Islamic Investment Banking 2009

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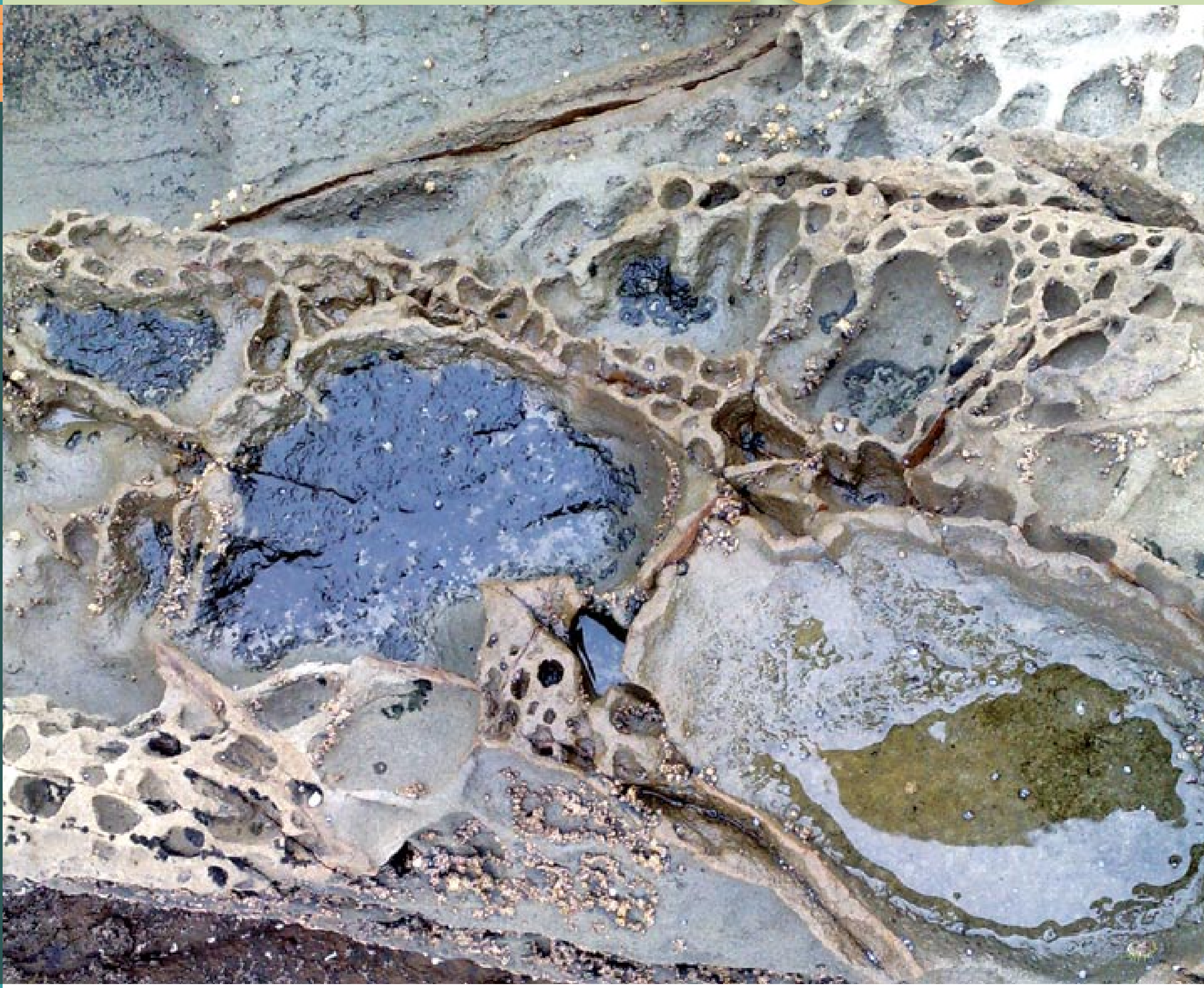

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Foreword from Majid Al-Sayed Bader Al-Refai

Managing Director & Chief Executive Officer, Unicorn Investment Bank

The unprecedented economic turmoil of the past year has in many ways created a significant ‘coming of age’ opportunity for the Islamic finance industry. As the global financial crisis has worsened and economies around the world have suffered from its catastrophic effects, we have seen a renewed focus on Islamic finance and on the inherent advantages of a conservative, asset-backed banking model. While the Islamic finance industry has been in the spotlight for many years now, the fundamental strengths and intrinsic benefits of the Islamic banking model are now becoming widely acknowledged and accepted.

Shari’ah principles prevent banks from engaging in excessively speculative activities and since all transactions must be backed by physical assets, the use of derivative and collateralised instruments is not permitted. This has shielded the Islamic finance industry from direct exposure to the toxic assets that have caused major losses to be incurred throughout the global banking industry. Furthermore, the principle of risk-sharing, which is fundamental to Shari’ah-compliant finance, introduces greater discipline to Islamic banks and encourages the adoption of prudent risk management practices.

In short, the global financial crisis has provided an ideal opportunity for Islamic banks to demonstrate how Islamic finance can benefit both Muslims and non-Muslims alike. Good governance and prudent risk management are inherent in Islamic finance, and there is now a growing recognition of the intrinsic link between Shari’ah compliance and disciplined growth.

Of course, Islamic banks have not been entirely immune to the effects of the market turmoil, nor have they emerged unscathed. The interconnectedness of the international financial system has ensured that the ripple effects of the crisis have been felt throughout the global financial community, and Islamic financial institutions have also been affected by the general crisis of confidence amongst investors. Most importantly, however, is that the crisis has highlighted a fundamental weakness of the Islamic finance industry within the GCC region: the lack of a truly diversified investment banking product and service offering.

Many Islamic banks in the region act as de facto real estate development companies and have yet to really diversify beyond real estate investments and development projects. This is in sharp contrast to the full-service and diversified conventional investment banking model with its emphasis on providing a comprehensive range of investment banking products and advisory services. The limited business focus of regional Islamic investment banks means not only that they are unable to meet the full spectrum of their clients’ requirements, but also that their resilience and capacity to withstand external and internal shocks is compromised.

Foreword from Majid Al-Sayed Bader Al-Refai

From its inception, Unicorn's vision has been to build a full-service, global investment bank based on the conventional investment banking model. As such, we have deliberately avoided a narrow focus on specific investment sectors such as real estate and the stock markets and have sought instead to develop a comprehensive and integrated product and service offering. We have six business lines and a geographic presence in five countries across three continents. This strategy – product and geographic diversification - has served us well, with each of our business lines contributing to our profitability in different proportions each year. At the same time, our full-service approach means that we are able to service our clients on both sides of the balance sheet, providing not only investment opportunities, but also assistance in obtaining funding through the debt and equity capital markets. This dual role is an integral part of our commitment to being a long-term partner and trusted advisor to our clients.

The current crisis provides Islamic and conventional financial institutions with a unique opportunity to work together on the ground to build a more robust global financial system, combining the best-practice credit assessment and risk management disciplines and techniques of the global conventional banks with the inherent strengths and stability of the Islamic banking model. At the same time, it also provides a good opportunity for Islamic investment banks to re-assess their strategy and re-align their objectives in order to build and strengthen the Islamic investment banking model, thereby ensuring that the Islamic finance industry achieves a level of resilience that can ensure its sustainability. It is our collective responsibility to shape the industry with long-term strategies, and we must seize the opportunity to build an enduring and competitive platform for Islamic banking, both within the GCC region and internationally.

Unicorn
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Not out of the woods yet

The Islamic finance industry is plagued by a lack of solid and reliable data. While the causes of this are the subject of much debate, the consequences are that the industry is largely ignorant of how big it is or how fast it is growing. Estimates of the size of the industry seem to peak around $1,000 billion although more conservative estimates indicate that the overall size of the industry is nearer $750 billion. Equally, the rate of growth of the industry is put at somewhere between 10 per cent and 20 per cent each year thereby making it one of the fastest growing areas of finance.

Even in mid-June 2009 industry experts are still bandying these same figures around when it is clear that the industry as a whole suffered the same kind of shrinkage that the rest of the financial world did. Sukuk issuance, for example, is down over 50 per cent year on year. The Sukuk industry is facing the same sorts of challenges that the conventional world has faced for many years including defaults and credit downgrades. Simply put, the Sukuk segment is not growing at between 10 per cent and 20 per cent and some individual Sukuk issues are now trading at 50 cents on the dollar.

Islamic funds, too, are having a rough time. According analysis by Ernst & Young average returns for Islamic equity funds for 2008 plunged almost 40 per cent. Private equity as an asset class has barely breathed this year, with the exception of a couple of transactions and there have been no new funds raised. Islamic private equity is not growing at all.

The house that Jack built.

And real estate, for long the darling of the Islamic industry, has had the worst ride imaginable. Real estate as an asset class has come to dominate Islamic investment banking activity over recent years, particularly in the Middle East. Investment banking in the conventional sphere has had much longer to grow and mature and as a result of this it has become a many-headed beast with a high level of expertise evidenced in a wide range of investment banking activities.

Introduction

The conventional market has, historically, been a lucrative place to be and to work and therefore ultra-bright people tend to be attracted to it, lured by the prospect of making vast amounts of money in a relatively short space of time. This has encouraged product innovators and innovation and the structuring of ever more exotic financial instruments. It is fair to say that the conventional investment banking world has successfully turned into a maze of complex derivative instruments and impenetrable job functions. While this complexity and opacity has been at least partly responsible for the global financial dramas of the last year, it had also been responsible for massive profits for investment banks over the past decade.

The Islamic investment banking world has perhaps been spared the worst excesses of the financial meltdown in part because of its antipathy to risk but also because the industry itself is less complex. While this lack of complexity may have been a blessing over recent months, it also means that many Islamic investment banks may have been foregoing profits over recent years that they could have been reaping.

But the fact is that Islamic investment banking can be as diverse as its conventional counterpart as this report will show. It is true that many Islamic investment banks have been focused too narrowly on real estate of late, but this is not because of any tenets of Shariah but rather that the investment teams at these banks have felt comfortable with real estate and it has offered them spectacular returns. When asked why they have not diversified into asset classes other than real estate many Islamic investment bank CEOs have, in the past, replied by asking which other asset classes could offer them returns that were better than the typical 250 per cent returns that they were seeing on their property portfolios.

Diversity and risk

The practical flaw in this argument has always been a simple one of putting too many eggs in one basket. If any investor, private or corporate, has too great an exposure to any single asset class then it simply is not safe. A cautious approach to risk should dictate that every investor has exposure to a series of asset classes and that, ideally, at least some of these asset classes should be uncorrelated. In this way, if one asset class takes a metaphorical beating then the other assets in the uncorrelated portfolio should be immune.

The fact is, however, not enough Islamic investment banks have delved into a diverse range of asset classes and as a result the industry is perhaps not as robust as it could be. This report looks at the main avenues of investment open to Islamic investment banks and aims to show where there may still be significant areas for development. While not every bank will want to be involved in every area, a healthier spread of asset classes and diversification away from real estate can only serve to produce an industry that is less prone to market dips and more prone to healthy and sustained profitability.

So what does the successful Islamic investment bank of the future look like? A rapidly maturing beast, is the short answer.

Such a bank cannot be locally or even regionally focused but must become an investment bank with a global outlook with a strong base in an established financial centre. This might happen through organic growth but is more likely to be achieved through acquisition. The question the CEO must ask himself and his team is, 'How do we become a world-class player with world-class products and services for our clients?'

These products cannot be solely about real estate and must embrace the best of everything. For the bank it also means employing the best people and then keeping them. The talent pool in the Islamic finance industry is notoriously thin and finding enough brilliant people in order to cope with the challenges ahead will be tough, but the rewards for those who succeed will be immense.

The finance industry has taken a battering over the past year and it is not over yet. The same goes for the Islamic finance segment. The winners, of course, will be the banks that diversify and that hire the best and brightest people.

Islamic private equity

An opportunity still waiting to happen

As the economies of the oil producing countries of the Middle East and North Africa (MENA) region have boomed over recent years most areas of finance have witnessed spectacular growth. Islamic private equity, however, has not been a particularly large beneficiary of this growth.

The reasons for this are hard to fathom. There is a close relationship between Islamic tenets of investing and private equity. By its nature private equity is participatory in nature and inevitably it must lead to the sharing of both risks and rewards. As long as the company seeking the private equity infusion is not operating in a haram area of business such as pornography or liquor, or is not heavily indebted, then few forms of co-investing could be more pure from a Shariah compliance perspective than private equity. The reality of the matter is that there is a close relationship between Islamic private equity and conventional private equity and therefore as private equity has grown in size across the globe then we might have expected its Islamic counterpart to have done the same.

Immediately prior to the financial crisis, conventional private equity had become the whipping boy of the financial world and there was much talk of the need for increased legislation and greater transparency on the workings of the private equity industry. Too many people were making enormous amounts of money out of private equity transactions that were, in essence, being fuelled by excessive cheap debt. Private equity players were being viewed as locust, corporate raiders, and pirates.

Islamic private equity never fell into quite the same trap in large part because of the prohibitions inherent in the Islamic financial system against too much debt. In the ideal Islamic private equity transaction, the goals of all of the shareholders are aligned: both the entrepreneur who started the business and the private equity investors who joined them want the same result. Both parties hope that they can achieve a significant return on their investment through a successful trade sale or an IPO listing. Equally importantly, the Shariah requirement that transactions have a productive activity underpinning them and that financial flows and assets remain correlated, meant that debt simply never had the chance to balloon out of control in the Islamic sphere to the same extent that it did in the conventional sphere.

Size of the market

Industry estimates suggest that the global private equity market is worth around $2,200 billion at present although the volume of transactions completed in the first quarter of 2009 is miniscule. According to Greenpark Capital, a specialist secondary investor in private equity, deals closed in the first quarter of 2009 amounted only to $2 billion. A market with too many sellers and too few buyers inevitably means depressed asset prices. Figures for the Islamic private equity industry are much harder to come by, but estimates from Yasaar Media research suggest that the industry is approaching $3 billion in funds raised and deals done, much of it in the MENA region. This is a far cry from the $40 billion that pundits suggested was the kind of level that the industry would reach by 2011. For an overall Islamic finance industry whose size is estimated at around $800 billion then it is not hard to see that private equity does not play a very significant part in the industry yet.

Before the credit crisis some observers had postulated that there were not enough potential Shariah compliant target portfolio companies around to be able to soak up the Islamic private equity funds available. Remember that at this time there seemed to be money for even the most speculative of investments, redolent of the dot.com boom where there was too much money chasing too few opportunities. The picture to emerge since the collapse of Lehman Brothers is still far from clear but there is now much less of a mismatch between the financial heft of investors and potential Shariah compliant private equity targets and the undeniable conclusion is that the Islamic private equity sector is particularly well placed for expansion at present.

The practicalities

The Islamic private equity model is very similar to the classic Mudarabah model with the alliance of general partner and limited partner being a straightforward example of what a

Mudarabah is supposed to be. Equally importantly, the long time frame involved in most private equity transactions is complementary to the overall tenets of Shariah investing. At its most basic form, Shariah finance is about participatory investing for the long term health of both parties in the transaction as well as to the overall Islamic financing system.

The reality, however, is that that the Islamic private equity industry is still in its infancy both in terms of overall size as well as numbers of players in the market. One of the core developments that will be needed for the mature development of the industry is for more and better qualified human capital: more people with a higher level of training. This is a requirement that afflicts much of the Islamic finance industry and the same dilemma applies here: does the private equity firm employ private equity experts and teach them Shariah? Or does it employ people who understand Shariah and then teach them the art of private equity? This applies both to those experts charged with structuring products as well as those on the marketing and relationship management side of the business.

In order to address this issue fully, however, there needs to be a greater level of standardisation across countries to ensure common levels of compliance. In this way the Gulf-based Islamic private equity practitioner can engage staff from Islamic markets in Asia and vice versa without the usual culture shock that so badly affects Islamic retail banks trying to ferry staff in from overseas to meet demand. As the financial world leaves the realm of excessive cheap debt and enters a world where any form of financing is much harder to come across, then Islamic private equity becomes a much more attractive beast when compared to its conventional cousin. Expensive debt is burdensome and paying down debt has been a real focus for most finance houses of late. The beauty of Islamic private equity is that it has no tolerance for high levels of debt and in practice if a private equity fund takes a stake in a portfolio company whose debt level is too high then the first priority has been to refinance conventional debt through using Shariah compliant instruments.

Dependence upon Shariah advice

Indeed this kind of refinancing manoeuvre illustrates the ‘intrusive’ influence of Islamic financing principles in a private equity transaction. The Shariah involvement in an Islamic private equity investment does not end when the documents are signed and money exchanged but rather it carries on for the length of the portfolio investment. If a company has been taken over as part of an Islamic private equity portfolio then it must remain Shariah compliant in all significant respects throughout the duration of the investment. Such compliance cannot be assured by the pre-existing management of the company since the management team would hardly be qualified to do so. The Shariah advisers on the transaction will have an ongoing duty to ensure that the tenets of Shariah are not strayed from: the portfolio company will not incur excessive debt or begin trading in haram areas of business. If the Shariah advisers on the transaction are not used on an ongoing basis then a separate and distinct Shariah board will have to be appointed for as long as the portfolio company remains a component of an Islamic private equity portfolio.

While this need for an extra level of oversight might be interpreted as an extra level of cost, it is absolutely essential in maintaining the integrity of the Islamic private equity system as well as the credibility of all those involved in the transaction. Amongst other things, ongoing Shariah compliance ensures the possibility of a robust secondary market for trading in private equity stakes in growing companies as well as when the inevitable IPO or trade sale take place and the original investors take their profits.

Islamic private equity

The origins of Islamic private equity in the Gulf

The Islamic private equity industry is a very young one and traces its roots back less than a decade. In 2003 Kuwait's Global Investment House appears to have been one of the first institutions to explore Islamic private equity through the launch of a Kuwaiti dinar denominated Private Equity Fund where the investments were channelled into little known unlisted Kuwaiti companies. Also in Kuwait during the same year Kuwait Finance House's $100 million New Zealand Australia Private Equity Fund was launched.

Unicorn Investment Bank from Bahrain was not far behind and in 2006 launched its $150 million Unicorn Global Private Equity Fund. This was not a domestic or regional fund and only 40 per cent of the fund was placed in the GCC, 35 per cent in the Levant, while 25 per cent of the fund was placed in the US and South East Asia. The most successful private equity funds are tightly targeted and so to provide some focus for this fund, investments had to be in one of four categories: consumer products, heath care, business services, and light manufacturing. The fund is to be used for acquiring positions in existing businesses and creating value through the use of prudent leverage, consolidation, financial restructuring, operational enhancements and the granting of management incentives. June 2009 saw the Unicorn Global Private Equity Fund acquire a 70 per cent equity stake in Bahrain Maintenance and Diving Services. The acquisition was completed through the fund's wholly-owned subsidiary, Regional Energy Services Holding. This is the sixth investment from the fund since launch.

That same year, 2006, also saw the establishment of Millennium Private Equity from the Dubai Islamic Bank stable whose remit was to launch and manage a family of seven sector-specific funds in energy, telecoms, media, communications, financial institutions, general industries, infrastructure, education, and real estate. The Millennium Equity Growth Fund is a closed ended equity investment fund that invests in IPOs, listed equities, private equity, Shariah compliant bonds, and other financial instruments. Harking back to the point we made about the Islamic finance industry's over exposure to real estate however, up to 70 per cent of the funds will have real estate exposure.

Since those early days the industry has grown and developed to some extent around the world although there has been a growth focus on the GCC which stems largely from the massive petrodollar boom caused by sky-high oil prices.

Other noteworthy examples of Islamic private equity would include the following:

- From January 2007 comes the Enmaa (Dubai Growth Fund) from 3i Capital Group. This $100 million fund was intended to invest in public and private equity securities

Islamic Private Equity Funds

Date of launch	Fund Name	Fund Manager	Domicile	Assets Type
04/10/2007	Al Imtiaz Investment Fund	Al Imtiaz Investment	Kuwait	Private Equity
31/05/2007	The Care 2 Fund	Gulf Investment House	Cayman Islands	Private Equity
01/05/2006	Unicorn Global Private Equity Fund I	Unicorn Investment Bank	Bahrain	Private Equity
01/09/2005	The Care Fund	Gulf Investment House	Cayman Islands	Private Equity

primarily in the Middle East and beyond.

- In April 2007 Khaleej Finance and Investment of Bahrain launched its $200 million Indian Private Equity Fund with the aim of investing 50/50 in private equity and real estate in India.

- The Al Imtiaz Investment Fund is a dinar denominated open ended private equity fund launched in October 2007 by Al Imtiaz Investment Company with a focus on both private equity and real estate.

- From Millennium Private Equity and Global of Kuwait comes the $500 million Global DIB Millennium Islamic Buyout Fund which was launched in 2008 as a true private equity fund focused on companies located in the GCC, Turkey, Egypt, Jordan, Lebanon, Tunisia, and Morocco.

