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December 2013

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Slow and steady wins the race

The Middle East is one of the pillars of the global Islamic finance industry and despite suffering in the global financial crisis and property crash of 2007 – 09, the region has made a slow but steady comeback over the last five years to retain its position as a strong and stable investment destination. With its core markets of Saudi Arabia, the UAE and Qatar booming on the back of excellent economic fundamentals and its satellite states gearing up to gather pace in their Islamic finance development, the future looks bright for the region.

In this month's Islamic Finance *news* Supplement: on the Middle East, our cover story provides a comprehensive rundown of the leading markets in the region – including their position, performance, prospects and potential. Continuing from this, our lead feature brings you an overview of the top investment opportunities currently available in the region, and analyzes the performance of key asset classes across the industry including property, project finance, debt capital markets, equity markets and more. And to ensure complete coverage, our Takaful feature discusses the predicament of the Middle East in terms of slow growth and low penetration, and discusses how these issues could be resolved.

Abu Dhabi Bank Egypt and the Kuala Lumpur Regional Center for Arbitration (KLRCA) provide insightful chapters on their recent activity; while we also bring you detailed analysis from Sidra-Ancile Global Structured Trade Investment and new trading developments from Malaysia's Bursa Suq Al-Sila'.

Islamic Finance *news* remains dedicated to bringing you the most comprehensive and detailed analysis from around the world and across every market and sector; and our Supplement series is a crucial pillar of that purpose. We hope that you enjoy reading this issue, the last of this year, and we look forward to returning with a new series in 2014. As always, we wish all our readers all the best for the coming month.

Lauren Mcaughtry
Managing Editor

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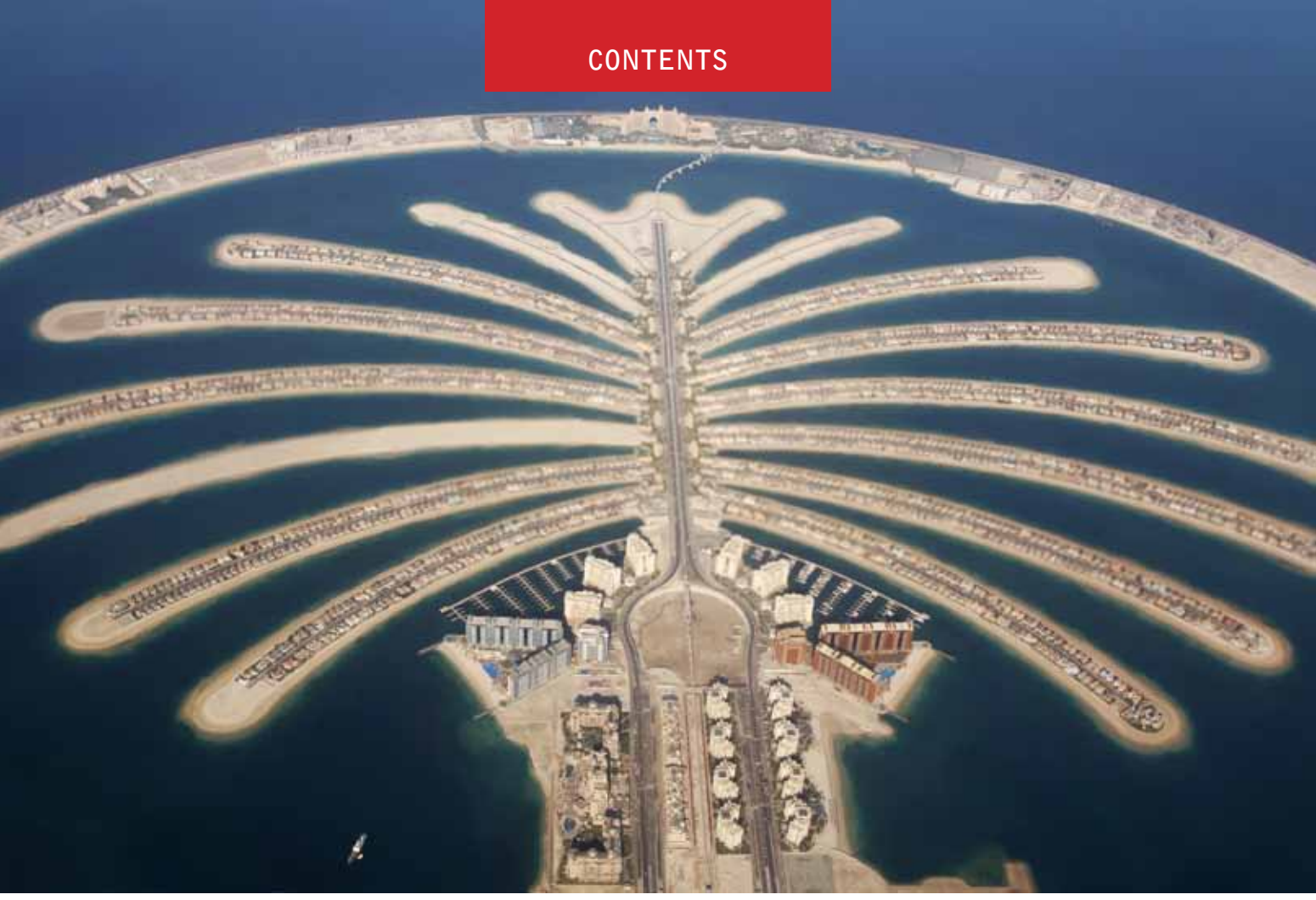

COVER STORY

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Islamic finance in the Middle East: A success story in the making

The Middle East has long been a stronghold for Islamic finance, but in recent years the pace has picked up as the sector surges forward in sophistication, expansion, innovation and investor expectation. As we approach the end of the final quarter, LAUREN MCAUGHTRY takes us on a tour of the region to see how 2013 has treated the markets – and what we can expect for the coming year.

Islamic banks now command around 25% of the total GCC banking market, according to EY estimates, with total assets reaching US$452 billion in 2012 and expected to top US$515 billion by the end of this year with an annual growth rate of 16% - faster than that of the conventional industry and highlighting the enormous potential in the region. Its capital markets also continue to boom, with US$27.66 billion in Sukuk issued as of December 2013, according to Dealogic.

Out of the six markets identified as systemically important to the future internationalization of the industry, three of these lie in the Middle East (Saudi Arabia, the UAE and Qatar). According to Ashar Nazim, a partner at the EY Global Islamic Banking Center of Excellence: "With trade patterns shifting decisively in favor of these rapid growth markets, this is a huge opportunity for Islamic banks."

Although the industry has seen a slowdown in some areas due to factors including political unrest, fears of US fiscal policy and economic uncertainty, overall the results for 2013 are sturdy and the prospects for the coming year look encouraging. In this cover story, we take a comprehensive look at the core markets driving the industry across the Middle East – including their performance in 2013, their current state of Islamic banking, their overall economic health and their prospects for 2014.

The UAE: Pushing the boundaries

The UAE is the second-largest Islamic finance market in the region after Saudi Arabia, and is home to a vibrant sector that has seen rapidly increasing growth in Islamic finance activity. Although UAE banks have struggled over the past few years due to limited credit growth following issues of asset quality, this picture looks to be finally improving. "The two key issues were real estate exposure and shortened debentures," explains Timucin Engin, an associate director at S&P. "However, in the past few quarters we have seen the credit losses of the UAE banks coming down, which has driven earnings growth." In 2014, a continued recovery in credit growth is expected along with a concurrent reduction in losses. "The overall picture of banking performance in the UAE is positive," confirms Engin.

