Swiss Passport to Islamic Finance

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MICHAEL SALEH GASSNER

Michael Gassner Consultancy Ltd.

Islamic Finance Survey

Market segments, guestimates and trends

More and more, Islamic finance becomes the focus of financial institutions – and not only in the Muslim world. But how much is Islamic finance really growing and which markets segments are moving forward the fastest?

“Many Westerners do not understand why certain returns are permitted, even though they are fixed in advance.”

The characteristics of Islamic finance are driven by vetting the compliance to Islamic law. Basically, the products are still governed and executed under the law of each respective jurisdiction; however, their legal documentation has to be reviewed by Islamic scholars who have authority to certify that they do not violate the principles of Islam. Many issues in this certification process are similar to what any lawyer would examine to create a fair and just contract. Accordingly, some of the features are specific, like the prohibition of dealing with banking interest or of any pork-related activities, whereas some are partly similar, like the prohibition of excessive legal uncertainty (Gharar), and others still are easy to understand from any ethical perspective, such as the prohibition of gambling or dealing with alcohol and other harmful goods for example. What many Westerners – and even many Muslims – do not understand, is how certain returns come to be considered permissible even though they are fixed in advance, which, from a Western perspective, makes them a form of economic interest. This is true for rental agreements and instalment purchases, both considered acceptable. However, Islamic finance is dominated by specific asset finance techniques (installment purchase or leasing, to name some) and allows to use profit/loss sharing equity modes.

The Islamic boom: so far so good

A frequent question about Islamic finance is one of size. An issue, which is unfortunately extremely difficult to tackle. The reason for this is that statistics are seldom worked out extensively in a niche market – especially when this market is itself growing inside an emerging market. Moreover, it is also a question of what segment we wish to talk about: is it bank assets, equity funds, real estate funds, the sukuk market, syndication, direct investments or private equity? Clearly, any of these asset classes must be considered separately, according to its market. Here is a little survey to give a rough idea of the range Islamic finance has reached, based on major estimations.

Assets under management

According to the General Council of Islamic Financial Institutions in Bahrain, the on-balance sheet assets of Islamic financial institutions amount to nearly USD 300 million, with a compound growth rate of 23% over 10 years. Another USD 200 million must however probably be added to the count, as Iran – which is all-Islamic

by state law – is not a member of that council. To further complete those figures, it is also important to take heed of the Islamic departments of Western institutions – often called 'Islamic Windows' – that offer Islamic products in segregated accounts. The amounts in question could well be of similar range, but no comprehensive survey has been completed so far.

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Islamic Private Equity funds experienced an unprecedented boost in 2006.
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Equity funds

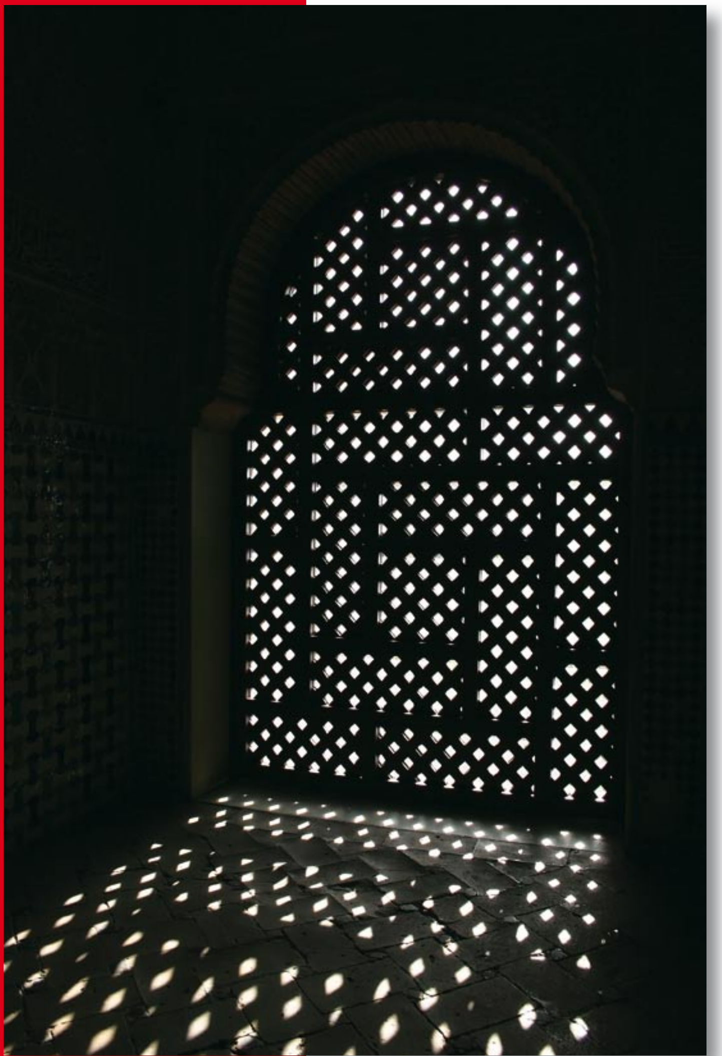
According to the fund research service company Failaka based in Chicago, the number of Islamic equity funds (excluding Asian funds) grew from 22 in 1994 to 122 in 2005, with about USD 13 billion in assets under management. Before 1994, this form of investment was not on the agenda. Today, despite applying rigorous screening criteria with regard to financials and industries – filtering out more than 50% of the stock universe in many regions – the funds are doing well, often beating their benchmarks with proper Sharpe ratios and even receiving Lipper Awards in some cases.