- In March of 2008 the $1 billion Dhow Gulf Opportunities Fund was launched by Qatar Islamic Bank (QIB) as a dollar denominated closed ended fund with a focus on telecoms, environmental recycling technologies, media, oil & gas, and infrastructure. QIB, QInvest, and Silver Leaf Capital (SLC) set up the private equity fund and a company to manage it.

- The Family Shari'ah Fund which is a closed ended fund that was launched in mid-2008 with the aim of investing in money market instruments, leasing and fixed income, equities, real estate, private equity, and structures replicating hedge funds returns.
- Arcapita, the Islamic investment bank from Bahrain, successfully exited its private equity investment in US-fast food firm Church's Chicken in mid-2009. The sale, to a San Francisco private equity group Friedman Fleischer & Lowe, is said to have seen Arcapita double its money on the $390 million it paid for Church's back in December 2004.

Snapshot of an industry sector

The pool of funds listed here, from IFIS, is rather small and because of the wide variations in published performance figures an average return figure for such funds would be largely meaningless. The figures tend to suggest that the great promise offered by private equity transactions to the Islamic finance industry has not been met and the Islamic private equity industry remains ready for the boom that is due. In fairness there are not many asset classes that have performed well over the past few quarters so perhaps the kindest conclusion that can be drawn from these figures is that the Islamic private equity sector has not performed any worse than others.

Over the years a number of specialist Islamic investment banks has grown up, some with a specific focus on Islamic private equity and others with a more general investment focus. We have already mentioned a number of the firms in this sector including KFH, Global, Uni-

Geofocus	Base Currency	Fund size in USD (Million)	Type	Total Returns
Gulf Cooperation Council (GCC)	KWD	Not disclosed	Open Ended	99.60%
United States	USD	50	Closed Ended	
Global	USD	150	Closed Ended-(Renewable)	-26.56%
United States	USD	30	Closed Ended	

Source: **IFIS**

corn Investment Bank, and Millennium Private Equity but there are also others including:

- International Investment Bank of Bahrain which was established in 2003 with Islamic private equity was one of its main planks. To date the bank has undertaken a number of private equity deals including in diverse sectors and companies such as IIB Paper Company Limited (UAE), IIB Power Company Limited (Asia), IIB Steel Company Limited (Bahrain), IIB Automotive Ltd (Tunisia), IIB Sugar Ltd (Bahrain), and Istethmary Mortgage Finance BS (Saudi Arabia). The bank reported a net profit of $13.5 million for 2008 although Q1 2009 showed a loss of $0.9 million compared to a net profit of $5.4 million for the same period of 2008.

- Rasmala from Dubai is another specialist in private equity and in January 2009 launched Rasmala MENA Private Equity Fund 2 as a Shariah compliant regional private equity fund with a target size of $350 million. The fund will primarily target opportunities in Saudi Arabia, UAE and Egypt and targets target mid-cap opportunities with an enterprise value of $50 million to $250 million.

- In the UK Prosperitus Capital Partners is a newly formed private equity and alternative investments advisory group focused on Shariah compliant private equity funds investing into emerging market real estate and infrastructure projects.

- Bahraini bank Capital Management House launched a $150 million Shariah compliant private equity fund called CMH Enterprise Fund I back in March 2007. CMH Enterprise Fund I was to invest in manufacturing, utility, energy, healthcare, services and technology related companies. Capital Management House is not a standalone private equity house but provides Islamic structured and corporate finance, investment advisory, asset management and private equity products.
- Gulf Finance House is one of Bahrain's leading Islamic investment banks which also focuses in Islamic private equity whose projects include Khaleeji Commercial Bank, Gulf Energy Holding Company, Gulf Holding Company, Bayan Holding Company, and Balexco.
- CIMB Islamic from Malaysia is also involved in private equity but through its mother organisation CIMB.

The future of Islamic private equity

As the Islamic finance industry grows, and as the financial services industry recovers from the global recession it is likely that the Islamic private equity industry will come back to life quickly. The industry has never lived up to the promise that it had, in part because of the lack of skilled professionals in the industry and in part because there has been a lack of landmark transactions to act as benchmarks.

> "The most successful private equity funds are tightly targeted and so to provide some focus for this fund, investments had to be in one of four categories: consumer products, heath care, business services, and light manufacturing.

Islamic finance and private equity are natural bedfellows and therefore it can only be a matter of time before Islamic private equity takes off as a significant part of the financial landscape. The essential requirements for this to happen will include attracting and retaining skilled talent, the return of liquidity to the market, and a set of benchmark deals to give the industry some profile.

Both the Malaysian Venture Capital Association and the Gulf Venture Capital Association will have a role to play in this resurgence, but these institutions will be covered in the following section on Islamic venture capital.

Islamic venture capital

Ripe for growth

If the Islamic private equity industry has failed to live up to its expectations then Islamic venture capital has followed the same path with even less spectacular results. Indeed discussion of Islamic venture capital is largely theoretical because real life examples are few and far between. The government of Malaysia has done more than any other body to promote and define the industry and indeed has launched a fund, albeit a small $10 million fund, to help show the way. The private sector has a few examples of Islamic venture capital at work but the reality is that often these are misnamed Islamic private equity efforts and yet venture capital and Islamic finance are tailor-made for each other.
Rather like its cousin private equity, venture capital is a mode of investing that seems perfect for Islamic finance through the application of various Islamic financing concepts, with the Mudarabah concept being the most common. Venture capital here is defined as the provision of seed capital for a new venture in the process of being established, rather than the provision of capital to a small business to facilitate its growth.

Rather like its conventional counterpart, Islamic venture capital appeals most to investors who understand a sector or an industry intimately and are prepared to risk a portion of their capital on the strength of a business plan, the management team of the proposed business, and their own ability to pick a winner. Other similarities between Islamic venture capital and conventional venture capital include the fact that deal sizes are small when compared to private equity transactions, since the start-up capital that is required for a burgeoning small businesses tends not to include monies for grandiose marketing and advertising plans but tends to be much more conservative in its outlook.

Some basic principles explained

The principle of Mudarabah in venture investing

Mudarabah financing involves a contract under which the investor, or rabal-maal, brings financing to the table and the entrepreneur, the mudarib, brings expertise, effort, and in the case of Islamic venture capital, a business plan. Collectively the parties share the proportionate profit from the results of the enterprise as per their pre-arranged agreement. The entrepreneur cannot be placed at risk of losing money since he has contributed only expertise. If the business venture fails, then the most the entrepreneur could lose is the investment he has already made in the business and the time and effort he had put into the venture. In other words no one can come after the entrepreneur for cash compensation. In a similar way, no one should expect the venture investor to have any say in the management of the company or any responsibility for it, since his part of the deal is to providing financing only.

The principle of Musharakah in venture investing

In the context of Islamic venture capital Musharakah financing is a partnership formed between parties to finance a business venture

where the parties contribute capital either in the form of cash or in kind. Profits are distributed based on a pre-agreed ratio. Losses are shared on the basis of capital contribution to the venture.

The principle of Wakalah in venture investing
In Wakalah financing a contract from one party gives the power and rights to another party to act on his behalf, based on the agreed terms and conditions.

Islamic venture capital: determining ownership shares

Some scholars have made the case that even in cases of Islamic venture capital, it is important to look at the details of each deal to make sure that they are being undertaken in the true spirit of Shariah. One exponent of this view is Dr Saiful Azhar Rosly who makes the point very forcefully in 'Critical Issues on Islamic Banking and Financial Markets" (Authorhouse, Bloomington, 2005).

Rosly says, 'in the Musharakah framework, the main element of the contract is the profit-loss sharing ratio (PLSR), which is determined on the basis of conditions agreed upon by the participating agents. But in modem finance, it is irrational to say that an investor will not give a look at the expected return on investment of a project, which all venture capitalists will do. So, how is the PLSR and pricing of the venture capital deal related?' To illustrate the point the author refers to the Hockey Stick Method and uses the following example:

'Let's say, from a $1.5 million investments (the investor) wants a return on investment (ROI) of six - or $9 million. Also he envisages the project to make a net profit of $2 million. If he decides on a price-earnings of 10:1 he will obtain a 45 per cent equity in the company. This is done by multiplying the projected earnings ($2 million) by 10 and dividing it by his targeted return of $9 million.

What we see here is a deal that a venture capitalist will offer to an entrepreneur. Here the former wants 45 per cent equity in the company on the basis of a ROI of six or $9 million on a $1.5 million investment. Can this be a genuine case in a Musharakah deal in which the spirit of co-operation or ta'wun is made visible? Is the fixation of profit ($9 million) in equity investment in the form of equity ownership permissible in a Musharakah contract? It is, therefore, inadequate to say that venture capital is by nature halal before any substantial research is made on the subject. There is a great deal of work one must do before the Islamic label is used'.

Islamic venture capital in the overall context of Islamic finance

The sector of Islamic venture capital had been largely ignored in the GCC until recently because of the lack of an 'entrepreneur class' which is essential for the development of a healthy venture capital environment: young, bright people with great business ideas and a determination to make a success of 'their' business. As the world becomes more of a global marketplace, and as the education and skills level of young people in the region increases, then venture investing along Shariah compliant lines may become more common. This is not to say that the greater Middle East and North Africa region has been bereft of venture capital. Countries such as Egypt, Lebanon and even Turkey have long had an entrepreneur class of their own and the VC industry is consequently more developed in these countries. In much of the GCC there have been impediments to foreigners (i.e. non-GCC nationals) owning their own businesses outright and this had naturally led to an absence of such businesses in the marketplace. As countries like the UAE have introduced 'free zones' such as Dubai Internet City, Dubai Media City, Dubai International Financial Centre, Jebel Ali Free Zone, and so on where foreign nationals and corporates can own 100 per cent of their own business then the market for venture capital has opened up. Naturally the business idea that will attract Islamic venture capital has to operate within the constraints of Shariah and must not dabble in haram areas.

But having a young entrepreneur class is only half of the equation. The other half of the equation is having venture investors with the risk appetite to back the business plans presented to them with hard cash. This is not simply a matter of having the money, it is also about having the tools to analyse the business plan, structuring a deal, and ensuring that the short, medium, and long term investment interests of both the entrepreneur and the investor are the same. This requires a level of education and expertise that had been lacking until relatively recently but has arrived in the region on the back of the tidal wave of oil revenues and increasing globalisation.

The combined effect of this has been that the Islamic venture capital industry was virtually non-existent, except for a few cases where Angel investors in the guise of ultra wealthy merchant families have funded new start-up businesses with their own cash, after ensuring that the business had no likelihood of straying into haram areas of business practice. The arrival of financial centres such as Dubai International Financial Centre, Malaysia International Islamic Financial Centre, Qatar Financial Centre, and Bahrain Financial Harbour has opened up the possibility that expert venture capital talent from more mature financial markets could be transplanted into rapidly emerging Islamic finance markets and bring with it the intellectual wherewithal to do lucrative Islamic venture capital deals.

Guidelines

Anyone serious about setting up an Islamic venture capital fund, or securing venture capital funding, in a Shariah compliant manner should acquire a copy of the Securities Commission Malaysia document on Guidelines and Best Practices on Islamic Venture Capital published in May 2008. Essentially these form a set of guidelines and best practices to promote the adoption of appropriate standards for the development of the emerging Islamic venture capital industry.

During her keynote address at the Islamic Venture Capital & Private Equity Conference 2008 launching these guidelines YBhg Dato Dr. Nik Ramlah Nik Mahmood, managing director, Securities Commission Malaysia said, 'Venture capital brings profound impact to the economy. It bridges the financing gap where direct bank lending or financing through the debt or equity market is difficult to obtain. The unique nature of the venture capital model, which is based on active management, leads to improved corporate governance and an overall alignment of stakeholder interests with that of the management. This then creates significant value above and beyond the use of financial engineering. New companies and industries spawned by venture capitalists for example Apple Computer Inc., Federal Express, Google, IBM have irreversibly changed the way we live and work today'.

The clear intention was to promote an Islamic venture capital industry whose aim was not simply to nurture small businesses but rather to be the catalyst behind the next wave of 'mega brands' too, in the mould of Apple and Google. Such thinking is certainly ambitious, but judging by the way the balance of global financial and economic power is currently shifting away from the traditional centres of London and New York it may contain an element of realism.

Dato Mahmood then went on to say, 'With the rapid expansion and innovation of Islamic capital market products such as Sukuk, Islamic unit trust funds, Islamic REITs, Islamic ETF and Shariah compliant listed securities, it is now timely for us to encourage and facilitate the growth of Islamic venture capital as another available asset class in Malaysia's broad range of Islamic products. The development of Islamic venture capital will offer the opportunity for Islamic investors to diversify their portfolios. Also, the fact that venture capital does not have perfect correlation with other asset classes such as listed securities allows more opportunity for investors to enhance their portfolio returns'.

Naturally Dato Mahmood was focused principally on Malaysia but the general concept remains the same for the industry wherever it is based. The speech by Dato Mahmood was by way of a precursor to the publishing of the Guidelines whose two core requirements for Shariah compliant venture capital were identified as being:

- The appointment of a Shariah adviser who provides continuous guidance in ensuring that amongst others, the proposed investment contract and instrument structures are Shariah compliant (our emphasis)
- The core activities of the investee company must be Shariah compliant

The Dato was clear that these guidelines were absolutely necessary for Malaysia if it was to stand a chance of attracting funds from the GCC, highly enriched with a vastly inflated oil price at the time. Wealth, and therefore venture capital interest, was blossoming in the Middle East and Malaysia did not want to lose out as a recipient of some of these funds. In order to attract Islamic venture capital funds in particular she identified the importance of the Shariah adviser who reinforces Shariah compliance throughout the whole process, from deal structuring and investing up to exit, and by doing so enhances confidence and attracts greater potential Islamic investors.

> "A similar success story in the Islamic venture capital field could prove to be just the fillip that the industry needs to spawn dozens of funds from the private sector looking for the next big Shariah compliant thing.

An industry emerges

Shortly after this announcement, in July 2008, the first Islamic venture capital Musharaka Fund was introduced by Malaysia Venture Capital Management with the fund managed by Musharaka Venture Management. Malaysia Venture Capital Management is the venture capital subsidiary of the Ministry of Finance in Malaysia. Apparently the fund drew interest from Swiss and Middle Eastern investors. Malaysia Venture Capital Management allocated RM 30 million ($ 8.3 million) for the fund while unnamed investors invested RM 5 million ($1.83 million). Malaysia Venture Capital Management will continue its efforts to attract participation from local and regional investors and hopes to increase the fund size in 2009. The Musharaka Fund aims to invest in at least four technology-based companies. Judging by the Dato's speech it seems likely that Malaysia's Islamic venture industry is hoping to breed the new Apple Computer Inc, Google, or IBM.

The Gulf Venture Capital Association

As its name suggests the Gulf Venture Capital Association (GVCA) is a body whose remit is to encourage the growth and prosperity of the venture capital industry in the GCC and the greater Middle East. While its remit is not solely confined to Islamic venture capital there are clear areas where the GVCA and Islamic venture capital intersect.

The original intention of the GVCA was never simply to be a body which promoted venture capital, however, but was seen as a counterpart to the Arabian Knowledge Economy Association (AKEA) whose remit was to increase entrepreneurial skills and awareness amongst young up-and-coming businessmen and women in the Arab world. Indeed the president of AKEA, Abdullah Al-Subyani, is also president of the GVCA.

The reality of the industry, however, is that the association focuses most of its attention on private equity and not on venture capital. The annual report produced by the GVCA from 2007 only makes passing reference to venture capital and even then only as a virtual footnote which reads , 'Venture capital funds raised money in 2005 and 2006, but lost their appeal in 2007. Venture capital funds still have to ascertain their viability in the MENA region in terms of availability of quality deal flow and realization of successful exits'.

The 2008 report from the GVCA said, 'Venture capital funds remain largely unattractive in the MENA region, with only three venture capital funds raised in 2008. The venture capital model has remained unproven in the region, despite many attempts by individuals and governments to adapt the western model to the Middle East'.

Malaysia Venture Capital Association

The Malaysia Venture Capital Association based in Kuala Lumpur has a similar agenda to the GVCA and the association works closely with the Islamic Banking and Finance Institute Malaysia to produce an annual event called Islamic Venture Capital & Private Equity Conference.

Islamic venture capital

At this conference held in May 2009 deputy finance minister Yb Datuk Dr. Awang Adek Hussin said, 'the (Malaysian) government has given strong commitment to the development of venture capital industry In Malaysia, and in 2008, as much as 48 per cent of the total venture capital funds under management, came from the government... The potential for purely 'Islamic' venture capital is great because the nature of venture capital financing itself is similar to the stated principles of Islamic finance, which favour profits, or losses, over interest. Besides, the industry can be lucrative, not only for investors, but also for the overall advancement and development of economic and innovative activity. By providing funds to budding entrepreneurs with sound ideas, Islamic venture capital can help to promote innovation, job creation and the development of high growth industries. Now, there are already many Muslim entrepreneurs seeking Islamic venture capitalists, and there are also a growing number of non-Muslim investors opting for Islamic investment schemes. From developments around the world, we can expect that Islamic finance, venture capital and private equity will be major tools in implementing various investments and realizing various projects at the global level. Given the contracting global credit markets currently, the promotion of Islamic venture capital and private equity is both appropriate and timely.'

The private sector

While the Malaysian government's endeavours are to be applauded it seems likely that the sustained growth and development of a strong and healthy Islamic venture capital an industry will rest in the private sector. If the Malaysian government can help to kick start such industry domestically then so much for the good. Perhaps what the industry needs more than anything else is a catalogue of success stories that will pique the interest of wealthy investors with a penchant for backing small business. The success story that Abraaj Capital, a Dubai-based conventional private equity house, had with its investment in Aramex bred dozens of imitators across the GCC. A similar success story in the Islamic venture capital field could prove to be just the fillip that the industry needs to spawn dozens of funds from the private sector looking for the next big Shariah compliant thing.

It seems a safe bet that successful Islamic venture capital investing in the future will be the speciality of Islamic investment banks rather than specially focused Islamic venture capital firms. The rationale here is that, as we have already observed, the quantum of individual venture capital investments tends to be small and therefore may not be lucrative enough in the short term to finance all but the most boutique of firms.

Bahrain's Venture Capital Bank (VCBank) is an example of a specialist Islamic investment bank launched with the aim of capitalising on this niche, although VCBank's remit is wider than simply venture investing. Established in October 2005 the bank also looks at private equity and real estate, while also trying to secure financial advisory mandates. In the current climate its business plan seems to be succeeding and for the year ended 31 December 2008 the bank achieved net profit of \$47 million which showed 47 per cent growth compared to 2007 and a 27 per cent return on equity. The bank is also increasing paid-up capital from \$165 million to \$250 million.

VCBank launched its first fund, the \$250 million MENA Small & Medium Enterprises Fund in December 2006 and has so far invested in Challenger Limited, an oil drilling company in North Africa.

The future of Islamic venture capital

Early signs would suggest that the industry is likely to flourish in Malaysia before anywhere else, in large part because of the initiatives of the government. What seems beyond doubt is that the industry at present is tiny, certainly smaller than \$100 million, and probably worth less than half of that. When the global recession is over, Islamic venture investing could easily be one of the fastest growing sectors of the industry, if for no other reason than it is coming off a very low base.

Islamic mergers and acquisitions

Opportunities abound

In the context of Islamic investment banking the subject of mergers and acquisitions covers two distinct areas. The first of these is when an Islamic finance house looks to grow or consolidate its position through either merger or acquisition. Generally this will involve an overseas move rather than a domestic one, although this is not always so. The second area involves an Islamic investment bank acting in an advisory capacity to another institution's merger or acquisition, undertaken within the parameters of Islamic finance, and for which the advising bank will earn fees.

In the heady oil-revenue-fuelled days before the financial crisis there were regular proclamations from various Gulf states about the establishment of an Islamic mega-bank that would rival the conventional world's mega-banks such as Citibank or HSBC. These were to be huge entities that spanned continents and managed to fund their investment banking and wealth management offerings through equally huge retail deposits from their hundreds of thousands of customers. The $10 billion capital Istikhlaf Bank from Bahrain is the latest in the long line of such banks to be announced.

Perhaps the financial crisis itself has been enough to make the architects of these grandiose plans grateful that they never got off the drawing board as they watched the giants of the conventional banking sphere become beset with problems. Nevertheless there is a core of sense in having an Islamic finance institution that is not tied to one geographic region or one area of financial services. It has long been argued that in the long run only truly international investment banks can survive since the real money to be made in investment banking lies in having mass or scale and this can only be achieved through having deals cooking in many countries at the same time. This does not hold true for retail banks where having a branch on every street corner of the world provides little by way of benefit to customers and little by way of profit to the bank.

Herein lies the wealth of opportunity presented by Islamic mergers and acquisitions: the art of identifying a complementary institution that can be bought or merged to increase the market value and influence of the resultant institution over and above the sum of its constituent parts.

