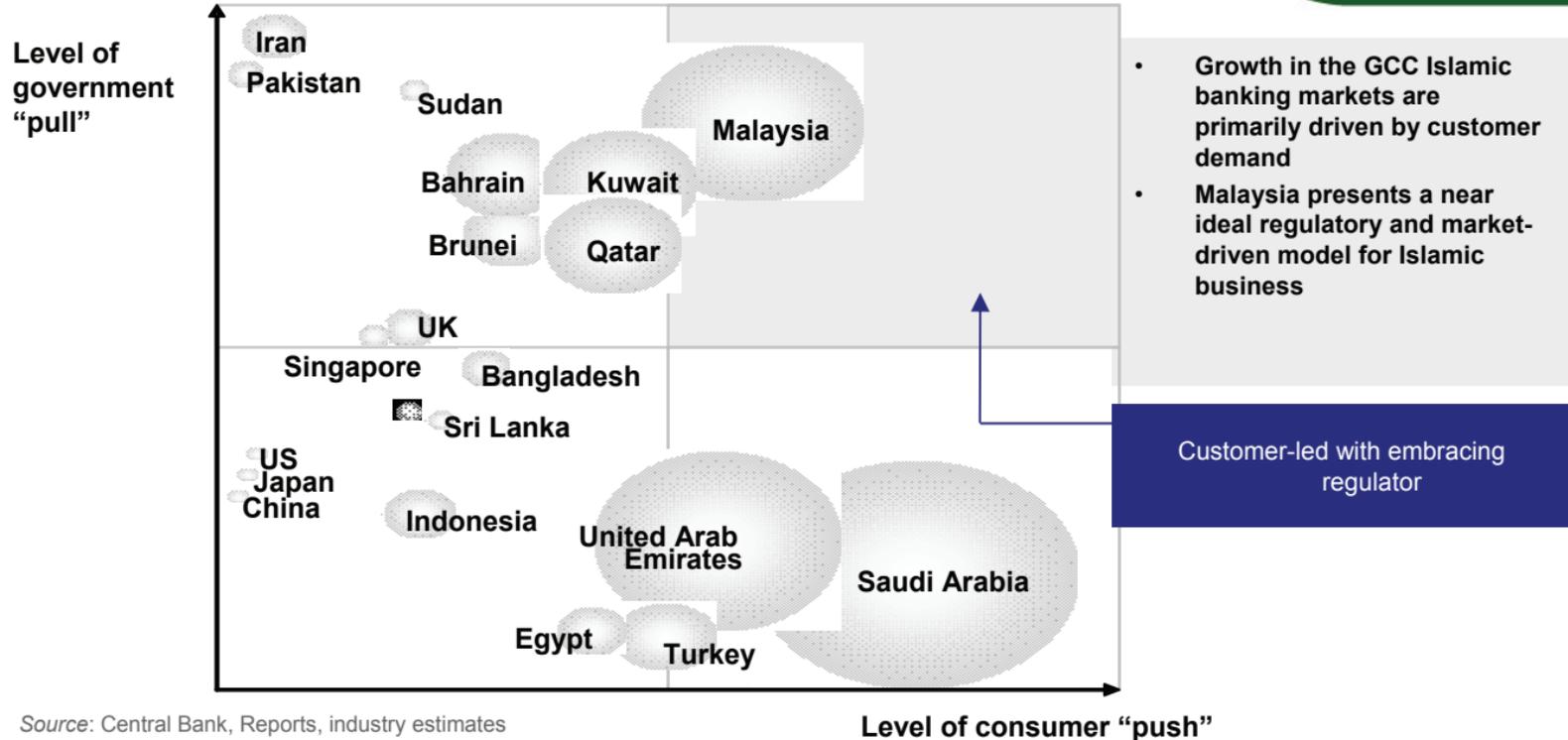
1950s	<ul style="list-style-type: none">- Development of theoretical framework- Muslim-majority nation independence
60s	<ul style="list-style-type: none">- Egypt and Malaysia pioneering institutions- Establishment of OIC (1969)
70s	<ul style="list-style-type: none">- Islamic Development Bank (1974) and DIB- One country-one bank setup
80s	<ul style="list-style-type: none">- Advancement of Islamic products- Full "Islamization" of Iran, Pakistan and Sudan
90s	<ul style="list-style-type: none">- Entry of global institutions e.g. HSBC Amanah
00s	<ul style="list-style-type: none">- Tipping point reached in some markets- Development of industry-building institutions