Islamic banking assets in the country, including windows,

Middle East Corporate Islamic bond volume since 2012 - with Deal nationality and YTD breakdown						
	Saudi Arabia		UAE		Total	
Deal pricing date by YTD	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.
2012	2,683	4	3,065	7	5,749	11
2013	5,967	6	2,193	3	8,161	9

Source: Dealogic

account for over US$86 billion with its two biggest Islamic banks, Dubai Islamic Bank and Abu Dhabi Islamic Bank, topping the chart with US$29.25 billion and US$26.23 billion respectively.

The UAE also ranks second in the Middle East in terms of its Islamic debt capital market, with US$5.44 billion-worth of deals in 2013. In Islamic loans, the UAE leads the region with a total of eight deals worth US$7.37 billion in 2013. The top deals over the last year include the UAE's Emirates Aluminium Co (EMAL) with its major investment grade Islamic loan deal for US$3.4 billion in April. The Investment Corporation of Dubai (ICD) also closed another significant commercial loan deal in June. The five-year upsized US$2.55 billion deal to refinance an existing US$2 billion loan was arranged by a group of eight local and international banks and attracted significant demand, with a total of 17 lenders eventually participating.

In Dubai especially, the government has been impressively and consistently supportive of the industry, specifically regarding its goal to develop Dubai into an Islamic finance hub, with plans to open a center for Shariah corporate governance in 2014 covering both financial and non-financial institutions, which will be capable of issuing Shariah compliance certificates. The UAE hopes to develop an independent authority to supervise the industry, according to central bank governor Nasser al-Suweidi, which is aimed at encouraging international standardization. "We will have a Shariah authority or board that will be outside the central bank," he confirmed at the recent World Islamic Economic Forum in London.

The game-changer for the UAE, however, could be Dubai's recent winning bid to host the World Expo 2020, which is expected to see over US$8 billion in state infrastructure investment plus additional foreign investment flows; not only providing exceptional development and project opportunities for Islamic institutions, but improving the overall economy and boosting credit growth as well.

Saudi Arabia: Cementing its position

Saudi Arabia is the biggest Islamic market in the region, with total Islamic assets reaching US$270 billion in 2012 according to the most recent EY Global Islamic Banking Center report. Its influence and size in the region cannot be overestimated: accounting for over 80% of the total GCC (2.15sq km), 57% of its population (28,3 million) and 47% of total GDP (US$5.77 billion) with GDP growth of 6.8% compared to a GCC average of 4.6% in 2012.

The country benefits from a strong fundamental economy: credit growth remains strong, banks are operating in a very liquid environment, and asset quality of the banks also remains strong. "The banks are some of the most profitable in the region. We don't see any change in that picture over the next year," confirms Engin.

With four major Islamic banks in the Saudi Arabian financial industry, Islamic banking assets totaled US$112.3 billion as at the end of September 2013. The country is home to the largest Islamic bank in the world, Al Rajhi, which holds assets worth US$72.8 billion; followed by Alinma Bank with US$15.8 billion; and Bank Aljazira and Bank Albilad with US$14.8 billion and US$8.9 billion respectively.

Yet it is the Sukuk market that has really put Saudi Arabia on the map, and its strength in issuance is undeniable. The kingdom has accounted for 56% of total Islamic deal volume in the GCC to date according to Dealogic data, issuing US$7.06 billion so far in 2013, of which 85% has been from corporates, highlighting the rapid evolution of the sector.

Although the total insurance represents a reduction of 19.8% against the same period last year, it still represents a thriving market which investors from across the region are thronging to tap. "From a debt capital market perspective, everyone knows that Sukuk is the star product that issuers in the region have come to love, given its inclusiveness and ability to ensure a maximum price tension in the book-building process," said a Saudi banker to Islamic Finance *news*.

Saudi's General Authority of Civil Aviation (GACA), which issued its first tranche of Sukuk in January last year, successfully concluded its second tranche of US$1.39 billion in September 2013. In March 2013, Saudi Electricity Global Sukuk Company priced its investment grade Islamic corporate bond worth US$2 billion. Subsequently in April 2013 Sadara Chemical Company priced a high-yield Islamic corporate bond for the same amount. However, since private placements predominantly characterize the Saudi market, the lack of ratings can restrict the entry of bigger fund managers such as pension funds into the market.

Middle East Sovereign Islamic bond volume since 2012 - with Deal nationality and YTD breakdown								
	Qatar		Saudi Arabia		UAE		Total	
Deal pricing date by YTD	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.
2012	4,000	1	4,000	1	1,250	1	9,250	3
2013	-	-	-	-	1,250	2	1,250	2

Source: Dealogic

Middle East Islamic bond volume since 2012 - with Deal nationality and YTD breakdown												
	Bahrain		Kuwait		Qatar		Saudi Arabia		UAE		Total	
Deal pricing date by YTD	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.	Deal value $ (m)	No.
2012	96	1	103	1	5,450	3	8,806	9	6,315	11	20,771	25
2013	49	1	-	-			7,062	8	5,443	8	12,554	17

Source: Dealogic

Shariah compliant equity funds are also topping the charts, accounting for around 20% of the global Islamic equity funds market and 51% of the GCC sector: with assets under management of over US$6 billion across 163 domiciled funds, according to the Global Islamic Asset Management Report 2014 from Reuters. And new asset classes are making their way into the mainstream. Saudi Arabia is now the largest project market in the GCC, driven by significant deal volume (rather than deal quantity) with an average size of around US$3 billion. "In the corporate finance arena, project finance is the most popular asset class," confirms Mansoor Durrani, the head of project finance at National Commercial Bank.

Qatar: Strong growth set to continue

With around US$55.2 billion in Islamic banking assets, Qatar's Shariah compliant banking industry is picking up pace, driven by massive infrastructure development. Qatar is one of the fastest-growing Islamic economies in the region and has the highest per capita income in the world.

The state is a major driver in the industry, accounting for over 45% of domestic credit growth. "The sector largely revolves around the major state infrastructure projects," says Engin. "Looking at next year, given the number of new projects we predict credit growth will be strong for the foreseeable future."

The Islamic banking sector is expected to continue to see continued growth next year as well. A few years ago the four Islamic banks had balance sheets of just US$50 million – a figure that is expected to reach US$100 billion by 2017. And although overall, margins are contracting slightly due to pricing pressures, he confirms that: "We expect the trend to continue next year with good balance sheet growth and strong earnings."

Four major players lead Qatar's Islamic banking industry: Qatar Islamic Bank (QIB) with a total assets of US$19.92 billion; followed by Masraf al Rayan, Qatar International Islamic Bank (QIIB) and Barwa bank with assets of US$18.37 billion, US$9.08 billion and US$ 7.87 billion respectively. With a high capital adequacy of around 19%, Qatari banks are also well-placed to implement Basel III regulations rather swiftly. In August 2013, the Qatar Central Bank (QCB) sent a draft of consultative guidelines on Basel III to both Islamic and conventional banks; as well as stipulating rules for the issuance of bonds that can be treated as Tier 1 capital.

Kuwait: A long way back

Kuwait has suffered from considerable asset quality issues in recent years, predominantly due to local investment companies buying large quantities of perpetual or long-term assets but funding them with short-term lending, meaning that when the financial crisis hit they ran into a lot of trouble and left the Kuwaiti banking system significantly exposed. However, over the last five years banks have achieved a positive deleveraging, and Engin confirms that: "We see asset quality issues becoming less of a problem going into 2014."