The benefits of size

Much as in the world of conventional business and finance, except with a Shariah compliant overlay, building strong Islamic finance businesses often involves buying other companies or merging with other companies rather than spending years launching a business and then going through years of costly competition. The benefits of M&A can also include knowledge transfer, technology transfer, and competitive advantage: in the financial services business in particular these can lead directly to much better product structuring capabilities. Equally importantly in M&A deals is the prospect of significant cost savings, which can make all the difference in tough markets. Duplicate layers of management can be removed and there are generally synergies at all levels of expertise that can lead to significant cost savings.

But perhaps the most important area where Islamic M&A could help Islamic banks is simply that consolidation should lead to larger balance sheets which should mean that the newly formed larger entity should have access to deal flow that was previously not available to them.

One clear area where there could be scope for Islamic mergers and acquisitions is in the UAE which is often described as being 'over-banked'. The domestic market has 52 banks, 24 domestic and 28 foreign, according to the Central Bank of the UAE. Of these local banks eight are Islamic. The world economic recession may increase pressure on some of these Islamic banks to merge but the truth is that there is often a fierce pride associated with a bank that bears the name of a specific emirate and this is often enough to quell any debate about the need to merge.

As Philip Dew says in his book Half a Century of Banking in the UAE, 'For many years there has been a suggestion that the UAE has been over-banked. Whether this is strictly the case is open to conjecture because, as the economy grows, so there is a concomitant increase in the demand for banking services. Furthermore, and perhaps paradoxically, the banks have never been more profitable than in the recent past, which of itself probably belies the argument there are too many banks in the UAE. Nevertheless, there is a strong belief amongst bankers that there is a need for consolidation in the sector, probably through mergers to create big institutions with bigger capital bases. Suggestions are that these could possibly be between local banks although in some minds they might better be between regional financial institutions and yet others consider that international banks from outside the region might invest in the capital of locally incorporated banks'.

Overseas expansion

Another area where there is scope for Islamic mergers and acquisitions lies in firms in the GCC acquiring partners in Malaysia, Pakistan, Brunei, and so on, while there is also much scope for firms in these countries to attempt acquisitions elsewhere. If the aim is to expand the Islamic finance footprint of an established entity then M&A can be a swift solution. One potential stumbling block to carte blanche M&A between the Gulf and Malaysia is that many Islamic banks operating in Malaysia are subsidiaries of conventional banks and therefore are not 'for sale' to third parties.

David Vicary

In spite of, or perhaps because of, the current market turmoil there is still a significant amount of Islamic M&A going on right now. As David Vicary (Daud Abdullah), managing director of DVA Consulting in Kuala Lumpur says, 'There is M&A Islamic consolidation activity in Indonesia. I am also aware of GCC entities looking for acquisitions in both Malaysia and Indonesia'. Discussions with senior bankers in the Gulf suggests that they are only too happy to wait for valuations of banks to decline further throughout Asia before they proceed with their acquisition plans. Vicary added, 'You need to have a tight definition of Islamic M&A. If it is an M&A which involves transacting on the ordinary shares in the company, then there is no real difference from a conventional M&A, with the exception of Shariah compliant business. If you mean M&A between Islamic financial institutions, the same applies as well. My view here is that there is some desirability to do this to help to create scale in both balance sheet size and capital and there are certainly entities out there looking. This primarily involves GCC entities looking for bargains in South East Asia'.

And what is the key to success in Islamic M&A transactions? According to Vicary it involves, 'A basic knowledge of Shariah principles and keen consideration of prohibited activities. Otherwise standard M&A advisory qualifications are needed including a strong network of potential players'.

Banks on the prowl

Banks like Saudi's Al Rajhi Bank are said to be actively looking for opportunities for M&A deals in Asia and the bank has recently set up an office in Kuala Lumpur to enable it to do so. There can be no substitute for 'people on the ground' when it comes to doing the due diligence on a deal or indeed when going through the target identification process. By contrast, various international banks have set up offices in Saudi Arabia although this is not thought to be about securing takeovers of existing Saudi banks since no acquisitions of domestic banks are allowed by foreign entities. Equally importantly, due to their sheer oil-price fuelled market size, it may not be possible for foreign banks to acquire Saudi banks even if they were allowed to do so.

But it is not all about acquisitions in Asia. In 2007 Saudi Arabia's National Commercial

"My view here is that there is some desirability to do this to help to create scale in both balance sheet size and capital and there are certainly entities out there looking.

David Vicary

Bank, at the time the Gulf's largest lender, paid $1.08 billion for a 60 per cent stake in Turkish Islamic lender Turkiye Finans, a Turkish Shariah compliant participation bank. At the time this was the biggest Islamic M&A deal ever and was closely watched by others hoping to replicate the success. The ruling Turkish political party, AK Party, had been actively encouraging Gulf investment into Turkey as a means of increasing stability to the sector and the NCB deal was only the latest in a long line of foreign direct investments the Turkish banking sector.

Earlier that year Unicorn Investment Bank and Inter Yatirim Menkul Degerler of Turkey completed a deal which saw Unicorn acquire 75 per cent of the brokerage and asset management company. Earlier still, in June 2006, Unicorn bought a 22 per cent stake in what was then called First Dawood Islamic Bank, a newly established commercial Islamic bank in Pakistan, now renamed Dawood Islamic Bank. In March 2009 Unicorn increased its stake in Dawood Islamic Bank to 37 per cent for a consideration of $13 million. In January 2009 Unicorn announced the acquisition of Bahrain Financing Company, one of the leading foreign exchange and remittance houses in the GCC. These acquisitions were made either directly or through the bank's Strategic Acquisition Fund, a $1 billion fund that seeks to acquire strategic stakes in commercial banks and other financial services institutions globally.

> “It will be very interesting over the next two years, on a global level, but in the Islamic wholesale space rather than the retail space'.
>
> ***Sameer Abdi***

In 2007 Samba Financial Group, another of Saudi Arabia's heavy team of banks, bought 68 per cent of the Crescent Commercial Bank of Pakistan. The $100 million purchase was part of the group's efforts to expand its activities geographically and enter into successful investment ventures on the basis of a long-term strategy. As we have seen Pakistan is a lure for other cash-rich Gulf based Islamic banks due to its profoundly Islamic nature and the size of its population as well the relatively depressed level of asset prices there. The Pakistani market consists of around 160 million inhabitants, 97 per cent of whom are Muslim.

Recession-proof activity

Kuwait Finance House is conspicuously active in the Malaysian market while CIMB Islamic in Malaysia has also been casting its net around within Asia. KFH's activity in Malaysia has been more investment banking focused rather than the bank making inroads into the domestic Islamic retail market. It has also launched a research oriented brand in Kuala Lumpur called KFH Research.

In September 2008, Dubai Islamic Bank and Dubai International Capital announced that they intended to buy a 52 per cent stake in the Industrial Development Bank of Jordan which was seen as a strategic acquisition that would pave the way for IDB's conversion into a Shariah compliant financial institution. The resulting entity would be called Jordan Dubai Islamic Bank.

Proving that the recession has not put paid to all Islamic M&A activity, on the run up to the summer of 2009 it was reported that Kuwait Finance House Bahrain was considering acquiring a stake in Bahrain Islamic Bank, the listed Bahrain-based bank from Investment Dar. Investment Dar, in turn, was rumoured to have lost a buyback option on a 19 per cent stake in the Islamic Boubyan Bank of Kuwait. Meanwhile non-Islamic National Bank of Kuwait was said to have bought Commercial Bank of Kuwait's shares in Boubyan Bank.


Sameer Abdi

"The world economic recession may increase pressure on some of these Islamic banks to merge but the truth is that there is often a fierce pride associated with a bank that bears the name of a specific emirate and this is often enough to quell any debate about the need to merge.

Other significant deals of late involve Qatar Islamic Bank which has been trying to acquire an undisclosed minority stake in Al Ijarah Indonesia Finance since February 2009 and plans to acquire PT Bank Jabar Banten, a banking services provider from the Indonesian government. Before this, in January 2008, Qatar Islamic Bank sold a 20 per cent stake in Al Jazeera Islamic Co, a financial services provider, to Qatar National Bank.

Sameer Abdi, partner, advisory services, Ernst & Young Middle East concurs that Islamic M&A could be in for a period of growth as a result of the global downturn. He said 'At the moment we are seeing a lot of interest in Islamic M&A and a number of institutions that have kept some dry powder over the past year are looking to do acquisitions, but most of the acquisitions are share swaps, they are not cash acquisitions. This is not surprising, given the liquidity situation at present. There is a view that the smaller banks, those with \$50 million-\$100 million capital bases may have to consolidate. It will be very interesting over the next two years, on a global level, but in the Islamic wholesale space rather than the retail space'.

A full listing of completed and announced Islamic M&A deals from January to June 2009 from Bureau Van Dijk's Zephyr database can be found at the end of this section.

Focus of activity

Perhaps much of the Islamic MA activity will be centred on the Gulf until a global recovery is underway. Even so it is possible that Islamic banks in Malaysia, Indonesia, and Pakistan would not have the balance sheet to be able to make acquisitions in the Gulf simply because of the wealth divide between the oil-rich Middle East and emerging Asia. Perhaps bucking the trend Al-Zamin Leasing Modaraba of Pakistan plans to merge with Emirates Global Islamic Bank.

These factors have led some observers to ponder the value of a pan-Asian Islamic bank holding company formed by the merger of a wide selection of smaller Asian players. While the theory of this is admirable and perhaps even desirable it is not necessarily practical because of the point we have already made that many Islamic banks operating in Asia are subsidiaries of conventional banks and are therefore not for sale.

Malaysia's oldest and second biggest Islamic bank, Bank Islam Malaysia, is looking at M&A as a way of clawing back the market share it has lost to new competition. The bank is looking at home as well as Indonesia, Singapore, and Thailand to source an acquisition partner that will put it back on the growth trail. The bank would still require regulatory approval for such a move. The problem seems to be that Malaysia's Islamic banking industry is overcrowded with 14 fully fledged Islamic banks as well as conventional lenders with Shariah windows.

As with the conventional M&A space the Islamic industry does not have a free hand in the realm of international Islamic M&A. There are often legislative barriers to straightforward acquisitions to be overcome. In Malaysia for instance, foreign companies are only allowed to take minority stakes in local companies and this extends to the financial services arena. This kind of impediment can stand in the way of a deal if the acquirer is looking for a controlling stake in the target company.

The future of Islamic M&A

The strengthening of bank balance sheets has been something of a trend in the market since the onset of the financial crisis. This has had a number of effects but one of the most pertinent affecting Islamic M&A is the reduction in valuations of banks caused by collapsing share prices. The next 12 month period would seem to be the perfect time for leading Islamic investment banks to capitalise on the new economic realities and bring forward their growth plans since targets may not be so cheap again and there may be significant advantages in being an early mover. Doubtless this will mean Gulf-based banks acquiring assets in Asia rather than the other way around although we may well see some internal consolidation within the Asian continent.

Islamic M&A Deals Jan-June 2009

	Deal No	Acquiror name	Acquiror country code	Target name
1.	278853	Islamic Development Bank Group	SA	United Albanian Bank
2.	1601026410	Shareholders		Gulf Bank KSC
3.	1601032179	Dubai Islamic Bank plc	AE	Industrial Development Bank
4.	1601032919	HE Sheikh Thani Bin Abdulla Bin Thani Jasim Al Thani		Islamic Bank of Britain plc
5.	1601035276	Qatar Investment Authority	QA	Qatar International Islamic Bank QSC
6.	1601047029	Unicorn Investment Bank BSC	BH	Bahrain Financing Company BSC
7.	1601047556	Al-Khabeer Merchant Finance Corporation	SA	Dari for Home Loans
8.	1601047951	Al-Zamin Leasing Modaraba	PK	International Multi Leasing Corporation Ltd
9.	1601050426	Qatar Investment Authority	QA	First Finance Company QSC
10.	1601051850	Qatar Islamic Insurance Company	QA	Al-Jisr Takaful Company QSC
11.	1601051978	-		Van Entegre Et Sanayi Ve Ticaret AS
12.	1601053846	Al Salam Bank Bahrain BSC	BH	Bahraini Saudi Bank BSC
13.	1601054757	Investors	QA	Syrian Islamic Company for Takaful Insurance, The
14.	1601056002	BBK BSC	BH	Shamil Bank of Bahrain BSC
15.	1601057106	Jordan Dubai Financial Investment Company	JO	First Takaful Insurance Company KSCC
16.	1601061615	Brookwell Ltd	GB	Noble Investments (UK) plc
17.	1601062874	-		Dubai Islamic Bank plc
18.	1601063097	-		International Leasing & Investment Company KSC, The
19.	1601069482	-		Arcapita Bank BSC
20.	1601075086	Barwa Real Estate Company QSC	QA	First Finance Company QSC
21.	1601076581	-		Noble Investments (UK) plc
22.	1601077502	Alliance Tuna International Inc.	PH	International Alliance Food Indonesia PT
23.	1601079266	SFS Group Public Company Ltd	CY	Shariah compliant Shipping Fund LP
24.	1601079687	-		National Bank for Development
25.	1603008626	-		AmBank (M) Bhd
26.	1603009366	Cahya Mata Sarawak Bhd	MY	UBG Berhad
27.	1603009495	-		Public Bank Bhd
28.	1603009760	-		Public Bank Bhd
29.	1603010357	CIMB Group Sdn Bhd	MY	CIMB-Principal Islamic Asset Management Sdn Bhd
30.	1603010360	Principal Global Investors Holding Co., Inc.	US	CIMB-Principal Islamic Asset Management Sdn Bhd
31.	1603010713	-		Al Rajhi Banking & Investment Corporation (Malaysia) Bhd
32.	1603013550	Putrajaya Perdana Bhd	MY	CMS Roads Sdn Bhd
33.	1603013551	Putrajaya Perdana Bhd	MY	CMS Pavement Tech Sdn Bhd
34.	1603015168	Khazanah Nasional Bhd	MY	Bank Muamalat Malaysia Bhd
35.	1603015238	Unicorn Investment Bank BSC	BH	Dawood Islamic Bank Ltd
36.	1603018883	Lembaga Tabung Haji	MY	BIMB Holdings Bhd
37.	1603019285	HLA Holdings Sdn Bhd	MY	Hong Leong Tokio Marine Takaful Bhd
38.	1603020150	RHB Capital Bhd		RHB Kawal Sdn Bhd
39.	1603023770	Bank Islami Pakistan Ltd	PK	Citibank NA's consumer housing finance portfolio

Target country code	Rumour date	Date announced	Deal type	All Deal values th EUR
AL	9/13/2004	3/30/2009	Acquisition increased from 15% to 55%	6,046.98
KW	10/28/2008	11/17/2008	Acquisition 50%	973,494.29
JO	9/15/2008	9/17/2008	Acquisition 52%	77595.00
GB	11/26/2008	11/26/2008	Minority stake 23.326%	8,064.17
QA	11/24/2008	11/24/2008	Minority stake 5%	98,486.20
BH	9/28/2008	9/28/2008	Institutional buy-out	n.a.
SA	1/2/2009	1/27/2009	Joint venture 100%	201,332.09 *
PK	1/19/2009	1/19/2009	Acquisition 100%	n.a.
QA	1/25/2009	1/25/2009	Minority stake 20.078%	54,607.52
	2/5/2009	2/5/2009	Minority stake 2%	1,080.64
TR	2/13/2009	2/13/2009	Minority stake unknown %	n.a.
BH	2/23/2009	4/21/2009	Acquisition 100%	56,431.72 *
SY	2/24/2009	2/24/2009	Joint venture 100%	16,664.73 *
BH	3/2/2009	3/8/2009	Acquisition 100%	n.a.
KW	3/2/2009	3/2/2009	Minority stake increased from 21.5% to 25.5%	4,257.67 *
GB	2/19/2009	2/19/2009	Minority stake 9.842%	1,469.70 *
AE	3/23/2009	3/25/2009	Minority stake 26.868%	605,283.23 *
KW	1/14/2009	1/14/2009	Minority stake 23.28%	117,398.73
BH	4/15/2009	4/15/2009	Minority stake unknown %	301,619.80
QA	5/5/2009	5/5/2009	Acquisition 100%	265,647.99 *
GB	5/7/2009	5/7/2009	Minority stake 8.528%	1,419.56 *
ID	3/12/2009	3/12/2009	Acquisition increased from 70% to 80%	n.a.
	5/4/2009	5/4/2009	Joint venture 100%	112,939.72 *
EG	5/20/2009	5/20/2009	Minority stake 14.286%	32,719.01
MY	12/23/2008	12/23/2008	Minority stake unknown %	106,765.51 *
MY	1/14/2009	1/14/2009	Minority stake increased from 37.726% to 39.1%	3,274.70 *
MY	1/9/2009	1/9/2009	Minority stake 0.05%	3,254.63 *
MY	1/21/2009	3/19/2009	Minority stake unknown %	1,034,278.51 *
MY	1/30/2009	1/30/2009	Acquisition 50%	1,716.67
MY	1/30/2009	1/30/2009	Acquisition 50%	1,716.67
MY	2/4/2009	2/4/2009	Minority stake 40%	84,946.43
MY	2/26/2009	2/26/2009	Acquisition	13,155.36
MY	2/26/2009	2/26/2009	Acquisition	2,505.78
MY	3/11/2009	3/11/2009	Acquisition increased from 100% to 100%	106,269.05
PK	3/5/2009	3/5/2009	Minority stake increased from 22.2% to 37.2%	10,278.76
MY	4/6/2009	4/6/2009	Acquisition 16.44%	36,439.72 *
MY	4/8/2009	4/8/2009	Acquisition 65%	11,246.36 *
MY	4/16/2009	4/16/2009	Acquisition 100%	610.03 *
PK	5/18/2009	5/18/2009	Acquisition 100%	n.a.

Source: **Bureau Van Dijk Zephyr Database**

Islamic syndicated lending

Profiting from collaboration

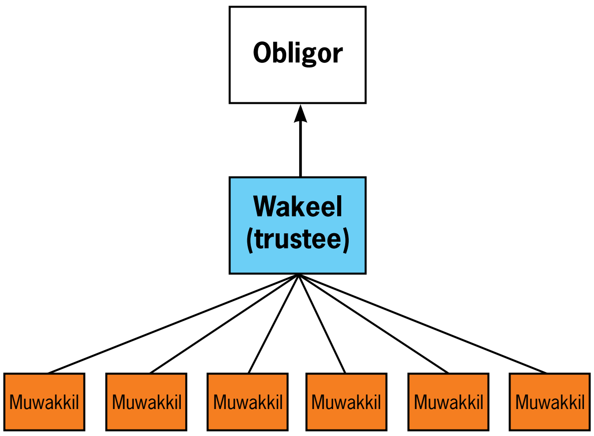
The concept of syndicated lending may have been born in the 1960s in the world of conventional finance but it was not until earlier this decade that it found its way into the Islamic finance lexicon. Syndicated loans are quite simply an integral part of capital raising for large corporate and financial institutions. Such loans may be used for general corporate needs like refinancing, acquisitions, back-up lines or more specialised or structured transactions.

Within the realm of Islamic finance, syndicated loans can take a variety of forms and may be a form of Musharaka financing but because of the prohibitions in Islamic finance concerning riba there are significant differences between an Islamic syndicated loan and a conventional syndicated loan. Islamic syndicated financing 'refers to the participation of a group of institutions in a joint financing operation through one of the Shariah permitted modes of financing' according to Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

In addition to Musharaka financing, such loan syndications are also often structured around the Tawarruq (Murabaha) concept and this occurs when an underlying asset such as a commodity is sold to the obligor on deferred payment terms. This means that conventional and Islamic finance houses can work together on the same Islamic syndicated loan as long as all the tenets of Shariah are complied with. Syndicated financing provides a means for Islamic banks essentially to combine their balance sheets to provide financing for higher value transactions than they would otherwise be capable of. Another significant advantage is that such syndications allow banks to mitigate some of their risk at the same time.

When the mandated lead arranger (Wakeel or agent) in the syndicate is selling down the loan to be syndicated it should do so at par without either marking it up or down but can instead, if it wishes to do so, charge a management or administration fee to cover the cost of the extra work that it has to undertake. The other banks involved in the transaction (Muwakkils or principals) should be party to an investment agency agreement.