Evolving richness in products



Industry has near like-for-like parity with conventional offerings

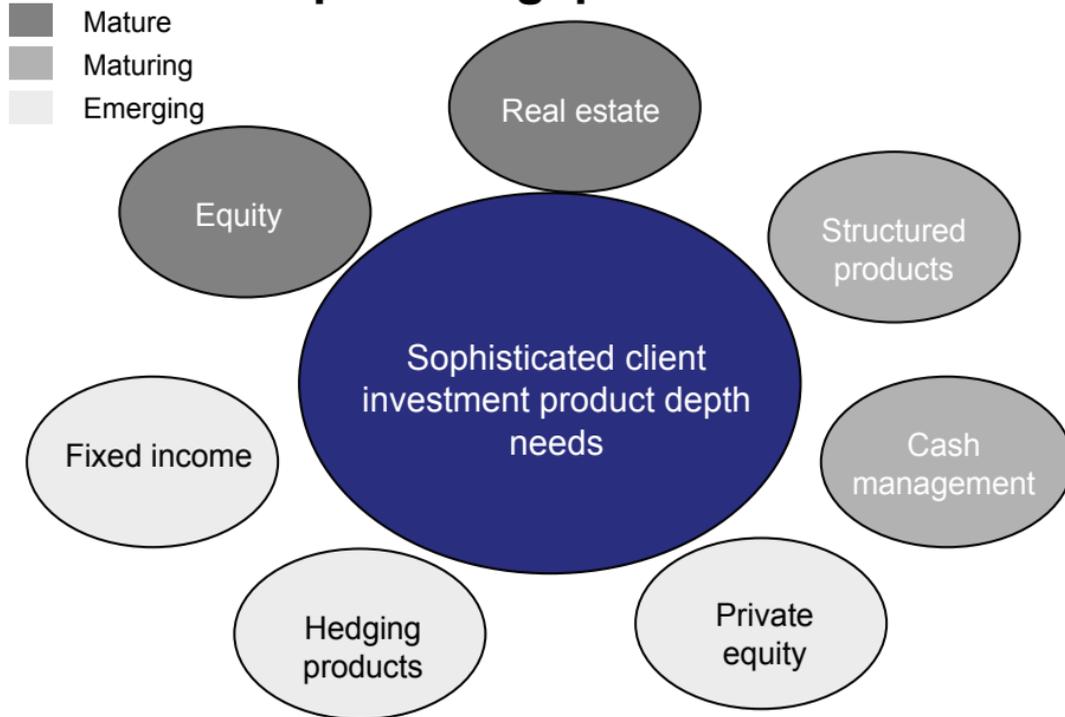
Growth and drive is being led by customer demand



Source: Central Bank, Reports, industry estimates



Industry still needs to deepen and address investment product gaps



- Achieving depth across range would enable industry to capture:
 - **NBFI, Institutional and government assets**

Challenges to overcome

- **Achieving Shariah-compliance while building out asset range and depth**
- **Achieving scale and capital efficiency**
- **Attracting experienced and dedicated human capital**
- **Real estate: REIT laws in OIC countries**
- **OECD and OIC Islamic private equity funds**



Industry's client base is evolving and deepening

	1970s	1980s	1990s	2000+
Retail	█	█	█	█
High Net-Worth		█	█	█
Islamic Financials		█	█	█
Non-Bank Financials		█	█	█
Institutions			█	█
• Endowments			█	█
• Ministries			█	█
• Pension Funds			█	█
Governments			█	█
• Local Govt			█	█
• Central Banks			█	█

- Retail sector provide historic backbone to industry development
- Recent trend of regional corporations tapping into Islamic market
- Public sector and pension funds are key to next phase of industry development

Biggest industry customers still waiting in the wings



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Industry landscape features different models with relative strengths and drawbacks

Model and Examples	Assessment	Strategic Outlook
<p>Local banks</p> 	<ul style="list-style-type: none"> - Able to mobilize local deposits - Deep insight of local market - Often lack scale and global systems 	<ul style="list-style-type: none"> • Potential acquisition targets, pending deregulation • Consolidation needed to achieve scale • Retail role remains important
<p>Regional banks</p> 	<ul style="list-style-type: none"> - Represent important platform for intra-OIC connectivity - Seeking growth through targeted market expansion - Must manage legacy issues and adapt to scale 	<ul style="list-style-type: none"> • Represent most dynamic segment of landscape • Challenge will be to transition from national to regional mindset • Increasingly feasible model due to reciprocity agreements and trade flows
<p>Multinational windows</p> 	<ul style="list-style-type: none"> - Extensive scale, reach and product & infrastructure depth - Able to leverage world-class (conventional) talent - Rely on institutional will and face authenticity challenges 	<ul style="list-style-type: none"> • Continue to play major role with global and most sophisticated clients • Face major credibility and organizational challenges • Regulatory pressure is growing on “windows”
<p>Specialist firms</p> 	<ul style="list-style-type: none"> - Bring deep expertise in area of focus - Often pioneers of product development - Lack end-to-end proposition 	<ul style="list-style-type: none"> • Will continue to thrive based on differentiated expertise • Are increasingly attractive acquisition targets as market grows

Islamic finance capabilities have become essential for global firms



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Financial Institutions

Advisory Firms

Goods and Services
Corporations

Client demand for
Shariah-compliant
solutions

Increasing number of
Islamic finance clients

Demand for consumer
and commercial finance



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Industry faces challenges as it evolves

- Enabling regulators
 - **Building parallel legislation for Islamic finance**
 - **Enabling creation of level playing-field**
- Increasing “real economy” impact
 - **Early phase was based on debt products with replication mindset**
 - **Equity-based instruments are growing with opening of markets**
- Attracting talent
 - **Industry needs top-class intellectual talent to drive new creativity phase**
 - **Industry needs to proactively partner in training programs, research centres and think tanks**
- Proactive engagement and sponsorship
 - **Academic input to formulate visionary framework and development**
 - **Regulators, practitioners and Shariah scholars to set a common agenda**
- Expanding Islamic financial institutions
 - **Current industry players have limited scale and reach**
 - **Need for global foci-shift and inter-regional ties and JVs**

Crisis has highlighted relevance of Islamic finance principles



Practices from the Islamic finance sector relevant to addressing the crisis

- 1 ■ Increased emphasis on asset-based financing
- 2 ■ Limits on the sale of debt
- 3 ■ Greater transparency in the transfer of debt
- 4 ■ Introduction of “Ethical Supervisory Boards”
- 5 ■ Separation of risk-free and risk-bearing accounts