However, the economy still struggles with credit growth due to a difficult political environment, in which projects are repeatedly delayed due to disputes in parliament. Credit losses for Kuwaiti banks remain high and although retail banking growth has supported the sector over the past two years, and should remain strong in 2014, it remains to be seen how corporate growth will fare.

There are five Islamic banks listed with the Central Bank of Kuwait (two of which were converted from conventional banks) and one foreign Islamic bank, in addition to investment companies operating in accordance with the provisions of the Shariah (but which do not deal with deposits). This sector has swelled to 51 companies over the last 10 years, but remain only a fraction of the industry, with over 95% of Islamic financing activity concentrated in Islamic banks.

Kuwait is also home to 106 investment funds, 54 of which are Shariah compliant. Total Islamic assets top KWD22.3 billion (US$78.74 billion) and account for around 38% of the total domestic market. "I believe that Islamic industry future in Kuwait is very promising following the largely established regulatory and supervisory framework. The Islamic industry's presence and development have become tangibly organized in terms of number of institutions and volume of market activity. It has become an effective resource of actual banking activity with a noticeable role in the economic and social development in the State of Kuwait," said Dr Mohammad Y Al-Hashel, the governor of the central bank, in a recent speech.

Oman and Bahrain: Little fish in a big pond

Although Bahrain has a long-established reputation in Islamic finance, while Oman is one of the most exciting new markets following its recent entry to the industry, the two countries remain small markets compared to the giants of the region.

Bahrain in particular has struggled with political and economic challenges over the past few years which have affected its banking sector. "The banking system has definitely slowed down," says Engin. "Issues over asset quality still exist, plus there is a lot of competition in the market and growth prospects are not what they were a few years ago."

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Who We Are

INCEIF, The Global University of Islamic Finance, is set up by Bank Negara Malaysia (Central Bank of Malaysia) to develop human capital for the global Islamic finance industry. Along with its dedicated Islamic finance academic programmes, INCEIF offers executive education, research, consulting and knowledge management services which are in line with its vision to be a knowledge leader in Islamic finance.

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Oman is in a rather different position, starting from a tiny market but with the expectation of positive growth. The country has two fully-fledged Islamic banks – Bank Sohar and Bank Nizwa – and existing conventional banks have also hastened to open their Islamic banking windows. Some of them already operate with dedicated Islamic branches – including Bank Muscat (Meethaq), National Bank of Oman (Muzn), Ahlibank (Al Hilal), Bank Dhofar (Maisarah), Oman Arab Bank (Al Yusr) and Bank Sohar (Sohar Islamic). The total Islamic window operations network now has 22 branches.

Total Islamic banking assets in Oman (excluding windows) reached US$700 million as at the third quarter 2013. In October, Tilal Development Company (TDC) also successfully launched Oman's first Sukuk. The issue was priced at OMR50 million (US$129.5 million) and was denominated in Omani rials. The Central Bank of Oman recently announced that it is looking to establish a national Shariah board to overlook the operations of Islamic banking in the sultanate.

However, Engin warns that the sector will not see much significant growth in the Islamic finance industry to compete with the major players in the region. "We don't see it picking up or generating any material portion of the banking sector any time soon." The issue is that there is only so much credit growth available.

A certain portion of this will inevitably turn towards the Islamic sector – and as happened in Kuwait and Qatar, the conventional banks see this as a loss of market share so they launch their own windows. "Because of this, growth will probably be high this year, but is unlikely to be meaningful – if you look at the overall GCC sector, Oman is a very small banking system."

Trends for 2014

A common theme across GCC Islamic banks is the fundamental repositioning of their balance sheets following the financial crisis, and this means that credit growth is of vital importance. In addition, moving forward, many banks are looking to expand regionally which represents an exciting trend in the Middle East Islamic finance industry as local banks focus on generating revenues outside their own local markets; driving cross-border expansion and accompanying improvements in regulation and standardization. However, challenges also exist. The biggest cost factor in 2014 is likely to be compliance with Basel III implementation, which will have an impact across the financial board.

However the key factor, suggests Engin, will in fact be the unlikely issue of interest rates. "As Islamic banks generally operate with large levels of non-interest liabilities in certain markets (such as credit accounts, on which you don't make much) these are very attractive when interest rates are high. But when interest rates come down, which they are expected to do, this may have a negative impact on asset generation for some Islamic banks."

Nevertheless, it is clear to see that in the Middle East overall, business is booming. Going into the new year, it will be exciting to see how these core markets develop – and which new players may emerge to challenge the dominance of the existing giants.

Dealmakers: Driving market demand

Lead managers and arrangers play a paramount role in facilitating Islamic finance offerings to reach investors and clients. HSBC is currently the leading bookrunner in the region with eight deals so far worth US$2.77 billion in 2013. The bank has however seen a drop of 68.7% in the number of deals closed compared to the same period last year. Deutsche Bank ranks second with deals worth US$1.57 billion closed including the major mandates of Saudi Electric Global Sukuk and Sadara Chemical Company Sukuk. Standard Chartered and local Islamic banks such as Dubai Islamic bank, Abu Dhabi Islamic bank, Albilad and Alinma Bank also rank among the major dealmakers in the region.

Top 10 Islamic debt capital market bookrunner deals - 2013 YTD*

Bookrunner parents	Deal value US$ million	% share
HSBC	2,774	22.1
Deutsche Bank	1,575	12.5
Standard Chartered	1,314	10.5
Emirates NBD	757	6.0
National Bank of Abu Dhabi	694	5.5
Dubai Islamic Bank	682	5.4
Citi	532	4.2
Riyad Bank	500	4.0
Alinma Bank	500	4.0
Al-Bilad Bank	500	4.0
Total	**12,554**	**100.0**

Top 10 Middle East Islamic loan mandated lead arrangers - 2013 YTD*

Mandated lead arranger	Deal value US$ million	% share
HSBC	735	6.6
Abu Dhabi Islamic bank	682	6.1
National Bank of Abu Dhabi	539	4.9
Arab Petroleum Investments Corp - APICORP	519	4.7
Abu Dhabi Commercial Bank	482	4.3
Standard Chartered	468	4.2
Saudi National Commercial Bank	447	4.0
Riyad Bank	447	4.0
Sumitomo Mitsui Financial Group	439	4.0
Emirates NBD	368	3.3
Citi	368	3.3
Total	**11,097**	**100.0**

**As at 25th November 2013*

Source: Dealogic

Ethical Investments: A methodical approach to ESG/SRI strategy

Sidra–Ancile Global Structured Trade Investment is a Luxembourg-domiciled Shariah compliant investment fund co-managed by INOKS Capital of Geneva and Sidra Capital of Jeddah. NAIM AZAD DIN elaborates on how the unique characteristics of the fund are both profitable and beneficial to society.

The fund commenced its activities in the first quarter of 2013 with assets under management (AUM) of US$15 million, which were mainly raised from high net worth individuals, family offices and wealth management firms. Ever since then, the managers have been keeping the fund's liquidity at a minimum in an albeit challenging first year of operations, in their efforts to surpass the hurdle rate of return of 7% per year. The target is nevertheless in sight with another month of the year to go.