Funds flow diagram in an Islamic Syndicated Loan



Source: **Yasaar Media**

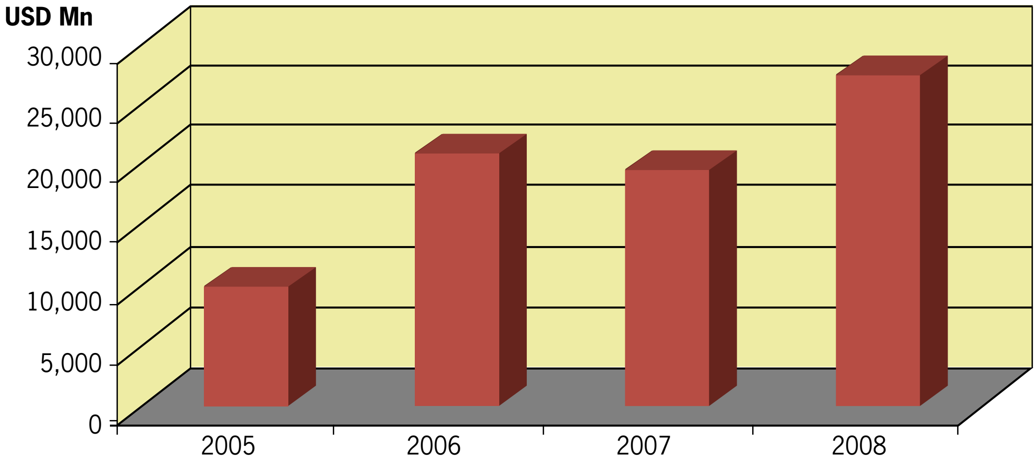
When the loan is used for specialised or structured transactions such as project finance, structured trade and commodity finance, export finance, property finance, or leveraged buyouts then the Wakeel will need to have the ability to place the loan simultaneously in several different geographic markets, which means that the origination team will have to have an in-depth knowledge of each of these countries and sectors.

The size of the market for Islamic syndicated loans

According to statistics gathered by IFIS, the Islamic finance portal from Euromoney, the Islamic syndicated lending market expanded from $19.6 billion in 2007 to $27.2 billion in 2008, which represents growth of 32 per cent. The bulk of this lending was in the GCC where volumes rose from $17 billion in 2007 to $22 billion in 2008. As we might expect, in reality this growth was achieved over the first three quarters of 2008 since Islamic syndicated lending all but froze in the last quarter of the year. To give these statistics some context and scale, it is worth noting that in 2007 the global conventional syndicated loan market was estimated at over $4,500 billion which shows either how underdeveloped the Islamic syndicated loans market is or that there is much more potential in this sector and that the volumes we see at present are only scratching the surface of what can be achieved when the industry is fully grown.

Islamic syndicated lending

Global Islamic Syndicated Lending



Source: **IFIS**

As this chart shows, the market for Islamic syndicated lending stalled between 2006 and 2007 and experienced significant growth in 2008 before that growth was stymied by the onset of the financial crisis and subsequent recession.

The following table shows that there has been a significant pick-up in deals since the start of 2009, with a total of 36 deals announced or closed worth a cumulative total of $9.5 billion. If the rest of the year continues as it started it would suggest that total Islamic syndicated loans for 2009 will end in the region of $21 billion which would be broadly in line with 2007 levels.

What is interesting is that $3.8 billion of these deals are from the UAE which indicates both how committed the emirates are to Islamic finance as well as the need that the nation has to refinance debt this year. What is equally interesting is the wide variety of arrangers on these deals, which include Intesa Sanpaolo, a leading bank in the Italian market with an international presence generally more focused on Central-Eastern Europe and the Mediterranean basin, and Industrial & Commercial Bank of China which is a banking giant in China as well as being the largest bank in the world. In 2008 Mizuho Corporate Bank from Japan was active in the Islamic syndicated loans market showing

2008 Islamic Syndicated Loans Arrangers Rankings

Ranking	Arrangers	Amount - US$m	Issues
1	Al Rajhi Bank	2,409.33	6
2	Noor Islamic Bank	2,120.16	13
3	Standard Chartered Bank	1,006.23	10
4	Samba Financial Group	995.95	6
5	Dubai Islamic Bank	948.23	9
6	HSBC Amanah	923.75	10
7	Gulf International Bank	767	3
8	Qatar Islamic Bank	752.25	7
9	Calyon	731	4
10	National Commercial Bank	667.5	2

Source: **IFIS**

that the industry has grown far beyond its traditional core and Islamic investment banks in the region will find the market crowded not just from their traditional rivals but also from banks of every stripe from every corner of the world.

Industry leaders

As the table on page 34 shows, Al Rajhi Bank from Saudi Arabia took the first place amongst Islamic syndicated loan arrangers in 2008 while new kid on the block Noor Islamic Bank from the UAE was in second place.

Analysts at IFIS said, 'Interestingly, even though the number and value of Islamic syndicated loans increased in 2008, the average amount of lending arranged by each of the top 10 arrangers went down from $1566.86 billion in 2007 to $1132.14 in 2008. With the ranking of the top 10 arrangers varying considerably between 2007 and 2008, this is further indication that unlike the Sukuk market, there are no truly established leaders in the syndicated lending market. This market is far more open for competition'.

Effects of the financial crisis

Clearly the financial crisis has taken its toll on the Islamic syndicated loans market and it is not likely that the market will recover overnight and reach the levels promised by activity in the early part of 2008. Lending of any sort has been severely constrained by a variety of factors, including the collapse in the real estate market, the drop in oil price and its continued low level, and general uncertainty in the credit markets. Interestingly enough some banks warned in early 2009 that a lack of liquidity would shrink syndication activity in 2009 to the levels of 2002 and that only a handful of deals would take place in the Islamic loan market this year. Such pessimism seems now to have been misplaced and while 2009 is not likely to be a spectacular year for syndicated lending it still appears to be making rather a healthy recovery that can only bode well for the industry at large.

The unprecedented drop in Sukuk issuance globally over the past year may inadvertently have led to an uptick in interest in the Islamic syndicated loans market as borrowers seek to raise debt from instruments other than Sukuk.

The future for Islamic syndicated lending

It is likely that 2009 and possibly 2010 will remain a tough period for borrowing of any kind but since syndicated loans help to spread risk and Islamic finance is moving into the ascendant, it is perfectly possible that such loans will regain their 2008 levels before the end of 2009 meaning that 2010 could be a bumper year for the segment. One caveat to this is that the lack of confidence that is brewing in the GCC over the creditworthiness of its large and wealthy merchant families might mean that the lending landscape changes again.

It has already been widely reported that Saad Group, the troubled Saudi group owned by Maan al-Sanea, is seeking talks with creditors in the UK and the Middle East as it looks to restructure its debt. The GCC has a reputation for a lack of transparency and both Moody's and S&P have withdrawn their ratings from Saad Group because of lack of information.

The concern is that if such a well established family group can come unstuck then it might be a symptom of something much worse and therefore the credit profile of similar groups might be called into question with the knock-on effect that this will have on the lending appetites of banks in the Middle East. At the present moment it is simply a question of 'wait and see'.

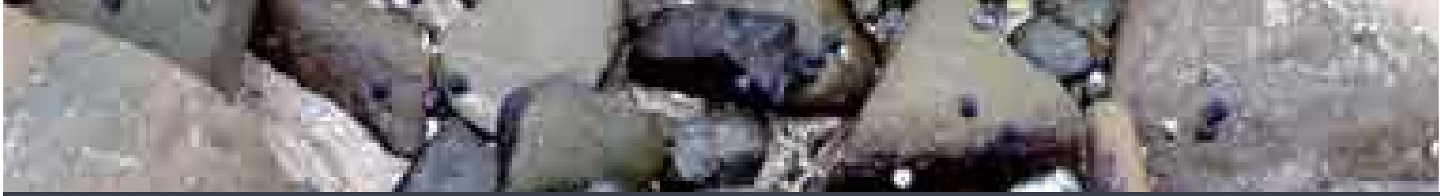
Islamic Syndicated Loans 2009

Date	Borrower	Country	Status
15/6/09	Al Dur IWPP	Bahrain	Announced
7/6/09	Government of Bangladesh	Bangladesh	Announced
5/6/09	AXIS Real Estate Investment Trust	Malaysia	Corporate Closed
5/6/09	AXIS Real Estate Investment Trust	Malaysia	Corporate Closed
2/6/09	Burgan Company	Kuwait	Corporate Closed
1/6/09	Turk Eximbark	Turkey	Announced
31/5/09	Bukhatir Group	United Arab Emirates	Corporate Closed
27/5/09	Emirates Transport	United Arab Emirates	Corporate Closed
25/5/09	Jabar Omar Development Company (JODC)	Saudi Arabia	Announced
21/5/09	Government of Morocco	Morocco	Quasi Sovereign Closed
6/5/09	Development and Employment Fund	Jordan	Corporate Closed
23/4/09	Government of Syria	Strian Arab Republic	Quasi Sovereign Closed
21/4/09	Barwa Real Estate	Qatar	Quasi Sovereign Closed
21/4/09	Barwa Real Estate	Qatar	Quasi Sovereign Closed
18/4/09	Development and Construction Council	Lebanon	Sovereign Closed
18/4/09	Republic of Yemen	Yemen	Sovereign Closed
14/4/09	Nurbank	Kazakhstan	Announced
11/4/09	Kuveyt Turk Katilim Bankasi A.S. (KFH-Turkey)	Turkey	Corporate Closed
8/4/09	Government of Punjab (Punjab Food Department)	Pakistan	Quasi Sovereign Closed
8/4/09	Dubai Electricity and Water Authority (DEWA)	United Arab Emirates	Quasi Sovereign Closed
8/4/09	Dubai Electricity and Water Authority (DEWA)	United Arab Emirates	Quasi Sovereign Closed
8/4/09	Dubai Electricity and Water Authority (DEWA)	United Arab Emirates	Quasi Sovereign Closed
7/4/09	PT (PERSERO) Pelabuhan Indonesia I (Port of Indonesia Corporate I)	Indonesia	Corporate Closed
5/4/09	Department of Civil Aviation (DCA)	United Arab Emirates	Quasi Sovereign Closed
5/4/09	Department of Civil Aviation (DCA)	United Arab Emirates	Quasi Sovereign Closed
5/4/09	Department of Civil Aviation (DCA)	United Arab Emirates	Quasi Sovereign Closed
2/4/09	Export - Emport Bank of Malaysia Bhd (EXIM) Bank)	Malaysia	Announced
2/4/09	Aden Sugar Refinery	Yemen	Corporate Closed
27/3/09	Dolphin Energy Limited	United Arab Emirates	Announced
19/3/09	Turkish State Railways Administration (TCDD)	Turkey	Sovereign Closed
26/2/09	Al Ghurair Group	United Arab Emirates	Corporate Closed
26/2/09	Al Ghurair Group	United Arab Emirates	Corporate Closed
25/2/09	Undisclosed		Announced
20/2/09	Borse Dubai Limited	United Arab Emirates	Corporate Closed
15/2/09	Al-_Aqar KPJ REIT	Malaysia	Announced
27/1/09	Ocado Limited	United Kingdom	Corporate Closed

Islamic syndicated lending

Arranger	Type	Amount (US$m)	Original currency	Number of issues
Calyon Al Rajhi Bank Saudi French Bank Islamic Bank of Asia	Islamic Istisna'a Facility	200	USD	1
Islamic Development Bank	Islamic Finance Facility	700	USD	1
CIMB Islamic Public Islamic Bank	Islamic Finance Facility	28.6	MYR	2
CIMB Islamic Public Islamic Bank	Islamic Finance Facility	48.8	MYR	2
Emaar Properties BNPParibas Boubyan Bank Ahli United Bank Kuwait Finance House (M) Bhd Liquidity Management House - Kuwait Gatehouse Bank plc European Finance House Limited	Islamic Ijara Facility	125	USD	1
Islamic Development Bank	Islamic Finance Facility	100	USD	1
Khaleeji Commercial Bank (KHCB)	Islamic Finance Facility	25	USD	2
Ajman Bank	Islamic Murabaha Facility	8.17	AED	1
Al Rajhi Financial Services Company	Islamic Finance Facility	3,300.00	USD	1
Islamic Development Bank	Islamic Finance Facility	200	EUR	1
Islamic Development Bank	Islamic Finance Facility	10	USD	1
Islamic Development Bank	Islamic Finance Facility	133	USD	1
HSBC Amanah	Islamic Finance Facility	28	QAR	7
Standard Chartered Bank	Islamic Finance Facility	200	USD	7
Islamic Development Bank	Islamic Finance Facility	15.5	USD	1
Islamic Development Bank	Islamic Finance Facility	21.3	USD	1
International Islamic Trade Finance Corporation (ITFC)	Islamic Finance Facility	5	USD	1
Liquidity Management House - Kuwait	Islamic Murabaha Facility	115	USD	3
Meezan Bank Al Baraka Islamic Bank (Pakistan)	Islamic Finance Facility	62.4	PKR	1
Dubai Islamic Bank Standard Chartered Bank Emirates Islamic Bank Calyon Samba Financial Group Badr Al Islami Al Hilal Bank	Islamic Ijara Facility	1,150.00	AED	4
Royal Bank of Scotland Citibank Bahrain	Islamic Ijara Facility	225	USD	4
Intesa Sanpaolo IMI	Islamic Ijara Facility	99	EUR	4
Islamic Development Bank	Islamic Istisna'a Facility	87.5	USD	1
Dubai Islamic Bank WestLB AG (London) Noor Islamic Bank Emirates NBD Industrial & Commercial Bank of China (ICBC)	Islamic Ijara Facility	70.15	EUR	4
Dubai Islamic Bank WestLB AG (London) Noor Islamic Bank Emirates NBD Industrial & Commercial Bank of China (ICBC)	Islamic Ijara Facility	100	USD	4
Dubai Islamic Bank WestLB AG (London) Noor Islamic Bank Emirates NBD	Islamic Ijara Facility	464	AED	4
Asian Finance Bank Bhd (AFB)	Islamic Finance Facility	15	MYR	1
Islamic Corporation for the Development of the Private Sector (ICD)	Islamic Ijara Facility	120	USD	1
Undisclosed	Islamic Finance Facility	500	USD	2
Islamic Development Bank	Islamic Finance Facility	220	USD	1
Dubai Islamic Bank Standard Chartered Bank Emirates Bank International Abu Dhabi Islamic Bank First Gulf Bank Badr Al Islami Arab African International Bank Ajman Bank	Islamic Ijara Facility	173.6	USD	2
Dubai Islamic Bank Standard Chartered Bank Emirates Bank International Abu Dhabi Islamic Bank First Gulf Bank Badr Al Islami Arab African International Bank Ajman Bank	Islamic Ijara Facility	173.6	AED	2
Gatehouse Bank plc	Islamic Finance Facility	128.5	USD	1
HSBC Holding plc	Islamic Finance Facility	820	USD	1
AmInvestment Bank Berhad Kuwait Finance House (M) Bhd	Ijara Facility	69.5	MYR	1
Bank of London and The Middle East	Islamic Finance Facility	10	N/A	1

Source: **IFIS**



Islamic real estate investing

That old chestnut

Real estate in its various guises has managed to monopolise Islamic finance and the Islamic investment banking industry for some years to such an extent that there are many Islamic investment banks that do nothing but real estate investment. Some banks have relied almost exclusively on real estate as their primary business tool, investing in property, developing real estate projects and lending to others engaged in the real estate sector. This carries the inherent risk that when the property market takes a downturn there is little chance of the bank performing well. This is not a problem that is unique to the real estate sector since putting all of one's eggs in the same basket has long been identified as a risky investment strategy.

The result of Islamic banks preferring to hold physical asset-backed investments means that many of them have increased their real estate exposure far beyond safe levels and far beyond the level that their conventional counterparts would ever countenance. Excess property exposure is beginning to look like a rather short-sighted strategy now that the property bubble has been pricked across much of the globe. The argument that was used most frequently during the boom times for an over-dependence on real estate was that it was virtually impossible to replicate the returns that real estate offered through using any other combination of asset classes. For a number of years this was quite true as property prices across the world increased and across the Gulf sky rocketed, fuelled by excess liquidity, negative real interest rates and a massive influx of expatriates.

One of the main reasons for the ubiquity of real estate throughout the Islamic financing matrix is that real estate as a term covers a wide range of assets: from warehouses to timeshare, serviced offices to luxury condominiums, student accommodation to shopping centres and hospitals. As long as the property itself is not used for a haram activity such as brewing or gambling then it has the potential to be used in a Shariah compliant structure.

The dangers of over-reliance on real estate

One of the concomitant effects of falling property prices is the destabilisation of the banking sector in the Gulf as falling real estate prices leads to an erosion of the equity of the banks funding property purchases. Leading ratings agencies in the region are on alert to the potential need to downgrade some of the region's smaller banks that are most exposed to the pricking of the property bubble. With non-performing loans and investment losses on real estate on the rise the industry is faced with the prospect that some Islamic banks will, inevitably, move into loss, possibly irreparably for the banks themselves.

As Robert Thursfield, director of Fitch Ratings, said 'While all GCC banks are exposed to real estate, Islamic banks have historically been more exposed as they were the only ones able to directly own real estate assets; however classifications remain opaque for all banks. Although direct ownership avoids the complication of making repossessions using untested legal frameworks, it does leave Islamic banks with significant real estate exposures. Following the reversal of the recent boom in regional real estate values, particularly in Dubai, Islamic banks could suffer higher impairments, although conventional banks could also suffer given the recent rapid growth in their indirect exposures'.

Islamic real estate investing

> Real estate also features prominently on the radar screens of many Islamic investors as a direct investment vehicle where properties of varying sizes, values, and locations are secured as part of a Shariah compliant portfolio. Such investments are by their nature illiquid and until recently were viewed as the non-speculative part of a portfolio.

As with most other aspects of property investment it is not likely that an investor will be interested in any real estate exposure unless he believes in the macro picture of the country or region in which the real estate is situated. For example, if the investor believes that the Indian economy is going to tank then there is little prospect of luring him into Indian real estate investment no matter how appealing the story surrounding the individual development. The reality is that property is a cyclical investment which means that investors with a crystal ball should invest at the bottom of the cycle and exit at the top. Undoubtedly the reason that real estate is such a core part of Islamic finance investing is that, cycles aside, property prices always go up eventually.

It is also interesting to note two important features about Shariah compliant real estate investing: the Islamic charitable tax of Zakat is not payable on investments structured around real estate: and secondly, all four schools of Islamic thought (Hanafi, Hanbali, Maliki, and Shafi) treat real estate the same way. Together these two facts help to explain the pervasive presence of real estate investment throughout the Islamic finance spectrum.

The following is a brief look at some of the more popular forms of real estate investing used by investors for whom Shariah compliance is a core requisite.

Islamic Real Estate Investment Trusts (REITs)

Islamic REITs are a type of real estate fund that are capital market vehicles for owning real estate and deriving income. These collective investments will pool money from a variety of investors to buy, manage, and sell real estate assets of one sort or another. A REIT can invest in income producing Shariah compliant real estate or Shariah compliant SPVs that hold Shariah compliant assets. Investors or unit holders in an Islamic REIT typically receive a proportion of the rental income generated from these assets as their reward for holding the units.

The benefit of holding such units from the individual investor's point of view is that these collective investments can offer exposure to larger commercial or industrial properties that individual investors would otherwise not have access to. Such investors may also find that these units are far more liquid that the underlying real estate assets themselves. In other words investors can invest in real estate through Shariah compliant capital market instruments that are easily tradable.

In many regards the Securities Commission Malaysia is a leading light in issuing guidelines on Islamic REITs and their treatment. As far back as 2005 the commission issued a set of guidelines for Islamic REITs. A brief summary of these guidelines would include:

- Rental income is derived from permissible business activities. Where a portion of the rental is from non-permissible activities, these rentals cannot exceed 20 per cent of the total turnover of the Islamic REIT
- Islamic REITs cannot own properties where tenants operate non-permissible activities
- Islamic REIT cannot accept new tenants whose activities are fully non-permissible
- Only 20 per cent of the floor area of a property can be occupied for non-permissible activities
- All forms of investment, including deposit and financing instruments, are Shariah compliant

- Property insurance must be based on Takaful except where Takaful schemes do not operate

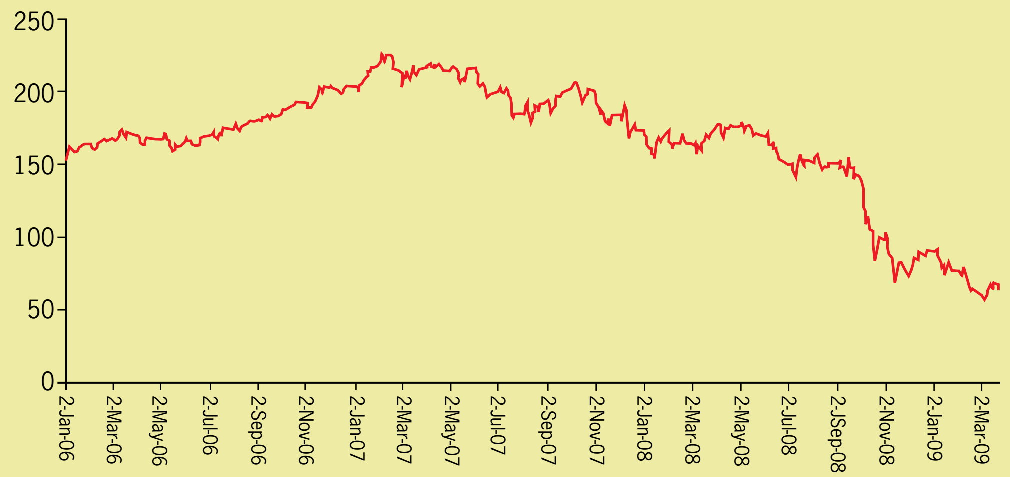
Each Islamic REIT must have a Shariah board responsible for ensuring that the Islamic REIT complies with Shariah principles. According to the Securities Commission Al'-Aqar KPJ healthcare REIT was the first Islamic healthcare REIT listed on Bursa Malaysia Securities in August 2006. The second was an Islamic plantation REIT called Al-Hadharah Boustead REIT.