Private equity and hedge funds

Another category are Islamic Private Equity funds: not all present in the Gulf region are structured 'Islamically', yet they experienced a boost in 2006 – which was unseen before – and are no longer targeting foreign transactions, but the Gulf countries. The Private Equity Monitor of Zawya, a business information company focused on the Middle East and North Africa region, shows that Private Equity investments in this area grew from USD 316 million in 2004 to USD 5.19 billion in 2006, with an increasing part of it structured under Islamic supervision. This appears to be the preference of Islamic investors, whereas to date, Islamic Hedge Funds have not attracted any substantial amount of assets when offered to high net-worth Muslims.

Real estate

Nobody has ever published reasonable figures on the very popular closed-end real estate funds. Yet real estate in total often represents up to two third of the asset allocation of a Middle Eastern investor, despite a very strong bias, illiquidity and a cluster risk, as we may call it. Why so? Because until recently, Muslim investors wanted no exposure to traditional bond funds; even the less practising apparently avoided



them. There are some short-term investment instruments in fixed income, but even if they are accepted by scholars, they have a bad reputation with respect to compliance. Basically, they consist in a replication of a short-term loan, which involves buying commodities on spot and selling them to a financial institution on deferred payment. The financial institution that acquires the commodity, platinum for example, will then sell it immediately to get the cash. This is not a solution that convinces for the long run, and it is debatable under the headline 'form over substance'.

Sukuk fund

At the end of last year, the first Islamic bond fund came into existence as a vehicle domiciled in the Cayman Islands under the name Sanad Sukuk Fund. It targets the portion of a Muslim's asset allocation that is traditionally attributed to fixed income, shifting assets away from non-interest bearing deposits to put them into economic action, and also partly replacing the short term so-called Murabaha funds and some of the illiquid assets in real estate. For conventional asset managers, it is hard to believe that for more than 1 billion Muslims this happens only today and not 50 or 100 years ago.

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Islamic bonds have only become relevant since the early 2000's, with increasing numbers of sukuk being issued, among them a number of jumbo sukuk above the threshold of USD 1 billion. Sukuk are not simply loans, they are a sort of asset-backed securities, which finance tangible assets, or projects. The total amount issued is estimated at USD 70 billion, according to the Business Times in Malaysia, a level that is already attractive to serve investors, but is far from matching their demand. What's more, a huge amount of each issue is bought by Western financial institutions that book it as their allocation of emerging market debt.

Financial institutions

The market share of Islamic financial institutions is not well documented either, but should amount to about 20-40% in the Gulf countries, whereas it is very low in other large potential markets like Indonesia, India or China. Regarding the Gulf countries, the market share is already so significant that all financial institutions actually offer Islamic financial products in order to retain their clients. Among smaller banks, turning Islamic is a viable strategy to protect one's position in the market – of which Sharjah Islamic Bank in the United Arab Emirates is a relevant example. Moreover, a number of new Islamic banks are either planned and soon to be started, or have already been founded in recent years. Basically, two major trends emerge: either banks are created with a larger capitalisation (e.g. Emaar) – whereas Islamic banks are currently not well capitalised, which prevents them from financing large scale projects on their own –, or highly specialised banks are founded, such as the Venture Capital Bank, the First Leasing Bank or the Tourism Bank (all in Bahrain), to name some.

More opportunities, more competition…

These developments have been recognised by major Western institutions for some years. All of them apparently have Islamic finance experts and maintain extensive relationships with Islamic financial institutions. Even syndications are made, including Islamic tranches. Western institutions typically prefer the variant of Islamic Windows to serve their clients rather than building stand-alone full-fledged banks, as UBS exceptionally did with Noriba in Bahrain. UBS however reintegrated Noriba at the end of 2006, following the one-brand approach.

Last but not least, there are some overseen markets for Islamic financial products, such as Europe and Africa. 15 million Muslims live in Europe, with the highest numbers in France, Germany and the United Kingdom. Each of these countries can be easily compared to the UAE in terms of market potential. However, with the exception of the UK, no retail banking is in place yet, which makes Europe a substantial untapped market. While the Abu Dhabi Islamic Bank is proud of its 150,000 customers, there is room for many more banks of similar size in Europe. In France, a group of investors is seeking to get an application forward, with the project name 'Tayseer Bank', and Switzerland has granted a license to Faisal Private Bank in Geneva, a fully Swiss bank, now operating under Islamic principles.

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On the African continent, South Africa stands out, but Kenya also has its first Islamic institution, the Gulf African Bank, with IFC (the International Finance Corporation) – the private sector arm of the World Bank – named as a 10% investor. The Central Bank of Morocco has just accepted Islamic financing techniques to be used by conventional-only banks; Algeria has the bank Albaraka operating; Nigeria is possibly starting with Jaiz Bank this year and Sudan is by state law all-Islamic, with a financial sector in which the Dubai Islamic Bank has some substantial shareholdings. The forgotten continent becomes more attractive, and the run for commodities as well as the growing Chinese influence will press the developed world for action. Gulf investors are however not as widely seen in Africa as the Chinese are. The typical channel is rather east-east, with petrodollars flowing to China and India, while Europe is not such a strong focus. Even the United States is challenged from the new investment opportunities for Muslims in Asia.

… and more communication

Reliable market studies and precise figures might still be unavailable, but the trend is very clear that more Islamic institutions are developing more Shariah-compliant products to serve their investors. With the industry gaining maturity, it will certainly also gain from the benefits of better communication and a broader exchange of information. ■