In addition to economic soundness, the fund's strategies take into consideration the social and environmental externalities that any investment opportunity has to offer as part of its investment assessment criteria. Such proactive alignment of interests on the investors' front is expected to result in a mutually beneficial relationship with the broader society, which in turn contributes towards strategy sustainability. Underpinned by the core principle, Sidra–Ancile Global Structured Trade Investment offers 'true' non-speculative commodity trade finance investment opportunities in accordance with the principles of Shariah. This is the first of its kind investment fund ever offered in the world. It offers investors the opportunity to have direct and long-lasting impact on the investees' capacity to generate sustainable wealth, whilst contributing positively towards social (e.g. poverty alleviation and food security) and environmental development of select communities. It is a dynamic balancing act between capitalism and socialism and the true application of Islamic economics.

We will first describe the fund's principles to demonstrate that its sustainable approach does generate both direct and indirect positive impact. In later parts, we will go through the concrete application of its process and the positive impact generated for society. The Environmental, Social and Governance (ESG) criteria are divided in two types:

a) Non-negative impact: The investment shall pass through excluding and discriminating screening criteria. These shall confirm if the investments result in negative externalities or not.

b) Positive impact: In addition to being compliant with ESG and socially responsible investment (SRI) selective

criteria, the investment must be economically sound and efficient for all stakeholders. In other words, the direct and indirect social and environmental positive externalities are as imperative to the investment as the financial profit.

[A] Negative disqualifying criteria
The 'discriminating criteria' seek to screen by discrimination, transactions which fall into any of the following category:

(i) Do not finance or invest in countries and entities (moral or physical) which are sanctioned by:
- the OFAC; and/or
- the UN; and/or
- the EU

(ii) Do not finance or invest in companies which:
- manufacture non-industrial alcohol, weapons, tobacco, use GMO crops or nuclear energy;
- are engaged in gaming or animal testing; and/or
- are guilty of human rights violations.

(iii) Finance or invest in companies which do not treat with respect and dignity its:
- workers;
- people;
- animals; and/or
- the environment.

[B] Positive qualifying criteria
The 'sustainability criteria' seek to define if the investment positively scores at least a direct and/or an indirect impact in:
- sustainable development;
- corporate governance and enhanced business performance;
- poverty alleviation;
- food security; and/or
- environment.

"The strategy applied seeks to proficiently mitigate all other non-market risks. Its distinctive approach generates steady returns with low volatilities, making it an attractive investment that enhances diversification and returns"

The strategy applied seeks to proficiently mitigate all other non-market risks. Its distinctive approach generates steady returns with low volatilities, making it an attractive investment that enhances diversification and returns. The strategy is to finance organically growing SMEs' non-speculative activities in the commodity value chains in emerging markets, as illustrated in Figure 1.

Figure 1: Financing value added and not speculatively generated profits

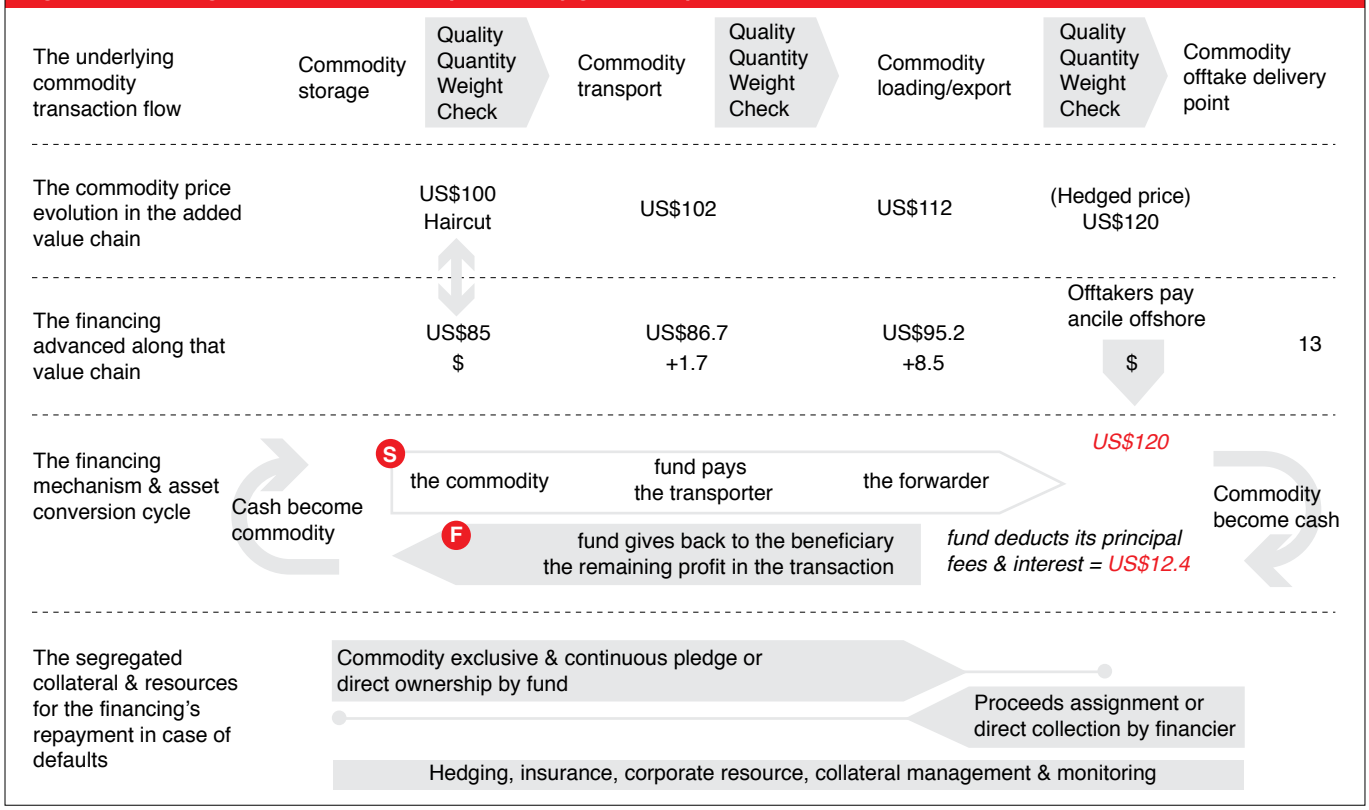

Figure 2: Sustainability of returns

	Jan	Feb	Mac	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2006								0.15%	0.15%	0.67%	0.44%	0.47%	**1.89%**
2007	0.03%	0.33%	0.57%	0.75%	0.92%	0.79%	1.01%	1.17%	0.86%	0.98%	1.01%	0.76%	**9.86%**
2008	0.96%	0.64%	0.83%	0.51%	0.69%	0.69%	0.74%	0.78%	0.68%	0.63%	0.81%	0.86%	**9.20%**
2009	0.50%	0.46%	0.54%	0.53%	0.64%	0.48%	0.56%	0.60%	0.54%	0.79%	0.80%	0.93%	**7.62%**
2010	0.91%	1.05%	1.05%	1.39%	1.03%	1.30%	1.49%	1.29%	1.24%	1.56%	1.51%	1.42%	**16.36%**
2011	1.47%	1.37%	1.53%	2.56%	1.50%	1.14%	1.62%	1.44%	0.49%	1.04%	1.10%	1.06%	**17.59%**
2012	1.04%	0.95%	1.00%	0.97%	0.61%	0.84%	0.98%	1.08%	0.83%	0.48%	0.94%	0.87%	**11.10%**
2013	0.50%	1.56%	0.69%	0.39%	0.49%	0.51%	0.53%						

By servicing these non-speculative working capital requirements along the commodity value-added chain, the fund takes pride in passing on to shareholders hands-on and active participation to the economic growth, wealth creation and sustainable development of emerging markets. The fund plays a catalyst role by funding tangible real economic activities that are the basis of these societies' everyday lives. The potential beneficiaries of a financing must comply with a thorough due diligence process which embeds two synergetic investment analyses: namely (a) The financial and operational due diligence; and (b) The ESG and SRI due diligence.