Judging performance

An interesting research study called 'Shariah Compliance in Real Estate Investment' was undertaken by Muhammad Faishal bin Ibrahim and Ong Seow Eng of the Department of Real Estate of the National University of Singapore in 2006 to establish whether Islamic REITs underperform conventional REITs in terms of returns. The exercise had to be theoretical since Islamic REITs were such a new breed that there were not enough real life examples to undertake empirical research. To simulate this exercise Ibrahim and Ong constructed a synthetic portfolio and analysed the returns. They concluded, 'The key result is that Shariah compliance seems to create a return trade-off and less restrictive compliance requirements appear to provide better historical returns. However, Shariah compliance does not mean that Shariah compliant real estate mutual funds necessarily under-perform relevant indexes when relevant risk factors are considered and allowing for differing sensitivities to benchmark returns'.

The authors concluded with the final word on the subject, 'the acid test will be empirically possible only with time and as more Islamic REITs and real estate funds become established'. What experience over the past three years since the research study was undertaken shows is that REITs as a whole have not performed well in the cold light of the financial crisis as the following chart makes clear.

Global REIT Index



Source: **Global Business Monitor International, Eurekahedge, Zawya, Ernst & Young analysis**

Islamic real estate funds

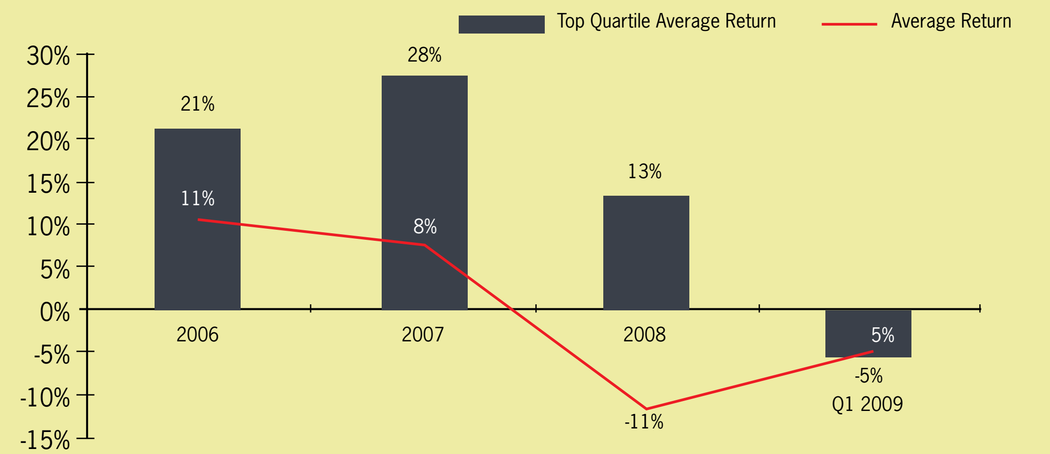
According to IFIS, the Islamic finance portal from Euromoney, there are currently 37 Islamic real estate funds either in existence or whose launch has been announced. With the exception of the Ethmaar UK Real Estate Fund from Kuwait Finance House with an investment focus on UK real estate, most of the funds that have disclosed their size are relatively modest. Since the first fund dates from August 2002 this means that over the past seven years an average of just over five funds per year have been launched and are still in existence although the reality of the situation is that the number of funds launched per year has been increasing each year, with eight funds launched in 2008 and most of them in the first half year. The relatively modest Inovest Real Estate Investment Trust of $80 million is the only fund to have been launched since August of 2008 when the financial crisis swung into its most debilitating phase.

As the table shows, performance figures are not available for many of the funds, making comparison between funds difficult and comparison with other asset classes more difficult still. According to Ernst & Young's Investment Funds & Investment Report 2009 average returns from Islamic real estate funds fell from 8 per cent in 2007 to minus 11 per cent in 2008 and minus 5 per cent in the first quarter of 2009. It is clear that these funds have been badly affected by the downturn in real estate asset prices.

Real estate also features prominently on the radar screens of many Islamic investors as a direct investment vehicle where properties of varying sizes, values, and locations are secured as part of a Shariah compliant portfolio. Such investments are by their nature illiquid and until recently were viewed as the non-speculative part of a portfolio. The pricking of the property bubble globally has led to a reassessment of the proper place of such investments in a balanced portfolio.

No matter how specialist and focused the real estate investment, the fact is that the performance of these sorts of investments are necessarily at the whim of the local market. Such issues as the prevailing domestic interest rate,

Islamic Real Estate Funds - Average returns



Source: **Ernst & Young Islamic Funds & Investments Report (IFIR 2009)**
Note: **Data includes returns of 17 funds**

Direct investment and other uses

Islamic private equity real estate investment is also a feature of some Islamic investment banks. Savvy banks focus on developing opportunities for investing in recurring income development projects, and invest in operational and real estate assets with substantial added value components. Islamic private equity real estate investments typically involve an active management strategy that might range from a moderate repositioning or releasing of properties to the development or extensive redevelopment of the property.

domestic supply and demand clearly affect the continued value of any real estate investment. While this can mean that such investments are uncorrelated to performance of the global real estate market, this is not always a positive. The reality, however, is that some sectors of the real estate market are more volatile than others with unit/flat developments often the most volatile and commercial premises rented on long-term leases the least volatile. The message from this may be that international diversification of property investments as well as diversification across sectors makes sense when trying to even out local property market fluctuations.

Islamic real estate investing

Islamic real estate funds 01-06-09

ID	Date	Fund Name	Fund Manager	Domicile
612	9/4/09	Inovest Real Estate Investment Trust	Inovest	Bahrain
496	25/8/08	SHUAA Saudi Hospitality Fund	SHUAA Capital Saudi Arabia	Saudi Arabia
592	11/6/08	Al Imtiaz Real Estate Fund	Al Imtiaz Investment	Kuwait
619	27/5/08	Waed Real Estate Investment Fund	Al Dhow Investment Company	Kuwait
536	13/3/08	Emirates Islamic Global Property Fund - Institutional	Emirates Fund Managers (Jersey) Limited	Jersey
535	13/3/08	Emirates Islamic Global Property Fund - Retail	Emirates Fund Managers (Jersey) Limited	Jersey
409	28/2/08	Danat India RIA Fund	Khaleeji Commercial Bank	India
407	18/2/08	Islamic Turkey Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
529	2/2/08	Taibah KSB Real Estate Fund	KSB Capital Group	Saudi Arabia
403	22/8/07	OSK-UOB Asian Real Estate Fund	OSK-UOB Unit Trust Management Bhd	Malaysia
505	11/7/07	Amar Real Estate Fund	Amar Finance and Leasing	Kuwait
233	23/5/07	Markaz Real Estate Opportunities Fund	Kuwait Financial Centre (Markaz)	Kuwait
330	1/5/07	Al Islami US Properties III Fund	Investcorp Bank B.S.C.	United Arab Emirates
94	15/2/07	Samba Real Estate Fund	Samba Asset Management	Saudi Arabia
289	1/12/06	U.S. Development Opportunities Fund	Shamil Bank	Cayman Islands
169	30/11/06	Islamic European Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
178	16/9/06	Boubyan Global Real Estate Fund	Boubyan Bank	Kuwait
75	1/8/06	Global Asia Real Estate Fund	Global Investment House	Cayman Islands
45	1/5/06	Asian Real Estate Fund	Kuwait Finance House	Kuwait
608	1/3/06	Prime Industrial Real Estate Fund 2	Kuwait Finance House	Kuwait
230	24/1/06	China Realty Modaraba Fund	CIAM-Shamil Asset Management Ltd.	Cayman Islands
229	24/7/05	Global US Real Estate Fund	Global Investment House	Cayman Islands
601	1/7/05	Emirates Real Estate Fund - AED	Emirates Fund Managers (Jersey) Limited	Jersey
448	1/7/05	Emirates Real Estate Fund - Income	Emirates Fund Managers (Jersey) Limited	Jersey
138	1/7/05	Emirates Real Estate Fund - Accumulation	Emirates Fund Managers (Jersey) Limited	Jersey
74	14/6/05	GCC Real Estate Fund	Global Investment House	Bahrain
424	17/4/05	Awaed Real Estate Fund	Aayan Leasing & Investment Co	Kuwait
85	1/2/05	Amlak First Real Estate Fund	Amlak Finance	United Arab Emirates
18	1/11/04	Solidarity European Real Estate Fund	Solidarity BSC(c)	Bahrain
279	31/7/04	Ethmaar UK Real Estate Fund	Kuwait Finance House	Kuwait
148	30/5/04	Islamic Asian Real Estate Fund	Wafra Investment Advisory Group	Cayman Islands
52	1/5/04	Al Islami French Property Fund	Dubai Islamic Bank	United Arab Emirates
16	20/4/04	Solidarity International Real Estate Fund	Solidarity BSC(c)	Bahrain
606	1/3/04	Shuawaikh Real Estate Fund	Al Madar Finance & Investment	Kuwait
563	28/5/03	Makaseb Real Estate Fund (Previously Aayan 1st Real Estate Fund)	Aayan Leasing & Investment Co	Kuwait
232	1/2/03	Markaz Real Estate Fund	Kuwait Finance Centre (Markaz)	Kuwait
221	29/8/02	Al Dar Real Estate Fund	Al Dar Asset Management	Kuwait

Assets Type	Geofocus	Base Currency	Fund size in USD (Million)	Type	Total Returns
Real Estate	Gulf Cooperation Council (GCC)	BHD	79.81		
Real Estate	Saudi Arabia	SAR	240	Closed Ended	
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Open Ended	-2.50%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Open Ended	
Real Estate	Global	USD	Not disclosed	Open Ended	
Real Estate	Global	USD	Not disclosed	Open Ended	
Real Estate	India	AED	57.18	Closed Ended-(Renewable)	
Real Estate	Turkey	USD	Not disclosed	Closed Ended	
Real Estate	Saudi Arabia	SAR	52.01	Closed Ended	20.75%
Real Estate	Asia Pacific	MYR	Not disclosed	Open Ended	22.75%
Real Estate	Kuwait	KWD	Not disclosed	Closed Ended-(Renewable)	-12.90%
Real Estate	Middle East and North Africa	USD	200	Closed Ended-(Renewable)	
Real Estate	United States	USD	Not disclosed	Closed Ended	4.28%
Real Estate	Global	SAR	Not disclosed	Open Ended	
Real Estate	United States	USD	48.42	Closed Ended-(Renewable)	
Real Estate	Europe	EUR	Not disclosed	Closed Ended	
Real Estate	Global	KWD	Not disclosed	Open Ended	
Real Estate	Asia	USD	100	Closed Ended	-1.82%
Real Estate	Asia	USD	250	Open Ended	
Real Estate	United States	USD	Not disclosed	Open Ended	
Real Estate	China	USD	150	Closed Ended	
Real Estate	United States	USD	100	Closed Ended-(Renewable)	90.24%
Real Estate	UAE	AED	Not disclosed	Open Ended	
Real Estate	UAE	USD	Not disclosed	Open Ended	
Real Estate	UAE	USD	262	Open Ended	
Real Estate	Gulf Cooperation Council (GCC)	USD	100	Closed Ended-(Renewable)	5.94%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Closed Ended-(Renewable)	30.27%
Real Estate	UAE	USD	75	Closed Ended	-0.07%
Real Estate	Global	EUR	10.07	Open Ended	26.52%
Real Estate	GB	GBP	5073.22	Open Ended	
Real Estate	Asia	USD	Not disclosed	Closed Ended	
Real Estate	France	EUR	39.6	Closed Ended	
Real Estate	Global	USD	15.65	Open Ended	16.79%
Real Estate	Kuwait	KWD	Not disclosed	Open Ended	16.10%
Real Estate	Kuwait	KWD	Not disclosed	Closed Ended-(Renewable)	45.31%
Real Estate	Kuwait	KWD	103.15	Closed Ended	3.39%
Real Estate	Gulf Cooperation Council (GCC)	KWD	Not disclosed	Closed Ended	-3.61%

Source: **IFIS**

Islamic wealth and asset management

Scope for more development

As investment banking has developed it has become clear that wealth management offerings for ultra high net worth (UHNW) individuals should be more closely aligned to the services offered to companies than they are to the services offered to other private individuals. As a consequence of this the wealth management function for many global conventional banks sits within the investment banking area rather than sitting as some kind of niche at the head of retail banking operations. People and families with great wealth often require access to the kinds of products and services that would be inappropriate for those with lesser means. Put another way, the very rich increasingly want to have access to every product available in the Islamic wealth management sector irrespective of who it was designed for and this can mean, for instance, investing in Sukuk directly rather than through some kind of Sukuk fund, which would be more appropriate for the merely wealthy.

As a consequence of this the subject of Islamic wealth and asset management is a vast topic and one that can only be touched upon in this report. A separate report on Islamic wealth management is published annually by Yasaar Media.

A changing landscape

Discussions of wealth management have traditionally centred on offshore tax havens where high net worth (HNW) and ultra high net worth individuals could park their cash while it was being manipulated in secret by their wealth manager or private banker to offer the client the best possible returns for the lowest possible risk. The Muslim investor who fell into the HNW or UHNW category was rarely looked after with the same degree of dedication as his conventionally-investing counterpart in part because the same range of assets was not available to him and in part because the Islamic finance wealth manager was a much rarer breed.

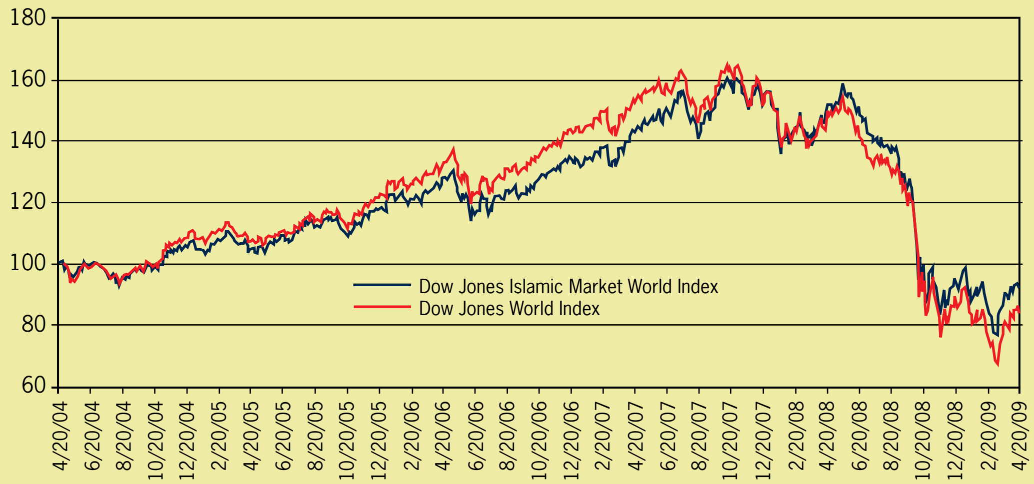
The financial crisis and ensuing global recession have changed much of this as one after another former tax havens have suddenly accepted international standards on tax transparency to avoid being blacklisted. What started with a US investigation into UBS soon spiralled into capitulation by Switzerland, Austria, Luxembourg, Lichtenstein and Andorra to reveal more information about the customers in their private banks. Both Hong Kong and Singapore also signalled that they understood that things had changed. The core problem seems to be that no single financial centre wants to change before the others for fear of being the first to lose their competitive advantage. Furthermore, enacting any changes could be slow because it could take many years to renegotiate tax treaties. What is beyond doubt is that the world for private bankers and wealth managers has changed forever.

While these stricter measures were being introduced principally to stop tax evaders and recoup dues from the estimated $11 trillion in clandestine personal wealth hidden in secret offshore havens, these same measures also had the effect of reducing overall levels of secrecy in private banking, which is not by itself a good thing and many worry that this will lead to more of a Big Brother state emerging. It could also mean that wealth managers find that they have to increase their charges to clients because they will inevitable face higher regulatory and compliance costs. Indeed these higher costs coupled with the end of tax secrecy could well mean the end for the smaller offshore centres which may no longer be able to compete. In reality what is likely to happen is that each offshore tax haven will try to specialise in a particular area and develop 'unique selling points' that ensure their survival, at least until the next stage in the development of financial services unfolds.

Tax is often not such a big issue

Many HNW and UHNW Muslim investors from the Middle East and Asia had and have assets in these offshore havens but, since their home countries are often no-tax or low-tax environments, these Muslim investors were not using the havens to avoid tax but were often simply looking for good service and confidentiality. Any serious report on Islamic wealth manage-

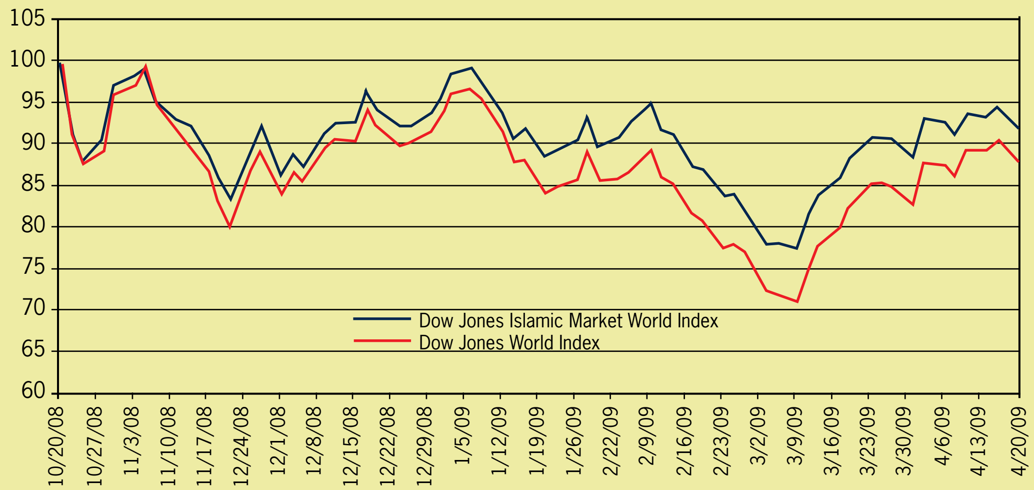
Performance of the Dow Jones Islamic Market World Index vs. the Dow Jones World Index over the past 5 years



All data is as of April 20 2009

Source: **Dow Jones Indexes**

Performance of the Dow Jones Islamic Market World Index vs. the Dow Jones World Index over the past 6 months



All data is as of April 20 2009

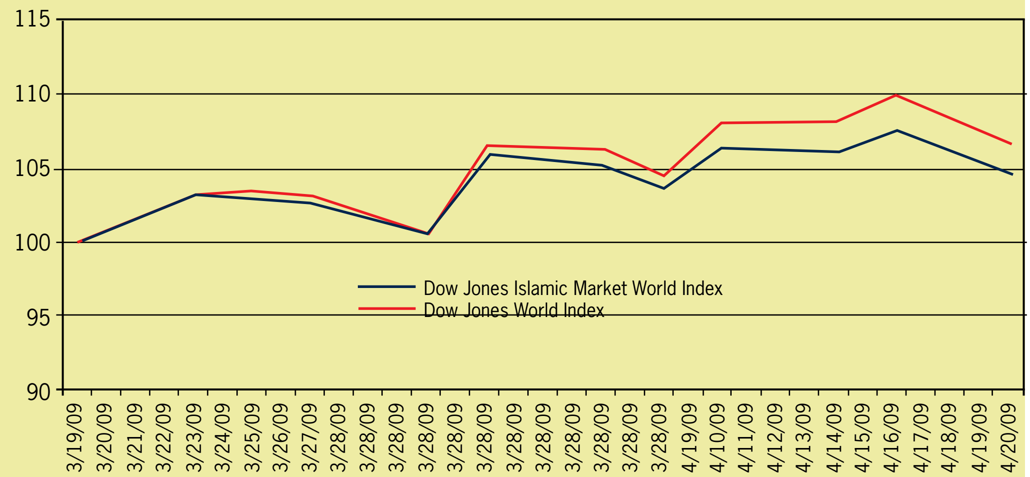
Source: **Dow Jones Indexes**

ment in 2009 has to deal with this shifting landscape as it affects both the investor and the wealth manager.

In the past, the wealth that has been owned by rich families in the GCC has been invested in much the same ways as wealth from any rich family around the world: they had traditionally bought hedge funds or structured products from 'trusted' western brand name finance houses. Domestic or regional banks within the GCC often did not offer true 'private banking' services to their HNW Muslim clients because they knew that they could not compete with the range of offering that the major international wealth managers had.

In the light of recent events in the global financial arena, it seems that the more conservative approach taken by Islamic financiers and bankers to investing has helped protect investors in a downturn for precisely the same reasons that it did not deliver the same quantum of returns during the growth phase. In other words,

Performance of the Dow Jones Islamic Market World Index vs. the Dow Jones World Index over the past month



All data is as of April 20 2009 Source: **Dow Jones Indexes**

the longer the global downturn continues the more appealing will Islamic financing become to HNW and UHNW Muslim investors.

Many instances where Muslim investors have lost in the current market is where they have invested in products that replicate the performance of conventional assets in a Shariah compliant way. For instance by assigning money to a counterparty which separately invests in underlying hedge funds or derivative products, the Muslim investor can earn returns that track the performance of the haram, or non-Shariah compliant, assets. Islamic investors have been drawn to such investments because of the relatively limited pool of investments that would be available to them otherwise.

Regaining trust

One of the primary aims of both the conventional and Islamic wealth management industries today is trying to win back client trust after their wealth has been eroded by the global financial upheaval. This has led clients to be more drawn to simple asset classes such as equities, Sukuk, and precious metals. The near uninterrupted 15 years of growth that the wealth management industry witnessed has come unstuck very suddenly and shown that the experts that the industry had relied upon have been found wanting. Almost universally what clients want to do at present is recoup the money they lost by any means available, but hopefully in a Shariah compliant way. Once they have regained their former level of wealth they are likely to be more willing to look once again at more speculative asset classes, although it is probable that they will still favour capital protected products for some time to come.

Islamic finance institutions have not emerged unscathed from the current meltdown. Many Islamic banks have announced profits for 2008 that were far below those of 2007 and since Islamic finance is based on the sharing of risk between the institution and the depositor it is probable that many clients will, for the first time, see what exposure to risk really means. This could stem the growth in the number of new customers that these same Islamic banks have witnessed over the years since many of these same banks have invested heavily in both real estate and equities: asset classes that have not held up well in recent months.

What sorts of developments are we likely to see in the year ahead?

Real estate

Real estate has taken a hammering globally, reflecting the ending of the asset-price bubble that many had predicted beforehand. The simple fact is that real estate valuations had grown out of control and many observers and investors had predicted that prices would fall but only the smart few did anything about it. Given time real estate prices will increase again and smart investors are already looking at increasing their exposure once again to selected properties in selected areas.

Analysts have pointed out that prime Hong Kong property has started moving again, as has the West End of London, and other prime areas where supply is limited by geography or legislation. Equally, 'high end' real estate in the multi-million dollar range as well as exotic beachfront penthouses seem to have held their value and are on the way up. Investors wishing to take advantage of this growing pool of bargains would have to pay cash, however, since credit is still very tight.

Perhaps the single biggest drawback for real estate is that it is illiquid at the best of times and is even less liquid in a crunch. One solution to this problem for Islamic investors is to gain real estate exposure through the very limited universe of Islamic REITs, although Gulf-based investors will find that the tax-free appeal of these instruments is limited since they already live in tax free environments.

Equities

Unless the wealthy Muslim investor is an expert stock picker, then the safest way to gain exposure to equities may be through index investing. Indeed even if the Muslim investor is an expert stock picker, he would have to undertake a Shariah audit of the stock being picked at lightning speed to be able to snap up a bargain when it appears. Typically the Shariah auditing process is a lengthy one and the investor may find that the price of the stock has gone up by the time the Shariah audit is finished, presuming he had the time, the money and the resources to undertake one in the first place. In any event there is a growing proliferation of Shariah compliant indices including those covering equities. An example of one of these is shown here. The chart shows the Dow Jones Islamic Market World Index versus the Dow Jones World Index over the past five years.

The key lesson from this index would seem to be that the reduced volatility of Shariah stocks is a slight hindrance in a bull market but is a help in a bear market.

Private equity

Along with venture capital, this is an asset class that virtually disappeared both in the conventional realm as well as the Islamic realm as soon as the financial crisis struck. According to Zawya's, a Middle East business information provider, Private Equity Monitor there have been no new private equity funds launched this year, either conventional or Islamic although there is a rumour of the IDB launching IDB Infrastructure Fund II for $2 billion soon. While leading private equity houses in the GCC have commented publicly that they are keeping their powder dry for the time when valuations reach bottom, the truth is that nothing much seems to be happening at all. One exception to this, from the Islamic space, is Unicorn Investment Bank Global Private Equity Fund's acquisition of a 70 per cent equity stake in Bahrain Maintenance and Diving Services. The acquisition was completed through the fund's wholly-owned subsidiary, Regional Energy Services Holding and this marks the sixth investment by the fund. There seems little doubt that Islamic private equity will be a quiet haven for some time to come, the potential IDB issue aside.

Sukuk

At the time of writing the very high prices being paid by corporates and sovereigns to borrow through Sukuk seem to be tailing off: recent months have seen profit rates on new issues fall from 10 per cent to nearer 5 per cent. Oversubscription is rife on the limited number of non-ringgit issues available and it seems that only Malaysia is still actively issuing Sukuk in any great number, although there is still talk of masses of 'pent up demand' for Sukuk to be issued before the end of 2009. Bahrain has just issued a sovereign Sukuk from CBB International Sukuk Company (No. 2) for $750 million. This issue was significantly oversubscribed in spite of its keen pricing. If supply of Sukuk new issues remains tight, and with a glut of conventional bond issues about to appear, then receiving an allocation could be the challenge faced by many Islamic investors.

Islamic wealth and asset management

Funds

Islamic equity funds form the largest segment of all Islamic funds and, since they are exposed to an asset class that has suffered universally from the recent downturn, then returns have been very disappointing indeed. According to IFIS, the Islamic finance portal from Euromoney, the sector as a whole experienced an overall decline of 23 per cent in 2008, with equity funds declining by almost 37 per cent, and Sukuk funds by 8 per cent. These averages often conceal widely differing performance figures across funds. There is some evidence to suggest that having Islamic mutual funds in an investment portfolio helps to hedge the downside risk in an adverse economic situation.

The wise investor would doubtless have to believe in the macro story of a fund before taking the plunge and believe in the longevity of the underlying components. It is hard to imagine a situation where Islamic funds do not witness improved performance over the year ahead.

Shariah compliant sustainable investments

Much like Islamic wealth management Shariah compliant sustainable investments are really an area all to themselves, and indeed they are the subject of another report from Yasaar Media. What seems clear is that sustainability and greening is the way business is headed as environmentally unsound practices become increasingly frowned upon. More importantly sustainable investing is profitable, as a few private banks in Europe discovered for themselves many years ago.

From an investment banking perspective this would have to be one of the next big things and marrying Islamic finance and sustainability would seem to be an increasingly logical and profitable area of business particularly for private equity investments but also for venture capital and even straightforward listed equity investment.

Alternative investments including hedge funds

The Shariah picture surrounding hedge funds is murky at best: trading in an asset that the investor never actually intends to own is speculative and therefore tantamount to gambling. Perhaps more importantly, there is a strong argument to suggest that producing a financial instrument whose intention is to replicate the performance of another instrument that is patently haram is in itself haram.

The Islamic investor is no longer so disadvantaged in terms of the asset spread that he can invest in and therefore there may be no real need for such speculative structures as Islamic hedge funds. Nevertheless, the customer is king and if there is enough demand for such products in the years ahead then the market will doubtless see a proliferation of them. Recent attempts to introduce such products have had variable success.

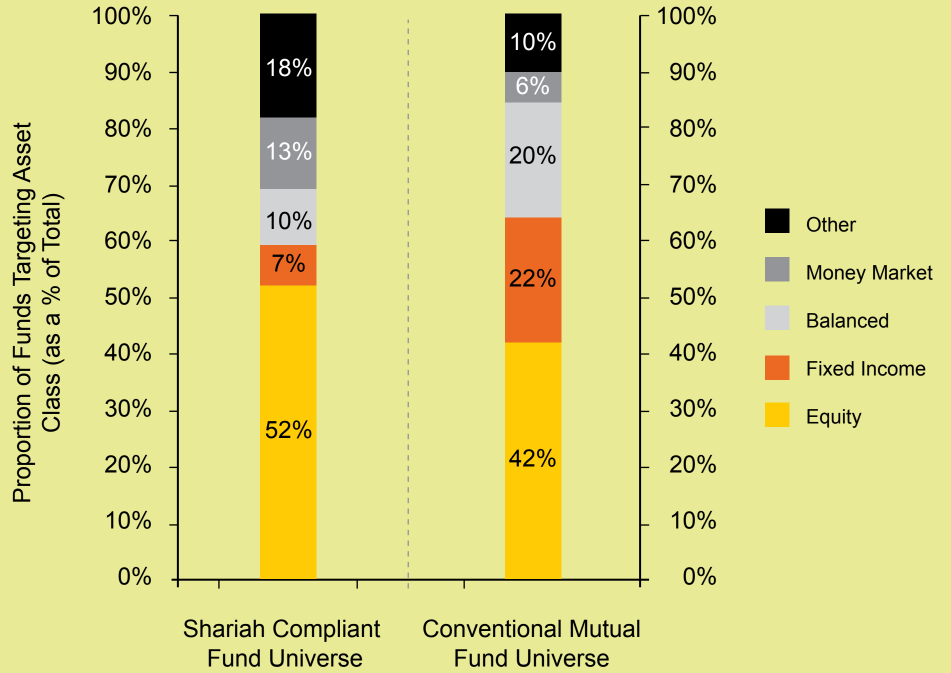
Islamic funds management

A wealth of opportunity

Islamic funds are one of the real success stories of the Islamic investment banking scene. They have proliferated over recent years and cover all manner of asset classes and geographies. Hardly surprising, therefore, that much attention has been paid to their growth and development. According to Eurekahedge, the funds information company, there are 679 Islamic funds in operation as of June 2009 while total funds under management are estimated to be in the region of $45-$50 billion. Analysis by Ernst & Young's Dr. Pierre Weimerskirch in May 2009 in a report called 'Islamic funds – market dynamics and opportunities' suggests that the breakdown of funds by asset class looks like this:

As the illustration shows, Islamic equity funds make up over half the total universe of Islamic funds which represents a significant point of difference from the conventional world and also gives some indication of how reliant the Islamic finance industry itself is on equities as a form of investment. According to Eurekahedge in a report from June 2009 on key trends in Islamic finance, 'equity exposures dominate this figure as they represent over 52 per cent of the total. A distant second goes to private equity and real estate offerings with a combined 18 per cent of the total. Whereas money market, balanced and fixed income have much smaller showings (13 per cent, 8 per cent and 6 per cent respectively). Other products – predominantly leasing funds – round off the total at 4 per cent'.

Composition of Investment Funds by asset classes



Source: Eurekahedge Islamic Funds Database, Investment Company Institute, Ernst & Young Analysis
Note: Asset class allocation in conventional mutual funds is from over 61,000 mutual funds from across the world

These funds are managed by over 300 different funds management companies, a testament to the growth of the sector since the first fund was launched in the late 1980s. Indeed the funds management sector has not only grown in size but in diversity as well and these days it includes exotics such as exchange traded funds, hedge funds, and socially responsible funds.

The birth of new Islamic funds

Naturally bringing a new fund to market is a complex business and involves not just fund managers but also fund structurers, distribution agents and networks, product developers, an expert sales and marketing team, and a Shariah board. This all presumes that there is a compelling case to launch a fund in the first place with a perceived market gap.

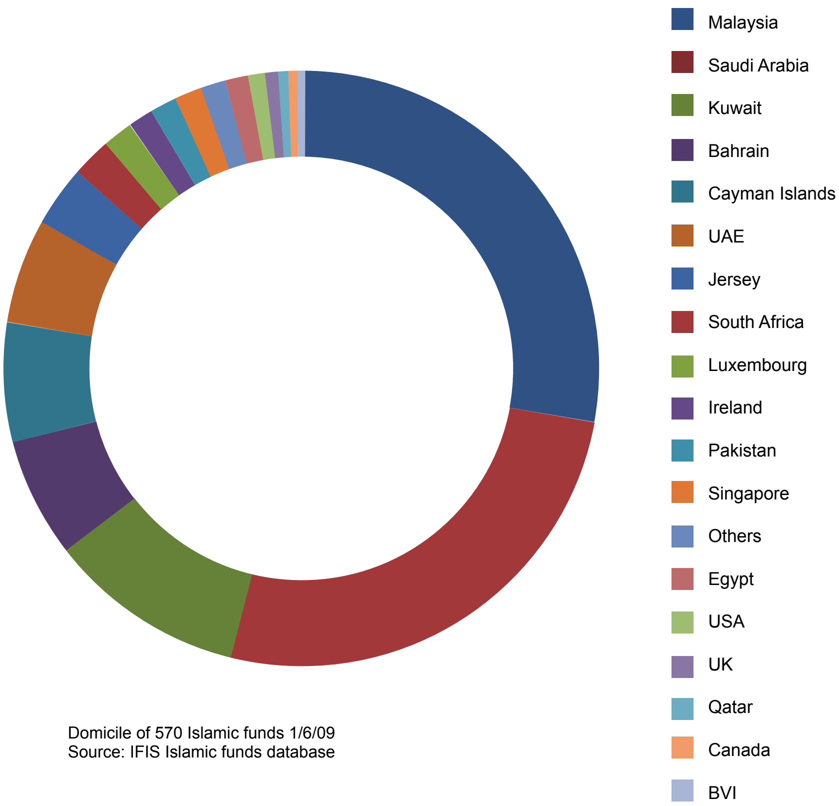
Each new fund that is launched should be accompanied by a business plan that relies heavily on market research and studies undertaken to predict the likely demand for the new fund, since potential investors have to show an interest in the fund and believe that it is likely to offer them the sorts of returns that they are looking for. They also have to be convinced that the fees charged by the fund manager are acceptable, whether they are fixed or related to performance, and the fund manager has to be convinced that the timing is right. There is little point in launching an equity fund when the underlying markets are tanking. The Shariah board has to sign off on the concept of the fund as being halal and lay down parameters within which the fund can invest. There is also a range of structuring issues that need to be addressed at the Shariah stage to ensure that the resulting fund will be acceptable to investors. The business plan will also cover off on how the fund is to be brought to market, which distribution channels will be used, and whether or not a 'white label' version of the fund will be offered.

The discussion over distribution channels would have to take account of the legal aspects of marketing the fund internationally. For instance, under EU law Shariah compliant funds have to comply with EU law based on the directives for UCITS III and Shariah principles at the same time.

Choice of jurisdictions

In terms of jurisdictions for Islamic funds management, there are a number of financial centres vying for poll position including Luxembourg and Malaysia. Indeed Malaysia has been at the forefront of the Islamic fund management industry, beginning with the establishment of two Islamic unit trust funds in 1993 as well as several other 'firsts' such as establishing the world's first Islamic real estate trust in 2005 and the introduction of Asia's first Islamic exchange traded fund.

On occasions different jurisdictions will work together on joint initiatives. An example of this would be when Malaysia and Dubai came together and forged a mutual recognition agreement between the Securities Commission Malaysia and the Dubai Financial Services Authority for the cross-border marketing and distribution of Islamic funds between the two markets. This goes to show how competitive the niche can be. Domestic fund managers may also find themselves courted by the regulators in specific jurisdictions through being offered various tax incentives and privileges.



Domicile of 570 Islamic funds 1/6/09
Source: IFIS Islamic funds database

Malaysia

In Kuala Lumpur the Malaysian Islamic International Financial Centre (MIFC) is the body that offers fund management licences to foreign Islamic fund managers to conduct foreign currency Islamic funds. Foreign Islamic fund management businesses in Malaysia have to to register with the Securities Commission Malaysia and are governed under the Capital Market Services Act. Fund managers can manage funds sourced from inside or outside Malaysia and are able to establish and distribute unit trust funds. Fund managers are offered a wide range of incentives to set up within MIFC such as start-up incentives, relaxed foreign ownership rules, and help with immigration procedures for staff. While it should be noted that the vast majority of Islamic funds listed in Malaysia at present are ringgit denominated and therefore presumably aimed at a domestic audience, the remit of the MIFC is to establish the nation as a leading Islamic finance hub and therefore the MIFC's target market is much broader than the domestic market.

Labuan

Labuan's International Business and Financial Centre (IBFC) also helps in promoting Malaysia as a leader in Islamic finance. IBFC's infrastructure includes a specially created facility for both conventional and Islamic financial instruments to be listed on a public exchange, the Labuan International Financial Exchange (LFX). By the end of 2007 eight of the 31 active listings on the LFX were Shariah compliant securities, and today

LFX's Islamic capital market capitalisation is $4.7 billion or 30 per cent of the total for the exchange. Islamic banks can undertake a broad spectrum of capital market activities through the LFX including engaging in Islamic funds management. In April 2009, the Organisation for Economic Co-operation and Development (OECD) designated IBFC as among the financial centres that have committed to the internationally-agreed tax standard.

Luxembourg

Luxembourg may at first look like an unlikely candidate to be the global centre for Islamic funds but The Luxembourg Financial Centre is taking the Islamic finance industry very seriously. The Luxembourg Stock Exchange was the first European stock exchange to enter the Sukuk market with the first listing of Sukuk in 2002. In the depths of the global financial crisis in September 2008 there were 31 Shariah compliant investment funds and sub-funds established in Luxembourg.
In addition to running conferences geared to establishing Luxembourg as centre for Islamic funds the Grand Duchy also boasts a wealth of ancillary services such as legal advisers, custodian banks, tax advisers, transfer agents, central administration agents and auditors to make the establishment and performance of funds possible. Perhaps more importantly Luxembourg is the second largest investment fund centre in the world after the United States, with over $3,500 billion under management in addition to being the largest private banking centre in the Eurozone. According to Luxembourg for Finance, the Luxembourg legal framework is largely compatible with Islamic finance and suitable for the creation of Shariah compliant products. Rather than taking a high visibility promotional approach to promoting itself as a centre for Islamic funds management the Grand Duchy has adopted a more discrete approach based on organising targeted events.

Dubai

Dubai is taking Islamic finance seriously and the DIFC has been at the spearhead of these efforts. The Dubai Financial Services Authority's (DFSA) collective investment regime, contained in the Collective Investment Law, the Investment Trust Law and the Collective Investment Rules, contains special provisions for Islamic funds. These are broadly similar to those for firms conducting Islamic financial business and include the appointment of a Shariah supervisory board as well as disclosures in the fund prospectus. In the early part of 2008 the DFSA signed an MOU with Hong Kong's Securities and Futures Commission to help promote and develop their respective Islamic capital market segments, in particular to work together on facilitating the distribution of Islamic funds in the DIFC and Hong Kong.

The DIFC, meanwhile, is focused on becoming the 'international financial centre of choice for financial institutions offering Islamic products ... The DIFC also plans to offer a new domicile for the registration of Islamic collective investment schemes, reflecting an increasing investor preference for Shariah compliant investment products originated and managed in the region.' In order to attract this business DIFC, like Luxembourg, also offers a range of incentives including 100 per cent foreign ownership, zero per cent tax rate on income and profits, no restrictions on foreign exchange or capital/profit repatriation, and strict supervision and enforcement of money laundering laws.

Nasdaq Dubai, formerly DIFX, meanwhile aims to be the exchange of choice for regional and international issuers of Islamic securities including Islamic funds, Islamic Real Estate Investment Trusts (REITs), and Islamic Exchange Traded Funds (ETFs).

Saudi Arabia

In contrast to the funds listed in Malaysia which are largely ringgit denominated, 43 per cent of the funds listed in Saudi Arabia are dollar denominated, 50 per cent are Saudi riyal denominated, and the remainder are denominated in Euros. The Capital Market Authority is responsible for authorising all Islamic funds registered in the kingdom and seems to have no trouble attracting new funds, presumably because the wealthy Saudi domestic audience is a lure for most financial service providers hoping to tap some of the oil wealth that is present in the kingdom.

> "The over reliance on equity funds is another area where the industry might benefit from some diversity, both in terms of management style as well as in underlying assets.

Bahrain

The Central Bank of Bahrain (CBB) has long been regarded as the most active financial services regulator in the Middle East while the Islamic fund industry has been a fast growing segment of Bahrain's overall mutual funds industry. Bahrain's proximity to Saudi Arabia and Saudi's oil wealth, together with the CBB's stellar reputation as a regulator, in large part explain Bahrain's popularity as a domicile for Islamic funds. All but a handful of the Islamic funds listed in Bahrain are dollar denominated.