Figure 2 tabulates the sustainability of the returns under the strategies.

We duly consider the ESG dynamic in our pre-investment qualification process. In addition to the financial, economic, risk and operational aspects that are normally analyzed, we perform an ESG-specific vetting portion. By implementing our approach, we have obtained concrete direct and indirect impacts on numerous transactions. Let us single out an example on how the approach sustainably impacts the societies we invest in, which can, and have been, replicated in other societies as well:

The West African cotton sector initiative:
The strategy was very early on recognized with a Trade Finance Deal of the Year Award from Islamic Finance *news* in 2008, on the basis that its syndicated crop farming and export financing worth EUR28 million (US$37.85 million) in Côte d'Ivoire could at the same time:

- Generate tangible and direct repercussions reaching in excess of 20,000 cotton farmers;
- Stabilize an entire sector of the economy – in a crisis-ridden and impoverished portion of the country – by ensuring the sustainability of a historical but depleted cotton producing/marketing activities which are strong factors of rural developments;
- Result in immediate and concrete poverty alleviation effects by annihilating the farmers' unjustified and unnecessary indebtedness simply through the timely and due payment of their harvested crop and therefore labor when cotton is delivered;
- Greatly enhance local food safety by properly and divisively partially allocating inputs supplies to subsistence farming (i.e. local food crops) to avoid diversion from the cotton-specific inputs requirements;
- Allow for the proper selection and use of the best inputs tailored for cotton and separately for the local food crops, in full respect of the best environmental norms and practices (zero residue in the soil and plant); and
- Yield sustained and secured returns for the investors in what was perceived as a "very complex" business environment.

This structure has been repeated multiple times since 2008 in Côte d'Ivoire as well as in Burkina-Faso and Ghana. As a matter of fact, the last investment made in Ghana's northern region cotton area for US$5 million was awarded the Islamic Finance *news* Trade Finance Deal of the Year in 2012.

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KLRCA i-Arbitration Rules

This is the final piece of a three part discussion, examining the resolution of disputes in Islamic banking and finance through commercial arbitration and the KLRCA's new i-Arbitration Rules (the Rules).

The first paper, published in the Islamic Finance *news* Asia Supplement (October), contains a breakdown of the Rules and examines the problems faced by Islamic finance users. The second, published in the Islamic Finance *news* Capital Markets Supplements (November), looks at the selection of governing law and how parties are able to ensure the application of the correct and desired system of law. This final part will look firstly at the recently released and translated second edition of the i-Arbitration Rules, and secondly compare the Rules with Islamic arbitration options presently available in the Islamic banking industry.

Revised rules: The 2013 KLRCA i-Arbitration Rules

On the 24th of October 2013 the KLRCA launched the revised and translated editions of its core rules, including the second edition of the KLRCA i-Arbitration Rules. The Rules were translated into six languages – Arabic, Spanish, Korean, Mandarin, Bahasa Malaysia and Bahasa Indonesia – cementing the internationalization of KLRCA's Rules and services. The new edition of the i-Arbitration Rules brings into effect several revisions and additions, building on the theme of global application. The most notable changes are the removal of any reference to a specific jurisdiction, and the incorporation of an optional late payment charge mechanism permitting the arbitral tribunal to deal with the issue of default.

Revised reference procedure – Going global

Rule 11 (previously Rule 8) contains the procedure for reference of Shariah issues to a Shariah advisory council or expert. In the revised edition, there is no reference to a specific jurisdiction or authority. Rather, the appropriate council or expert is determined according to the characteristics of the agreement and any underlying transaction, as well as the will of the parties. This reflects both the mandatory nature of banking and finance regulation and the consensual and flexible nature of international commercial arbitration.

In the Islamic Finance *news* Capital Markets Supplement we examined how the appropriate authority might be determined. Where there is governing legislation, as exists in Malaysia or Indonesia, there may be a statutory authority that can be called upon. Otherwise, it may be the bank or financial institution involved that maintains a Shariah advisory board, or ultimately the parties may agree on a Shariah expert to deal with such issues.

It bears remembering that a ruling obtained under Rule 11 will be treated as expert evidence and not interfere with the decision making powers of the tribunal. This preserves the international enforceability of any award rendered under the New York Convention, applicable in 149 countries.

Late payment charges – Dealing with default

Disputes containing issues of a Shariah nature conventionally have no mechanism of redress where there is default by the party against whom a decision has been made. This deprives the successful party of the benefit of his award and fails to deter the delay of payment, indirectly affecting the competitiveness of Islamic finance users compared to users of conventional finance.

> **"The most notable changes are the removal of any reference to a specific jurisdiction, and the incorporation of an optional late payment charge mechanism permitting the arbitral tribunal to deal with the issue of default"**

To rectify this disparity, the Shariah Advisory Councils of the central bank of Malaysia (Bank Negara) and the Malaysian Securities Commission jointly formulated a mechanism known as the late payment charge, based on the Shariah principles of Ta'widh, corresponding to compensation on actual loss, and Gharamah, referring to late payment.

The late payment charge is calculated pursuant to a formula based on the overnight Islamic Interbank Rate of the Islamic money market, with the Ta'widh portion recoverable by the party to whom the payment is owed and the Gharamah portion going to charity. The mechanism is outlined in guidelines issued by the Shariah Advisory Council of Bank Negara titled 'Shariah Resolutions in Islamic Finance' and available on their website.

Rule 12 of the Rules includes the late payment charge as an optional mechanism that the tribunal may use in the case of default. The decision whether or not to apply the mechanism will depend on the principles applicable to the matter and the choice of the parties. Nevertheless, the option exists as a way

of ensuring full compensation and preserving competitive standing.

Existing forums for Islamic arbitration

Arbitration has been present in Islam since its inception. Prophet Muhammad himself acted as an arbitrator in various disputes. Islamic arbitration is practiced both on an ad hoc and institutional basis, and is offered through a variety of institutes such as the International Islamic Center for Reconciliation and Arbitration (IICRA), Islamic Institute of Civil Justice, Independent Shariah Tribunals (in Nigeria, among other countries) and the Muslim Arbitration Tribunal (UK). AAOIFI likewise offers international accounting and banking standards, including for the conduct of Islamic arbitration.

There are limitations in this approach to arbitration. Islamic arbitration as practiced throughout history has involved a mix of what we know now as mediation, conciliation and arbitration, and as a result there is very little in the way of an accepted uniform practice when it comes to Islamic arbitration. Issues such as confidentiality, qualification of arbitrators and the role of arbitrators are not necessarily dealt with in any coherent uniform manner.

The IIRCA, as a dedicated Islamic arbitration institution, offers arbitration services and expertise similar to conventional commercial arbitral institutions like the KLRCA. There are significant differences, however, in how those services are carried out. Following is a breakdown of the main differences.

Scope

The most important difference lies in the scope of service offered by the different institutions. For the reasons explored above, the KLRCA does not attempt to offer blanket Islamic arbitration in line with what has been traditionally offered. Rather, the KLRCA seeks to augment its already established and internationally recognized commercial arbitration services by making them accessible to parties utilizing Islamic banking in their business. The i-Arbitration Rules build on existing UNCITRAL Model Law principles by adding scope for determination of issues relating to Shariah principles through reference to the relevant Shariah council or expert, and allowing the remainder of the dispute to be resolved on commercial basis according to the governing legal principles agreed upon.