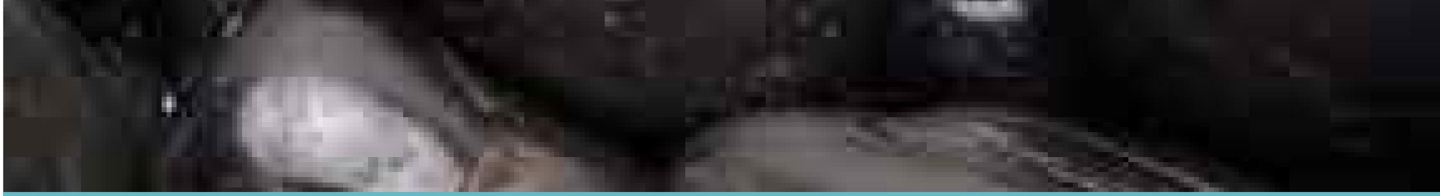
Kuwait

Of the Islamic funds registered in Kuwait 20 per cent are dollar denominated and the remainder are KD denominated apart from a single sterling denominated fund.

The golden opportunity lies ahead

The opportunity facing the Islamic funds industry at present is to try to capitalise on the growth to date and to enlarge the pool of investors who take advantage of the sorts of risk/return profile that well-managed Islamic funds can offer. There are still large sections of the Islamic finance investing public who have no exposure to Islamic funds and this is where the growth opportunity lies. In the medium term this might mean moving outside the traditional markets of the GCC and Malaysia for new customers and focusing instead on other markets like Pakistan and Egypt. This may well mean a review of the remuneration process for fund managers with a move towards performance related fees rather than high upfront percentages.

The over reliance on equity funds is another area where the industry might benefit from some diversity, both in terms of management style as well as in underlying assets.



Islamic capital markets

Waiting for the real upturn

Of all areas of Islamic finance, perhaps the Islamic debt capital markets have received more coverage and interest than any other. While equity capital markets can function without observers taking an undue interest, there is something about the Islamic debt capital markets that acts as a magnet for headlines and excess.

In fairness much of this hoopla has been centred on the GCC while the most active Islamic debt capital market in the world, Malaysia, has often been happy simply to get on with it. Indeed the pragmatism evidenced by those issuing debt instruments in Malaysia could, and perhaps should, be a model that others follow. A swift look at the offering circular for a typical ringgit denominated domestic Sukuk from Malaysia will show that it is a document prepared for one purpose only: raising funds. Such circulars are rarely works of art, comprising no colour and no pizzazz. They are the perfect icon for the industry in Malaysia itself: hard working, practical and working to a strict budget.

The same circulars emanating from the GCC, by contrast, have often been produced with the prime intention of getting across the message that this particular Sukuk is the first of its kind, the biggest of its kind, and the most unique of its kind. The structures of each new GCC-based Sukuk were rarely the same as the one that came before and each Sukuk revelled in the fact that it was different from its predecessors using ever more convoluted structures. Such largesse was easy to accommodate because the industry itself seemed to be expanding faster and faster and seemed to be a bellwether of the industry's expansion.

After the crisis struck

But this was before the financial crisis. Issuance of Sukuk fell by more than half last year, down to $20 billion in 2008. Difficulty in raising money was inevitable as the crisis led investors to avoid any kind of debt, Islamic or conventional. Another potential dampener on the Sukuk market came in the form of a paper published by Sheikh Muhammad Taqi Usmani, the renowned Pakistani scholar and chairman of the AAOIFI Shariah board, that was circulated towards the end of 2007 which was interpreted by the media to mean that 85 per cent of Sukuk had broken two key principles of Islamic law. Since his remarks were aimed at Musharaka and Mudarabah Sukuk, which form a small minority of Sukuk issuances when compared to Ijarah, the 85 per cent figure was almost certainly overstated and misunderstood.

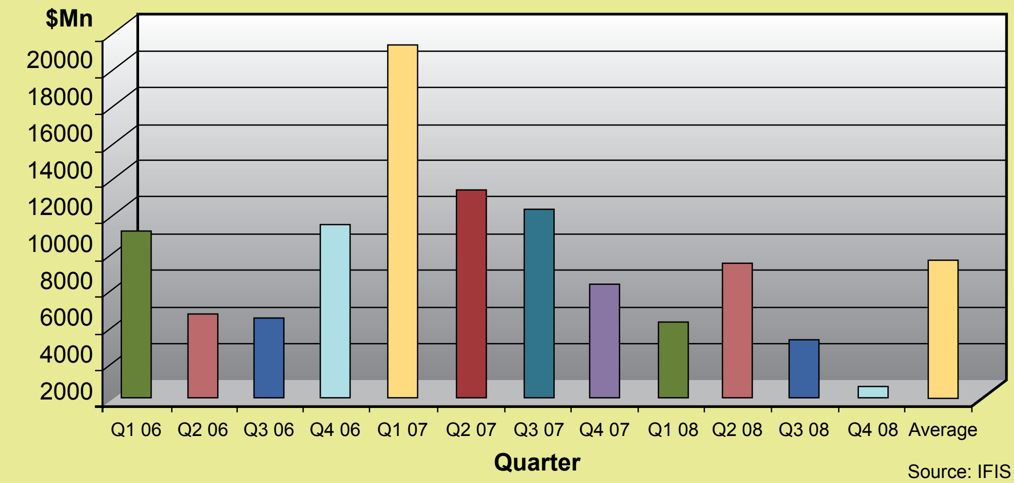
The issue with Musharaka and Mudarabah Sukuk was that they seemed to offer investors a repurchase undertaking in which the issuer promised to pay back the face value of the Sukuk when it matured or in the event of a default. This was deemed to be a little too much like a guaranteed return and a little too unlike risk sharing.

AAOIFI clarified the new position in a statement that was to be applicable from July 1 2008 that stipulated, 'Any unrealised losses resulting from re-measurement at fair value of investments in real estate carried at fair value shall be recognized in the statement of financial position under "Investments fair value reserve," taking into consideration the split between the portion related to owners' equity and equity of unrestricted investment account holders, to the extent of the available balance of this reserve. In case such losses exceed the available balance, the unrealised losses shall be recognised in the income statement under "Unrealised re-measurement gain or losses on investment." In case there are unrealised losses relating to investments in real estate that have been recognised in the income statement in a previous financial period, the unrealised gains relating to the current financial period shall be recognised to the extent of crediting back such previous losses in the income statement. Any excess of such gains over such prior period losses shall be added to the "Investments fair value reserve" in the statement of financial position. However if the investments in Sukuk and/or shares are impaired, the unrealised loss if any, that had been recognised in owners' equity and the equity of unrestricted investment account holders, shall be reclassified to income statement. Impairment recognised in income statement for investment in Sukuk or shares classified as available for sale shall not be reversed through the income statement."

In truth the decline in Sukuk issuance in 2008 is more likely to have resulted from the financial crisis. This assumption seems to be borne out by the numbers themselves which show that the last quarter of 2008 saw a marked drop even on the previous and muted three quarters.

Many investors are hoping that Sukuk issuance will pick up again soon but the reality is that this is not likely to happen until such times as the conventional debt market picks up and investors of the world prove that they have regained their appetite for fixed income investments. Indonesia has long been an also ran in the Islamic finance market and many had been hoping that the country would emerge as a significant Sukuk issuer. This eventually came to pass in April 2009 when a massively oversubscribed $650 million sovereign Sukuk from SPV Perusahaan Penerbit came to

Global Sukuk Issuance by Quarter



Source: IFIS

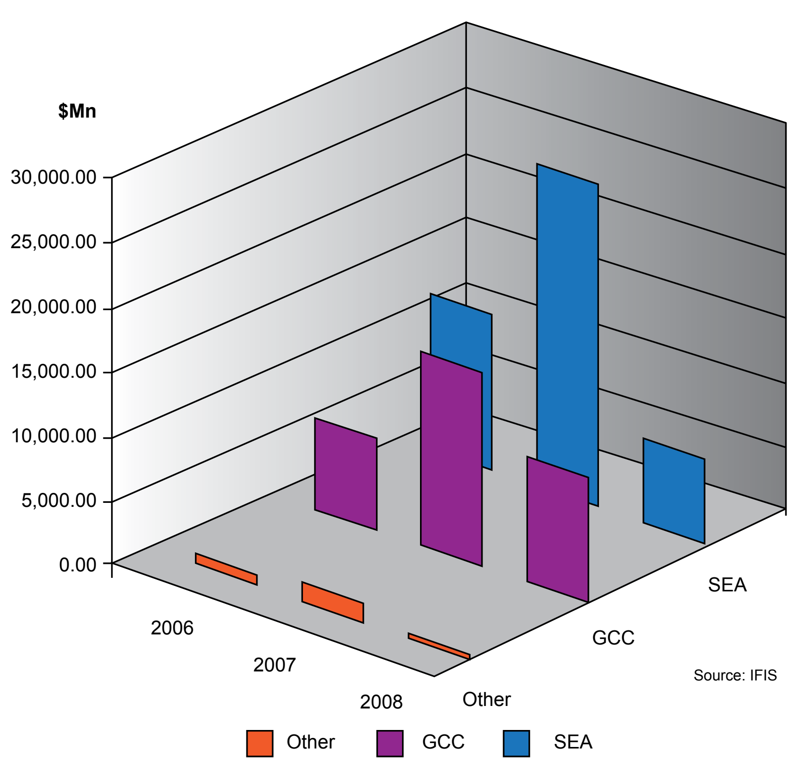
Analysts at IFIS commented, 'The decline in Sukuk has been global, affecting both South East Asia and the GCC. For Q4 2008, we saw no issuance in US dollars at all, and we saw the amount of Sukuk issued dropping to a mere $584 million, which makes Q4 the worst quarter since Q4 2002, before the boom in the Sukuk market. South East Asia was more severely impacted than the GCC in 2008, with issuance falling by 76 per cent down to $6.57 billion for the entire year. The decline in the GCC was quite severe as well, however, with issuance falling to $9.06 billion, a 51 per cent drop. The global total for Sukuk issuance, $15.77 billion, was 66 per cent lower than the figure for 2007. This is the first year on year drop in Sukuk issuance since 2000'.

market, marking not only the first dollar denominated Sukuk of the year but also the first dollar denominated issue from Indonesia. The issue was rated by each of the main agencies as below investment grade (Fitch BB, Moody's Ba3, S&P BB-) and, not surprisingly in the light of Sheikh Usmani's comments, was an Ijarah issue. The issue is backed by a 100 per cent government guarantee and underlying assets.

Oversubscription at a price

While the massive seven times oversubscription was a source of glee to many in the industry, the fact that the pricing for the issue was so generous to investors at 8.8 per cent was clearly a big factor. Servicing that kind of cost of debt will doubtless be

Sukuk Issuance by Region



extremely onerous in the five years of the Sukuk's tenor. Nevertheless investors came from all over: Middle Eastern and Islamic investors accounted for 30 per cent of the take up: Asian investors 40 per cent, US investors 19 per cent and European investors 11 per cent. Furthermore funds accounted for 45 per cent, banks 37 per cent, retail investors 14 per cent and insurance and pension funds 4 per cent.

The Indonesian Finance Ministry said, "The issuance is the largest (recent) straight issuance of dollar denominated Sukuk, outside of the Gulf Cooperation Council, and it is the first benchmark of dollar denominated Sukuk in Asia since 2007" according to the Jakarta Post.

Showing that Indonesia has come of age, in January 2009, the Ministry of Finance issued the country's debut sovereign retail local currency Sukuk which raised 5,000 billion rupiah ($540 million) from the domestic market as part of its public borrowing requirement. This three year issue paid a coupon of 12 per cent, again showing that raising money is expensive.

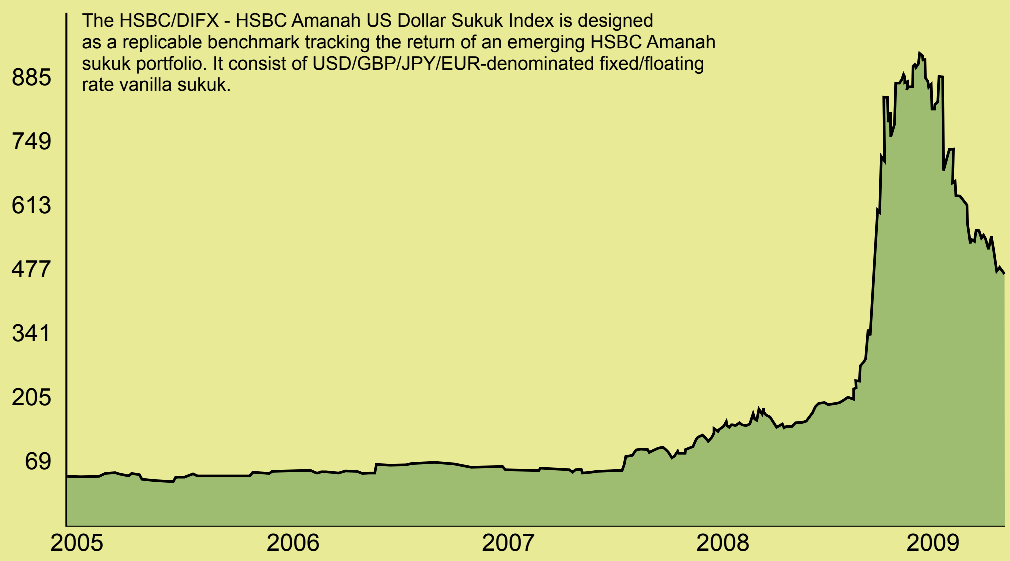
This high cost phenomenon is global, as Dr Jarmo Kotilaine pointed out in a research note for NCB Capital from March 2009 when he said, 'The wider spreads, which reflect rising premiums being offered to compensate investors for their perception of heightened credit risk and tightness in regional liquidity, have taken average GCC corporate bond yields to levels as high as 10–12 per cent. These instruments have begun to look increasingly attractive to investors, even as issuers perceive the bond market as a viable source of funds in otherwise tight global credit markets'.

This same point can seen graphically below from HSBC Indices.

Treasuries to under 500, as can be seen in the chart below. Some observers are worried that there may have been too many issues in too short a time frame and that supply may soon outstrip supply. Mubadala, the Abu Dhabi investment fund, borrowed $1.75 billion while Aldar, also from Abu Dhabi, raised $1.25 billion although the coupon was 8.75 per cent. QTel from Doha also came to market with an issue worth $1.5 billion and while these issues have been conventional, Bahrain came to market with a sovereign Sukuk for $750 million.

Less successful altogether was Turkey's attempt to re-launch itself into the Islamic debt capital market. In January 2009 the

HSBC/DIFX Amanah Sukuk US Dollar Bond Index



Spread since inception
Source: HSBC Indices

Mixed messages

The dearth of any debt issues from the GCC in the first quarter of 2009 in either the Islamic or conventional sectors may be easing toward mid-year. There has been a flurry of issues coming from governments and government-related bodies and this has resulted in a narrowing of spreads from a February high of 825 basis points over US

Turkish government raised only one quarter of the 1.89 billion Turkish lira ($1.1 billion) that it had hoped to through its bond issue. This was in keeping with the government's objectives of attracting capital from the Gulf into Turkey. The issue was not called a Sukuk but a bond for the same reason that Islamic banks in Turkey are called participation banks. These moves are attempts to

de-politicise Islamic finance and while the state has enabled participation banks to function in Turkey since 1983 it has never gone to the international financial markets to raise capital in a Shariah compliant fashion. Part of the reason for the lack of interest in this bond doubtless stems from the lack of a secondary market for such instruments which means that investors would potentially have to hold their investments to term for the duration of the three year issue.

Equally interesting is the delay of the sovereign Sukuk issue mooted from the UK for some time. While this issue slipped onto the backburner when the UK government's champion of Islamic finance Ed Balls moved jobs, the issue now seems to have slipped off the back of the stove altogether and discussion of it may not be revived for some years to come.

More serious concerns arise

But debate surrounding Sukuk has taken a new tack recently when Kuwait's Investment Dar defaulted on payments for its $100 million Sukuk issue. The debate agonises over how the claims of Sukuk holders stack up against those of other stakeholders in the event of default. The claim of Sukuk holders is not against cash flows but against the underlying assets and are therefore more like equity than debt. Analysts at S&P estimated recently that there was up to $45 billion in pent-up demand for new Sukuk issuance but that it may stay on hold until pricing becomes more favourable. It is also likely that such demand may remain on hold until the legal debate brought on by the Dar default is resolved and investor confidence returns. The pent up demand is mostly supposed to be to meet the onerous schedule of development projects from the Gulf as well as to plug some holes in government budgets.

Equally fascinating for industry observers was the bankruptcy filing of East Cameron Partners from Houston, Texas. In October of 2008 East Cameron Partners, the issuer of the first Sukuk by a US based company back in 2006, filed for Chapter 11 bankruptcy. Chapter 11 governs filings where companies expect to submit a financial reorganisation plan and continue operations. This bankruptcy is important for two main reasons: it provides a test of whether the courts in the US will recognise the securitisation of assets; and it also tests the assertion that Sukuk should not be treated like traditional interest-bearing debt. The issuers were looking for a cheaper alternative to the credit line they previously had with Macquarie Bank of Australia.

Blake Goud, a principal of US-based SharingRisk.org and a keen observer of Islamic finance in North America, said, 'As the bankruptcy proceedings move forward, there will be important rulings on the securitization process and whether Sukuk structures are 'bankruptcy remote', at least in this one instance in US courts. Another important issue in the bankruptcy, particularly for the Sukuk investors, is whether the filing was caused or causes a suspension, termination or amendment to the lease held by ECP granted by the Minerals Management Service, a part of the Bureau of Land Management. According to the Sukuk offering circular, "any suspension, amendment or termination of the Leases will terminate the ORRI and would cause [sukuk] Certificate holders to lose the value of their investment". He concluded by saying, 'The proceedings of the bankruptcy case will not be resolved quickly, but they could have important implications for future US corporate Sukuk issuance if the underlying securitization structure does not hold up in bankruptcy court'.

The next, but perhaps not last, Sukuk potential poblem to arise concerns the Golden Belt 1 Sukuk Company $650 million issue from troubled Saudi Arabian Saad group. According to Thomson Reuters in June 2009 the issue was trading at almost 50 cents on the dollar. Saad's chairman Maan Al Sanea is in the process of trying to financially re-engineer his group under heavy pressure from the central bank in the kingdom. The effects of the restructuring for Sukukholders is unknown but Citicorp Trustee Company has requested that Saad provide funds to secure against liabilities.

Where to from here?

Once upon a time the main problem faced by the Sukuk industry was illiquidity which was brought about by lack of secondary trading which was in turn a direct result of lack of primary issues. The consequence is that when a new Sukuk issue came to market it was immediately oversubscribed and then held to term. That is no longer the case but many of the same elements persist and the fact is that, while there is an active capital market in Malaysia for both conventional and Islamic products, there is no equivalent in the GCC. The consequences of this include the difficulty in constructing a useable yield curve to price new issues.

The future of Sukuk will require a number of key elements to come together. Perhaps the most pressing is a clarification of how Sukuk perform under crisis conditions, and it is likely that the industry will see some development on this front soon.

The next will be a general uptick in primary issues, particularly from the GCC. We are already seeing some signs of this but there also has to be some calming down of the prices paid by issuers to attract investors.

The final problem to be overcome is not a new one and concerns the development of a secondary Sukuk market in the GCC much like the market in Malaysia. The central banks of both the UAE and Saudi Arabia are already making some moves to make sure that this becomes a reality but for a real market to develop will require input from more than just a couple of central banks. It will also mean that scholars will have to have confidence in the structures that they are giving fatwas to, and charging their fees for, in order that both the issuer and the investor can have confidence that these same fatwas remain in force, unchallenged, throughout the life of the Sukuk.

Islamic liquidity management and treasury

Overcoming the obstacles to liquidity

The essence of good liquidity management involves having an optimal level of short, medium, and long terms assets to invest in and having access to cash when a bank or other institution needs it, either through the asset side or the liability side of the business. For banks, on the asset side, it is a question of the preservation of capital on demand which means that the asset must be of undoubted quality with little or no exposure to either credit risk or price risk or both. The bank should be able to match the maturity of its assets and liabilities on a daily basis and cope with such short-term pressures as may arise in the process of ensuring that the assets are fully funded.

However most conventional instruments that are available to be used for liquidity management have been developed over the past 200 years are based on paying or charging interest and are therefore not Shariah compliant. This is why there is a lack of a credible Islamic inter-bank market where banks can access overnight funds or funds for six months, nine months and 12 months in the way that their conventional counterparts can. In order to remedy this situation there has to be much more concerted action from central banks around the world and particularly those from Muslim countries. While both Bank Negara Malaysia and the Central Bank of Bahrain have already taken steps to address this, more action from more central banks is required as well as the introduction of another set of liquidity instruments.

Commodity Murabaha

Many Islamic banks would like to invest in long-term assets but they are faced with the problem that most of their deposit liabilities are short-term, which could lead to an obvious mismatch of liabilities. There is a clear lack of depth to the Shariah compliant liquidity management tools available and as a result of this many Islamic banks simply end up placing their surplus funds with western banks through Murabaha trading on the London Metal Exchange. In some cases these are bilateral trades which means that counterparty limits can be restrictive.