The IICRA by contrast, provides a forum for arbitration of disputes wholly in accordance with Shariah law. Under the IICRA, an arbitral panel is to disregard any applicable legal provisions selected by the parties where the application of same is not compatible with Islamic Shariah principles. In addition, the arbitral panel "may invoke for the disputed issue whatever it deems appropriate from among the viewpoints of various schools of Islamic thought, rulings of Islamic Fiqh academies, and opinions of Shariah supervisory boards at Islamic financial institutions. The Panel may choose to be guided by local or international commercial rules or conventions that are not at variance with the provisions of Islamic Shariah". The IICRA maintains a specialized Shariah Advisory Committee to whom a draft award may be referred for review. The role of the Advisory Committee is to bring the attention of the arbitral panel to "any violation of the principles and provisions of Islamic Shariah". This review of the Advisory Committee is applied to the whole of the award, and not only to specific issues. It should be noted that such recommendation is not binding on the arbitral panel.

Scope is where the main difference lies, and the differences in scope as applied by the two institutions are readily apparent. While the i-Arbitration Rules seek to isolate Islamic finance issues to which Shariah principles are to be applied, the IICRA uses Shariah principles to define the entire procedure.

Venue and language of arbitrations

Other differences lie in the logistical details of how arbitrations are administered. Under the IICRA, the official language is Arabic, and while other languages may be agreed between the parties all written submissions and statements must attach an Arabic translation and all awards must be rendered in Arabic. Under the KLRCA, international arbitrations are carried out in English. In relation to venue, under the IICRA the executive committee reserves the right to reject any agreement for proceedings to be held outside the UAE. The KLRCA provides for proceedings to be held in any venue agreed by the parties.

Who are these services most suited to, prospective parties and arbitrators

This is a direct consequence of the issues raised above. The holistic application of Shariah principles is by its nature more suited to local transactions, limited to parties within the Islamic finance community and preferably parties within the same jurisdiction (for the purpose of finding common ground regarding the appropriate Islamic authority and applicable interpretation of Islamic jurisprudence). This is reflected in the IICRA's provisions regarding language and venue. Furthermore, the scope exercised by IICRA necessitates a narrow range of available arbitrators. Arbitrators included in the IICRA panel will need knowledge and experience in Shariah principles and likely a working knowledge of the Arabic language.

A global solution

The i-Arbitration Rules are by design suitable for parties of all nationality. They are well suited to both domestic and international transactions and agreements and in line with leading international commercial arbitration standards. The KLRCA maintains a broad and extensive panel of arbitrators, including arbitrators with Shariah and Islamic finance expertise but also arbitrators of varying industry, jurisdictional and commercial experience. The result is the ability to provide parties utilizing Islamic finance transactions with the same resources in resolving disputes that are available to other commercial entities around the world.

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Investment opportunities in the Middle East: Building blocks

The financial crisis irrevocably changed the investment landscape of the Middle East, with banks now focusing more on streamlined balance sheets; smaller, easier to place deals; slimmer credit costs; and a focus on risk management. Yet despite the more conservative appetite, the high levels of liquidity in the region along with a boom in infrastructure expenditure and a drive towards diversification have kept the Middle East on the map as an investment destination. LAUREN MCAUGHTRY explores what's hot; what's not; and what to watch in 2014.

Although the macroeconomic outlook for the Middle East has stabilized, GDP growth is still expected to slow this year – with the IMF expecting an average GCC rate of 3.2% in 2013 compared to 5.7% in 2012. Nevertheless opportunities are still available in a range of asset classes to tempt Shariah compliant investment; and global investors (particularly from Asia) continue to flock to key sectors in the Gulf region.

Real estate resurgence

Property has always been a favorite for Islamic investors, and despite the bubble burst of 2009 the region has seen a resurgence in real estate over the year; with a shortfall of supply in key markets including Saudi Arabia, the UAE, Kuwait and Bahrain driving the construction sector and spurring investors to enter the market as the sector seeks to narrow the demand-supply gap with a boom in development. In the UAE in particular, fears of another bubble have risen with house prices increasing by over 20% over the last 12 months, prompting a warning from the IMF. However, new measures imposed by the central bank including limits on mortgage loans and restrictions on bank lending should control growth and prevent another crisis. Measures are now being taken to encourage foreign as well as domestic investment in the sector, with Dubai-based Noor Islamic Bank recently launching mortgages for non-UAE residents in the GCC and G20 to tap growing international interest in regional real estate; with a profit rate of around 5.75%.

The growth is also having an impact on Islamic debt, with region's leading development companies seeing exceptional returns on their Shariah compliant instruments, prompting new entries to the capital market. In the UAE the yields on Sukuk from Emaar and Nakheel Properties have plummeted in recent months amid surging Dubai property prices; while Abu Dhabi's Aldar Properties also came to market with a planned US$500 million issuance launched in November at US$750 million following oversubscription of three and a half times with significant interest from Asia and Europe. The funds will be used to refinance the firm's US$3.08 billion-worth of debt due to mature in 2014, and is part of its new strategy to reduce borrowing costs and extend its maturity profile.

In Saudi Arabia, massive unmet demand (with a US$67 billion program to build 500,000 new homes launched in 2011 and a massive supply-demand gap with a need for over 1.25 million units estimated by 2014) has also boosted the market. The Dar Al Arkan Real Estate Development Co US$450 million Sukuk due February 2015 earned over 7% in 2013 to top the Bloomberg Sukuk league table for the GCC; with Emaar Properties coming second with its 2016 Sukuk returning 5.7% - compared to a GCC average of 2.1%, as of September.

Infrastructure boom

While the property market is an old favorite, a new asset class prompting excitement is the infrastructure sector, which has garnered considerable attention due to vast state investment across several Middle East territories. Last year Nasser Saidi, then the chief economist of the Dubai International Financial Center (DIFC), noted that the leading developing oil export economies should commit 11% of their GDP to maintaining and improving their national infrastructure; with transport and energy being the most urgent areas for investment.

GCC countries are seeking to diversify away from a reliance on petrodollars, and as result are looking at significant investment in infrastructure as a means of becoming more efficient and attracting foreign investment inflows. Consultancy firm EC Harris' Global Infrastructure Investment Index, which ranks 40 countries in terms of attractiveness for infrastructure investment, lists the UAE and Qatar in its top 10 with Saudi Arabia coming in and 11; and the firm predicts that the GCC has the potential to become a leading destination for global infrastructure investment.

Project finance push

On the same page as infrastructure investment, one of the most

exciting new areas for Islamic finance in the Middle East region this year is project finance, which is rapidly becoming a power player – particularly in the Saudi, UAE and Qatar economies, as the governments invest billions of dollars in infrastructure and industry as they prepare for major events such as Qatar's 2022 World Cup and Dubai's 2020 World Expo.

Saudi Arabia is already the largest project market in the GCC, driven by significant deal volume (rather than deal quantity) with an average size of around US$3 billion. This has led to a boom in the project finance sector in Saudi Arabia. Ground-breaking innovations in projects such as the Islamically-financed Jabal Omar project in Mecca and the SATORP greenfield Sukuk in 2011 and subsequent SADARA Sukuk in 2013 have opened up new avenues of incremental project debt beyond the traditional bank market, creating a new distribution footprint with public and private investors, corporates, pension and insurance funds.

A major feature of the 2014 investment landscape in the region is thus likely to be the project finance marketplace, as local companies seek new sources of capital to fund new projects and development. "Sectors such as transport need financing. Port companies, railways and airlines are looking to do this either through banks or Sukuk," Fahad Al Saif, the head of capital markets and corporate finance for HSBC Saudi Arabia told Bloomberg in October. "With a number of companies considering primary or secondary offerings, we are optimistic that there will be a healthy amount of activity next year."

Sukuk remains strong

Of course, Sukuk continues to be the main method of raising funds in the region and a preferred asset class for investment due to favorable market conditions. In a statement issued on the 30th October Steve Drake, the head of PwC's Middle East capital markets group, commented that: "We see no reason for this trend declining given the continued demand for capital the region is experiencing."

Although total Sukuk issuance levels have declined slightly from the bumper year of 2012, the sector has sustained an impressive performance with a positive trend in corporates entering the market. Recently Ooredoo Tamweel, the biggest phone operator in Qatar, ended a two-year hiatus of corporate Sukuk in the country with the announcement of its maiden issuance, a benchmark US$1.25 billion five-year Sukuk, following its US$500 million Murahabah financing facility of November 2012. The last corporate Sukuk from Qatar was the US$215 million deal from Almana Group in June 2011 but it is expected that the new issuance will pave the way for more corporates to issue, driving Qatar into competition with the UAE and Saudi Arabia as one of the region's biggest issuers as it launches over US$138 billion-worth of investment over the next three years.

Regional Sukuk are seeing exceptionally high demand from investors due to their favorable yields and high liquidity levels, with the majority of recent issuances significantly oversubscribed. In October this year the Al Hilal Bank issuance of US$500 million received orders upwards of US$6.3 billion; while the average yield for GCC Sukuk was up by 80bps to 372% as of the end of November, according to the HSBC/Nasdaq Dubai index compared to an 85bps increase to 4.15% for conventional bonds.

Equity market excitement

Yet despite the strength of the Islamic debt capital markets, equity investment also looks to be a tempting prospect for Islamic investors in 2014. Despite a traditionally small regional market (the combined GCC exchanges have reportedly traded only around US$2.2 billion so far this year) Islamic funds have put in a strong performance, according to the Thomson Reuters Global Islamic Asset Management Report 2014. The GCC has also enjoyed the highest fund inflows compared to other jurisdictions. Assets under management in Saudi Arabia, the largest funds market in the region, now exceed US$6 billion and account for 20% of the global Islamic funds market. This year in fact saw the highest global number of Shariah compliant fund launches in four years, of which 20% were in Gulf countries. However, the majority of these remain retail-driven, with only 20% of assets coming from institutional investors – primarily due to an absence of major Takaful operators and pension funds in the Islamic asset management space. Institutional participation and the entry of pension providers is therefore a key target for the industry in 2014.

Despite the general caution in the market over the past 12 months and a focus on more conservative investment and greater risk management and credit control, there are still a plethora of opportunities that maintain the Middle East's status as a leading Islamic investment destination. Going into 2014 we can look forward to sustained growth and continued fund inflows, laying the groundwork for yet another exciting year for Islamic investment.

Abu Dhabi Islamic Bank Egypt believes in the potential of the Egyptian Market

Abu Dhabi Islamic Bank (ADIB) is coming into its own in Egypt. After successfully completing a long-term restructuring process following the 2007 acquisition of a sizable stake (49%) in Egypt's National Bank for Development (NBD), ADIB Egypt is claiming its place at the head of the pack of a small number of rapidly growing fully Shariah compliant banks operating in the Egyptian market.

Currently, ADIB Egypt is among the largest Shariah compliant financial institutions operating in Egypt. It employs a team of over 2,000 experts, providing a comprehensive range of banking and financial services through a nationwide network of 70 branches, 39 microfinance units and 68 ATMs across 19 governorates. The bank this year won two prestigious awards from Islamic Finance *news* including Best Islamic Bank in Egypt (for the third consecutive year) and Best Islamic Private Bank (for the second year running).

If numbers are any indication, 2013 looks to be the bank's most successful year yet. Despite the economic, political and social uncertainty Egypt has witnessed, ADIB Egypt has stayed focused and committed to making good on its promise to provide ethical, reliable and affordable Shariah compliant financial services while expanding and integrating into the broader financial sector. ADIB Egypt's most noteworthy accomplishments in the first nine months of 2013 include posting a net profit, for the first time since the NBD acquisition, of EGP68.8 million (US$9.97 million); increasing its capital adequacy ratio to 11.28%, which has helped the bank meet the Basel II criteria; and increasing the bank's financing portfolio by EGP880 million (US$127.54 million) to reach EGP6.2 billion (US$898.56 million), marking a growth margin of 16.5%. The growth in ADIB Egypt's financing portfolio was largely achieved as a result of large corporate customers and public sector companies including two landmark syndicated financing deals for East Delta Electricity Production Company and Maridive and Oil Services SAE.

In February, ADIB Egypt announced the signing of the first

Shariah compliant financing agreement for the public sector segment in Egypt. The US$110 million syndicated financing agreement with East Delta Electricity Production Company (EDEPC) – the flagship name and arm responsible for electricity production in strategic governorates including Damietta, Port Said, Ismailia, Suez, North Sinai, South Sinai, and Red Sea – came as part of the bank's commitment to support the national economy despite the economic uncertainty at the time. The bank participated with 18.5% of the total financing amount equaling US$110 million, which was provided through a Shariah compliant Mudarabah product over five years with the participation of Banque Misr, Egyptian Gulf Bank, Baraka Bank, Bank Audi and United Bank.

The EDEPC deal reflected the bank's strategy to expand into infrastructure projects vital to the continued prosperity of the Egyptian economy. This groundbreaking syndicated financing agreement represents the beginning of ADIB Egypt's ongoing efforts to increase partnerships with core industries of the public sector by providing the financing necessary for projects. At the forefront of the strategy is supporting the energy sector, which in the words of Nevine Loutfy, CEO and managing director of ADIB Egypt, is: "Supporting the energy sector stands at the forefront of our strategy, as it is a driving force for the entire economy and a prime example of how Islamic finance can be implemented to provide the needs of development projects."

> **"It is clear that the bank is set to play a substantial role in developing the Islamic finance industry in Egypt and adding signficant economic value to the development process required in the rapidly developing nation"**

This is particularly relevant given the importance of electricity and power sector as one of the main industries driving the expansion of industrial projects and catering to the continuous increase in power consumption, both on the household and the mega project levels which, in turn, largely contributes to GDP growth. The EDEPC transaction has opened the door to new financing instruments that can cater to corporate financing needs while introducing the concept of Shariah compliant syndicated finance to the market.

This transaction marked a significant milestone in Shariah compliant finance, being the first syndicated finance compliant with Shariah principles In addition, the innovative EDEPC agreement fostered strategic relationships with public sector entities as well as other banks. This was particularly critical in this period, since it also fostered the confidence in the Egyptian government and the public sector which was essential given the local and regional conditions. This transaction has also positioned ADIB, as one of the primary banks supporting the crucial and strategic electricity sector. The Egyptian banking market is large, with more than 35 banks: however prior to the EDEPC deal, Islamic finance had been limited to bilateral transactions with retail and corporate customers.

Reflecting the bank's strategy to expand into finance infrastructure projects that are vital to the continued prosperity of the country, in May of this year ADIB Egypt arranged and signed the first Ijarah structure syndication worth US$150 million for Maridive and Oil Services SAE, which is one of the most prominent offshore oil and services company in the Middle East and North Africa, offering integrated business model serving wide spectrum of blue chip oil and gas services companies worldwide. ADIB Egypt, as Initial Mandated Lead Arranger (IMLA) and the Global Coordinator, signed the syndicated facility with its head office; ADIB-Emirates. Arab African International Bank, Banque Du Caire and the Arab International Bank also served as IMLAs, while ADIB Egypt assumed the facility and security agent roles.