Relying heavily on commodity Murabaha for short term investment and liquidity management, while providing Islamic banks with an opportunity to invest their short term funds, inevitably leads to an inefficient use of their capital due to low returns that they can expect from these instruments. The impact of such limited returns is tantamount to a serious business risk since it negatively affects the competitiveness of Islamic banks overall when compared to conventional banks. Conventional banks can squeeze every cent of value from the variety of their deposits since their spectrum of investment options allows this. Islamic banks are often stuck with 'plan vanilla' and have to take what they can get and this can make them uncompetitive.

The effect on the industry

The lack of an Islamic inter-bank market is a major impediment to the growth of Islamic banks. Unlike their conventional counterparts, Islamic banks cannot meet unexpected withdrawals from depositors through borrowing at the prevailing rate of interest. This makes it is difficult for Islamic banks to run mismatched asset and liability portfolios for any length of time. Another equally important drawback is the equivalent of interest rate risk that they run when their long term fixed profit rate investments, in Sukuk for example, are held in parallel to their short term liabilities that are re-priced on a frequent basis. In practice this means that Islamic banks have to overcompensate and as a consequence of this the overall positions of most Islamic banks are far more liquid than their conventional counterparts, with the profitability implications that this has, as they strive to position themselves to meet every liquidity eventuality.

Where the central banks come in
Conventional banks could not operate without the active support and systems of the central bank of the country in which they operate. The same is true of Islamic banks and therefore it should fall to the central banks of Muslim countries or countries where there are a number of Islamic banks to provide a set of facilities that are acceptable to the Islamic banks and compliant with Shariah. These measures might include putting the bank's excess reserves

into investment deposits with other Islamic banks, creating Shariah compliant investment instruments for the banks to use, accepting Shariah compliant placement certificates with international Islamic banks as reserves, and accepting deposits with the central bank. Some of the tools used by Islamic banks in managing liquidity

Commodity Murabaha

As already outlined, this is one of the most common forms of investment used by Islamic banks to address the problem of liquidity. It is a form of a short-term financing based on a Murabaha contract and is often used for the buying and selling of commodities in an international market.

Malaysia's Islamic Interbank Money Market

The Islamic Interbank Money Market (IIMM) was established by Bank Negara Malaysia in 1994 to help address some of the liquidity issues faced by Islamic banks operating in Malaysia. The intention was that IIMM would act as a short-term intermediary to provide short-term investment outlets based on Shariah principle. Through IIMM the Islamic banks would be able to match their funding requirements with their liabilities cheaply and quickly. In order to do this IIMM had to be able to offer a range of different products to meet banks' requirements. These include:

- Mudaraba Interbank Investment
- Wadiah Acceptance
- Government Investment Issue
- Bank Negara Monetary Notes-i
- Sell and Buy Back Agreement
- Cagamas Mudharabah Bonds
- When Issue
- Islamic Accepted Bills
- Islamic Negotiable Instruments
- Islamic Private Debt Securities
- Ar Rahnu Agreement-I
- Sukuk BNM Ijarah
- Qardh

Qardh is a liquidity management instruments that allows Islamic banks to channel liquidity surpluses to the central bank and, according to ISRA, works as follows:

1. Bank Negara Malaysia will issue a tender through FAST (Fully Automated System for Issuing or Tendering) system, disclosing the amount of loan to be borrowed;
2. The tender is based on uncompetitive bidding, whereby bidders are required to bid for total nominal amount that they are willing to lend to Bank Negara Malaysia;
3. The successful bidders will provide the loan, for a specified tenure, until maturity; and
4. On maturity, Bank Negara Malaysia will pay back the loan in total. Hibah may be given, at the discretion of Bank Negara Malaysia.

There have been a few further instances of domestic governments of Muslim countries attempting to develop products that would help ease the liquidity burden of their own Islamic banks, such as the Sudanese government's Musharaka certificates, but the most productive efforts have been seen in Malaysia and Bahrain.

The Bahrain story

Some of the liquidity instruments to come from the Central Bank of Bahrain include:

Sukuk Al Salam

For many years the Central Bank of Bahrain (CBB) has issued government bills in a series of monthly Sukuk Al Salam with a maturity of 91 days. The June 2009 issue was the 97th issue in the series (See separate box out – Sukuk Al Salam – for a full explanation of the working of such Sukuk)

Short term Ijarah Sukuk

These are another invention of the CBB. These short term leasing Sukuk have a maturity of 6 months and they are issued in Bahraini dinars for BD5 million ($13 million). The June 2009 issue was the 46th issue in the monthly series.

Bahrain has been very active in the area of liquidity management with the establishment of the Liquidity Management Centre (LMC), the Islamic International Ratings Agency (IIRA), and the International Islamic Financial Market (IIFM). IIFM was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank. LMC on the other hand is owned in equal parts by Bahrain Islamic Bank, Dubai Islamic Bank, the Islamic Development Bank, and Kuwait Finance House.

The original intention of these bodies was that IIFM would help institutions issue Sukuk, the LMC would help develop a secondary market, and the IIRA would provide a rating for each issue in order to make the instrument more tradable. The reality was rather different and LMC ended up assuming the role that had originally been planned for IIFM. One of IIFM's roles is still the 'development of the global primary and secondary Islamic capital and short term financial market and the creation of a market for Islamic financial instruments'. LMC's role is 'to enable Islamic financial institutions to manage their liquidity mismatch through short and medium term liquid investments structured in accordance with the Shariah principles' .The argument went that LMC was intended to help institutions with secondary trading but if there were not enough primary issues this might never happen and as a result the LMC started to arrange and manage issues itself. More recent developments have seen the establishment of the Liquidity Management House in Kuwait and owned by Kuwait Finance House whose role seems to be to replicate some of the functions of the LMC.

IIRA's role was two pronged: to offer a Shariah rating; and to offer a credit rating. In practice many issuers had already received a fatwa from their own Shariah board for any instrument they issued, and it was not immediately clear what added value there was in having a second Shariah rating from IIRA, one that could have been issued by the peers of the scholars from the issuer. Equally, it was not always clear what value a credit rating from IIRA would have in the eyes of investors. Many issuers and investors simply want a rating from one or more of the big three: Fitch Ratings, Moody's, or Standard and Poor's. The imprimatur of such a rating is that it makes it easier to sell to investors, particularly institutional clients, and particularly western institutional clients.

Ijlal Alvi, *CEO of International Islamic Financial Market, Bahrain*

'The absence of well organised money market and a limited number of products in most of the jurisdictions are barriers in the growth of the Islamic Financial Services Industry (IFSI). When we talk about liquidity management in Islamic finance the main areas of concern are:

IFI's tend to be more liquid than their conventional counterparts as they have limited short-term investment opportunities and most importantly the absence of lender of last resort. Even in present economic crisis it is highly likely that IFI's will have more liquidity than their conventional counterparts although the level of 50 per cent higher liquidity seen since 2005 may have been reduced in 2008.

IFI's main investments are generally long-term (Sukuk, project finance, real estate) and their main funding is from short-term customer deposits whether restricted or unrestricted, hence, there is a potential mismatch risk which is highlighted in Islamic International Rating Agency's (IIRA) Liquidity Assessment of Islamic Banks Research Report dated June 2009.

IFI's have limited ability to tap short-term funds in the interbank market to meet cash flow requirements. Most banking failures are due to liquidity shortages and once again the absence of lender of last resort remains a challenge to overcome.

Issuance of Islamic securities by central banks for liquidity reserve management purpose is the core requirement of a money market which is the missing link in a number of jurisdictions and needs to be addressed both at national and global level.

The availability of products for liquidity management are still confined to a few products such as Commodity Murabaha, interbank Mudaraba, Qard Hasan, point system etc; which are temporary solutions and have a number of drawbacks such as non-tradability. Wakala is now emerging as one of the alternate liquidity management tool; although improvement is needed in terms of accounting treatment, rate of return, transparency and disclosure on management of funds.

Short-term Sukuk is also now emerging to replace some of the inflexible products mentioned above though its issuance is limited to few jurisdictions such as Bahrain, Brunei, Pakistan, Malaysia, and Singapore.

In terms of future liquidity management products; collateralized arrangements, for instance using Sukuk as collateral, have great potential and collective efforts are needed to overcome issues such as netting of obligations and transfer of ownership similar to classic Repo. Moreover, changes will be required in law and regulation on collateralization in order to have a liquid and flexible product'.

The need for greater efficiency

The future development of the Islamic finance industry will require a series of serious efforts to improve the overall liquidity position of the banks within it. Islamic banks have to compete with conventional banks in a range of ways and the lack of a working inter-bank market seriously hampers their efforts to do so efficiently. These issues can only be resolved be concerted intervention from central banks or by a significant number of Islamic banks coming together to agree a set of common standards. These standards will have to centre on a new set of liquidity instruments that give individual banks the freedom to be as flexible as they need to be to face every liquidity scenario they are faced with. The development of the products themselves is likely to come from the bright new generation of Islamic investment bankers now operating around the globe.

Sukuk Al Salam

The Central Bank of Bahrain (CBB) and its predecessor the Bahrain Monetary Agency (BMA) have been at the forefront of the development of the Islamic capital market. In 2001 the BMA introduced the Sukuk Al Salam series, so named because securities are based on the concept of Bai Salam. The issues are generally oversubscribed and when this happens the bills are sold on a pro rata basis. These issues go some way to addressing Islamic banks' short-term liquidity challenges. The June 2009 issue was for 6 million Bahraini dinars ($16 million).

So how do they work? The government of Bahrain would undertake to sell aluminium (deferred) for an advanced payment. Price has to be prepaid in the contract of Salam because the objective in such contracts is to help businesses with working capital financing. Since there is full repayment, Salam sale is beneficial to the seller. The future price is normally lower than the prevailing spot price. Such price behaviour is different from the conventional futures contracts where the future price is typically higher than the spot price by the amount of the carrying cost.

Aluminium has been designated as the underlying asset for the Salam contract in Bahrain. The Bahrain government sells aluminium to the buyer. As consideration for this advance payment, the government of Bahrain undertakes to supply a specified amount of aluminium at a future date. On behalf of the government, the CBB securitises the sale by issuing Sukuk Al Salam. These are purchased by Islamic financial houses as a means of parking their excess liquidity. The purchasers then appoint the government of Bahrain as their agent to take delivery of the aluminium and sell it through their distribution channels.

The purchaser then appoints the government as an agent to sell the aluminium at the time of delivery through its distribution channels at a price that will yield a return equivalent to that available through other conventional short-term money market instruments to the Salam Sukuk holders. The Sukuk holders bear counterparty risk (the government may not be able to deliver the goods) as well as market risk (the government may be unable to sell the aluminium at the time of delivery or may sell it at a sale price lower than cost). These risks are mitigated by the structure of the deal and the risk in effect translates into a sovereign risk on the government of Bahrain.

In structure, therefore, this is similar to a secured commodity Murabaha but it is securitised. The benefits of the Sukuk Al Salam are that the cost price need never be declared, there is lower credit risk to the purchaser because of the sovereign counterparty and the cost is lower to the purchaser than in a secured commodity Murabaha because it has been securitised. The disadvantage is that they are not tradable therefore there is a loss of liquidity. Since the CBB Sukuk Al Salam are for 91 days this is not seen as a major issue.

Islamic trade finance

Islamic trade finance

A very important niche

Trade finance has developed over the centuries as a natural requirement to oil the wheels of international commerce. Indeed, without the mechanism of trade finance global levels of international trade would be a fraction of what they are today.

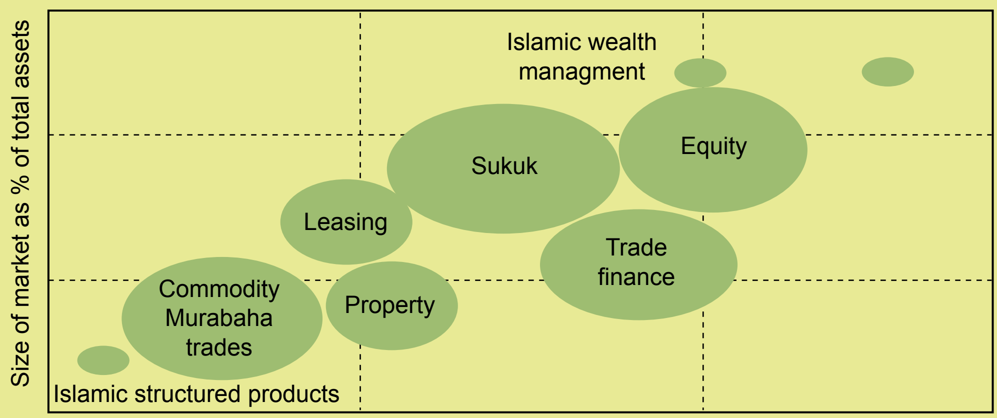
It is hardly surprising that there should be a Shariah compliant equivalent of trade finance for those institutions that wish to avoid engaging in haram business practices. Islamic trade finance generally consists of a short term banking facility to help buyers and sellers in managing their cash flow in the short run. Often the trade finance offering from banks is not something that they trumpet when recruiting new clients but is nevertheless a critical part of the Islamic finance jigsaw. What makes conventional trade finance easily translatable into Islamic trade finance is the fact that there are real assets underlying each transaction.

The trade financing operations of banks is very important to the overall development of entire industries as well as the economic development of countries. As the diagram below shows, Islamic trade financing already accounts for a large section of the overall trade finance pie.

According to a report from the Economic Policy and Statistics Department if the Islamic Development Bank called 'Achieving Intra-OIC Trade Target: A New Assessment' published in 2008, 'In terms of volume, intra-exports of the OIC countries fluctuate annually but in general they exhibited upward trends starting from $30 billion in 1990 to $201 billion in 2007, representing an average annual growth of 11.3 per cent ... Intra-imports, on the other hand, which also recorded upward trends, albeit with some spikes, reached $216 billion in 2007 from a low level of $27.5 billion in 1990, representing an average annual growth rate of 11.8 per cent. Consequently, the total intra-OIC trade (intra-imports plus intra-exports) range between $57 billion in 1990 and $416 billion in 2007, representing an average annual growth of 11.6 per cent'.

The OIC 10 year programme of action arising from the 3rd Extraordinary Summit held in 2005 in Saudi Arabia called on member countries to expand the scope of intra-OIC trade in order to achieve greater economic integration to raise it to a percentage of 20 per cent of the overall trade volume during the period covered by the plan (i.e. 2005-2015).

Global Islamic Landscape by Asset Value (2008)



Source: KFHR
Note: The chart above illustrates the global Islamic landscape by asset value

Products and structures used in Islamic trade finance

Islamic banks can use either Mudarabah or Musharaka principles in constructing a trade financing offering although in practice Musharaka has been largely ignored by many banks. There are a number of ways in which the bank will make money through trade financing activities including charging fees for opening letters of credit, charging fees for being the negotiating agent for exports and so on. A number of instruments have been developed that can be used by institutions wishing to both import and export goods on a Shariah compliant basis. The following is not intended as an exhaustive list of instruments, but rather as an overview of the sorts of services that may be offered by an Islamic bank when it comes to servicing the needs of a client with Islamic trade financing requirements.

Islamic letters of credit

Islamic letters of credit are based on the concept of Wakalah, which involves an agency relationship where one party is appointed an agent on behalf of the other. The letter is a written undertaking given by the bank to the seller at the buyer's request in making payment to the seller on his behalf at a future date.

Islamic bank guarantees

Islamic bank guarantees are based on the concept of Kafalah, which involves a contract of guarantee given by one party to discharge the liabilities of a third party in the case of default. The guarantee is an undertaking by the bank to pay the beneficiary of the guarantee an agreed sum if the bank customer defaults in fulfilling its obligations under the contract entered with the beneficiary.

Islamic shipping guarantees

Islamic shipping guarantees are also based on Kafalah. The guarantee is a form of indemnity by the customer to a shipping company to allow a shipping company to release merchandise to the consignee named in the Bill of Lading without the presentation of the original Bill of Lading. The guarantee is countersigned by the bank.

Islamic trade Murabahah

Islamic trade Murabaha is a typical Murabaha deal and is a contract between buyer and seller, where a bank will sell goods on deferred term to the buyer at an agreed selling price that comprises the bank's purchase price and profit margin. The bank will pay the cost price of goods direct to the supplier and the customer will settle the bank's selling price on lump sum basis at an agreed date in the future.

Islamic local bills discounting

This is based on the concept of Bai'Dayn involving a sale of debt arising from a trade transaction. The bank purchases the borrower's debt at a discount thus providing working capital to the borrower to finance their exports.

Islamic accepted bills

These are based on the concept of Murabaha for purchase and Bai'al Dayn for sale.

The role of the IDB in nurturing Islamic trade finance

The Islamic Development Bank has been active in fostering Islamic trade finane since 1977 when it set up Import Trade Financing Operations (ITFO). Islamic trade finance has become a major and core strategic function of the IDB and as time went on the IDB realised that it needed a mechanism to cope with a sector that was growing very fast as well as the growing sizes of operations for large clients. It did this through implementing two mechanisms: Syndication; and Two-Step Murabaha Financing.

Today the International Islamic Trade Finance Corporation (ITFC), the successor to the ITFO, has the following roles:

- 'To extend the developmental impact of the trade finance in the member countries through promoting intra-trade among member countries as well as encouraging their exports.
- To increase the volume of overall trade finance and intra-trade finance.
- To improve and upgrade the role of trade promotion activities.
- To give more emphasize on the private sector enterprises.
- To serve as a beacon in the Islamic banking community for trade finance, showing leadership in product development and training of local banks in member countries.
- To be market-driven and in line with the international best practices and consistent with the principles of Shariah.
- To be managed in a way that reflects both the developmental and financial objectives of the IDB'.

Conclusion

The future

The future's so bright ...

The Islamic finance industry is not an homogenous beast where all the entrants are playing the same game. For one thing there are different views on Shariah and as well as different views on risk. There is one school of thought that believes that the Islamic finance industry should simply replicate that which exists in the conventional realm and there is another that says that Islamic finance should aim to plough its own furrow irrespective of what goes on in the world of conventional finance.

Nowhere is this schism more plainly seen than in the Islamic investment banking arena where some banks simply grapple with the technicalities of real estate investing and leave the rest alone. In truth it seems to be a commonsense that investment banks should aim to offer their client base the best possible products across as wide a palette as possible. What their clients want, after all, is the best possible returns with the best possible spread of risk, whatever that might be.

It seems illogical that these goals can be met simply by relying on one underlying asset class. The basic lesson of any portfolio diversification strategy has to be spreading risk and this means trying to find asset classes that are uncorrelated so that when one segment is in a downturn the whole portfolio is not shot to pieces. In the conventional world this has sometimes led to excessive hedging that resulted in derivative instruments that were so obscure that few people understood them, including that group of people who were charged with regulating or supervising them.

There is no suggestion that Islamic investment banks should start to engage in wilfully obscure investment practices but rather they should look to diversify a little. There is a lot to be learned from the world of conventional finance in this regard.

There is also a great value in collaboration between Islamic investment banks and also between Islamic investment banks and conventional investment banks on Shariah compliant transactions. Only through working together can Islamic banks hope to match the weight of their conventional counterparts. Mass in terms of balance sheet can make all the difference in the world of finance.

But perhaps most importantly, the realms of Islamic venture capital and Islamic private equity need true champions to get behind them and make them industries in themselves. The rest of the world is watching what the Islamic banking space offers in the new dawn post financial crisis. What seems clear is that the global recession will not be over anytime soon no matter what green shoots of recovery pop up. Coming up for air after the kind of market carnage that we have seen will take time. The fact that the GCC appears to be in the process of being battered by a second tsunami, this time in the form of defaulting Saudi Arabian behemoths, means that the overall appetite for risk amongst banks, investors, depositors, and consumers will take a long time to recover.

On reflection it seems that perhaps the GCC was living in a fool's paradise pre-crisis and the region's banks are now facing the aftermath. According to the Financial Times, Mardig Haladjian, general manager at Moody's, told the newspaper in July 2009 that almost every Gulf bank the rating agency had met with recently as part of an ongoing review "has engaged in at least two or three restructurings of customer loan relationships".

The future of Islamic investment banking has to lie in diversification and collaboration. With these two elements harnessed the industry has a hope of reaching the heights that practitioners and observers have talked about for years. If the industry fails to grasp these two realities then it is doomed to commit the same mistakes that it committed in the past. That would be a seriously wasted opportunity.

About the author

Paul McNamara is co- founder of Yasaar Media, the leading Dubai-based Islamic finance media entity.

In 2004 Paul co-founded CPI Financial, publisher of Islamic Business & Finance magazine in Dubai after having spent two years in London with Euromoney Institutional Investor where he launched Islamic Finance Weekly, one of the first Islamic finance periodicals in the world.

Prior to that he was publisher of Asia-Inc magazine in Singapore and Brunei and also worked in Australia for eight years with Fairfax Business Publishing. Paul started his career at the Financial Times in London where he worked for nine years. He holds a BA Honours degree in Politics, Philosophy and Economics from Christ Church, Oxford.

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