Banks received final approvals for US$235 million (a coverage of 160%) however, the company decided to keep the facility at US$150 million, with a top up option to finance the existing capital expenditure (mainly vessels) to meet the increasing demand on its services, especially in Latin America where Maridive and Oil Services SAE had at time won contracts with World Class oil exploration companies.

The Maridive deal was the first Ijarah syndicated deal to ever happen in Egypt and is the second for ADIB Egypt after that of EDEPC.

These innovative syndicated financing agreements are just one way in which ADIB Edypt is making a name for itself as an industry leader. With the objective of being the top tier Islamic bank in Egypt by providing Shariah compliant financial solutions to the Egyptian community, ADIB Egypt's three-pillar approach to achieving those goals is based on a solid foundation supported by ADIB Emirates: build market leadership, create an integrated financial services group and pursue growth opportunities.

Following the remarkable turnaround in the bank's achievements in 2013, ADIB Egypt is looking forward to become the pre-eminent modern universal wholesale bank providing a full fledge Shariah compliant product offering and first rate service to various clients segments.

Bursa Suq Al-Sila'

Launched in August 2009, the Bursa Suq Al-Sila (BSAS) is specifically dedicated to facilitating Islamic liquidity management and financing by Islamic financial institutions. It is the world's first end-to-end Shariah compliant commodity trading platform.

BSAS is managed by Bursa Malaysia Islamic Services (BMIS), a wholly owned subsidiary of Bursa Malaysia which conducts periodical Shariah audits on trades to ensure that the trading rules governing members which were formulated in accordance with Shariah principles are adhered to with the objective of upholding the integrity of the industry.

BSAS integrates the global Islamic financial and capital markets together with the commodity market through one single engine. It encompasses a hybrid market where participants may opt between voice broking and the automated web-based electronic system. It undertakes contracts in various currencies to facilitate cross border trades between Islamic institutions and commodity players worldwide.

The essence of BSAS, which embraces the commodity Murabahah concept, involves one party buying a commodity and selling it to a customer at a cost-plus-profit basis. The customer will then pay the amount and the profit to the party on deferred-payment basis. The customer then sells back the commodity to the commodity market on spot for cash. The trade involves the sale and purchase of real physical assets.

Since its inception in 2009, BSAS has continued to grow from strength to strength and has done the nation proud by recording RM4.3 billion (US$1.3 billion) in ADV traded for the month of September 2013 with the largest deal valued at RM5.5 billion (US$1.67 billion) on the 18th January 2013. The largest trade in a day was recorded on the 22nd July 2013 with a notable amount of RM10.4 billion (US$3.16 billion). Local participants contribute 70% of the trade and foreign participants constitute the remaining 30%.

The rapid growth of BSAS and its reputation as a viable Shariah compliant trading platform is because nearly all of the domestic Islamic banks today are trading on this end-to-end Shariah-compliant platform. To date, there are 77 registered BSAS participants of which 61 (79.2%) are local participants and 16 (20.8%) are foreign participants.

Currently, there are five approved commodities that can be traded on Bursa Suq Al-Sila' which include Crude Palm Oil (CPO); Refined, Bleached and Deodorised Palm Olein (RDB Palm Olein); Plastic Resin (Polyethylene); Hardwood Timber and Softwood Timber, and these can be traded in 22 currencies. Trading on BSAS is from 9am to 10.30pm, Sunday to Thursday. On Fridays, BSAS operates in two sessions: 9.00 am – 12.30pm (morning session) and 2.30pm – 10.30pm (afternoon session). Using the concepts of Murabahah and Tawarruq, BSAS facilitates Islamic interbank placements, deposit taking,

> **There are clear signs that the growth trend for BSAS will spur and to meet the increased demand, Bursa will continue to seek new suppliers, both local and foreign, as well as introduce new commodity to be listed on BSAS**

financing and Sukuk issuance. In addition to that, BSAS also supports Islamic profit rate swaps and Islamic cross currency swaps. Given Malaysia's unique position of strength in Islamic finance, BSAS is well-poised to capitalize on this strength. There are clear signs that the growth trend for BSAS will spur growth and to meet the increased demand, Bursa will continue to seek new suppliers, both local and foreign, as well as introduce new commodities to be listed on BSAS.

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Exchange-traded bonds and Sukuk

Bonds and Sukuk are an alternative asset class that provide a stable income stream until maturity. Previously, the bond and Sukuk market was accessible only to high net worth and institutional investors. But today, both institutional and retail investors can have access to the bond and Sukuk market via exchange-traded bonds and Sukuk (ETBS).

Launched on the 8th January 2013, this is a new asset class that offers retail and institutional investors access to the bond and Sukuk market. ETBS are fixed income securities that are listed and traded on the stock exchange, and issued either by companies or governments (the issuer) to raise funds for their needs. This asset class has varying structures such as fixed rate, floating rate and hybrids.

As ETBS are listed on the exchange, investors will have access to the real-time price and volume, just like shares. This will enable investors to continuously monitor their investments and receive up-to-date information. Investors can also diversify their portfolio to include ETBS to complement their investments in other asset classes. Besides that, ETBS are ideal for any investors who want extra stability or steady income in their portfolio due to their regular coupon payments. ETBS utilise the same mechanisms as that of buying and selling shares in which investors need to have a trading account with the broker and trading Central Depository System (CDS) account.

Investors can buy ETBS both through the primary market via subscription, similar to applying for an IPO, and the secondary market, similar to buying shares via brokers. Selling ETBS is similar to selling shares via brokers. If held until maturity, investors will get back the nominal value of the bond/ Sukuk on the maturity date, as well as the interest/ dividend payable. Investors can make money from ETBS by earning interest/ dividends and capital gains depending on market conditions.

The maiden ETBS was issued by DanaInfra Nasional of up to RM300 million (US$91.25 million) in nominal value (guaranteed by the Government of Malaysia) with a tenor of 10 years and a profit rate of 4%, It was successfully listed and traded on the 8th February 2013.

The Takaful predicament

The Takaful industry in the Middle East has witnessed a modest progression in the recent years. Gross contributions between 2007-11 grew at a compound annual growth rate of 22.4%. Nevertheless the expectations of shareholders have often not been met. NABILAH ANNUAR explores the predicament confronted by the Takaful industry in the region.

Having generated gross contributions of approximately US$6.4 billion in 2011 (about 68% of the world's gross Takaful contributions), the Middle East is an important market for Takaful. General Takaful remains the popular option for consumers in the region while Family Takaful enjoys a much lower penetration and is largely untapped in comparison to other regions such as Southeast Asia. General Takaful penetration in Middle East countries commands a significant share of up to 90%, with Family Takaful taking the remaining portion.

Sohail Jaffer, the deputy CEO of FWU Group, explained some of the reasons behind the low take-up: "Customers in the Middle East favor Family Takaful products that are investment-linked. Family Takaful is viewed primarily in the context of wealth management and financial planning." He further noted that this does however provide a significant opportunity for product development. "In this regard, a few leading Takaful operators would be considering introducing Shariah compliant pension and savings plans, which offer both a savings component, as well as protection element. The market potential for Shariah compliant pension and savings plans is vast, particularly in the corporate sector, where employers would use these plans as part of their employee retention program(s)."

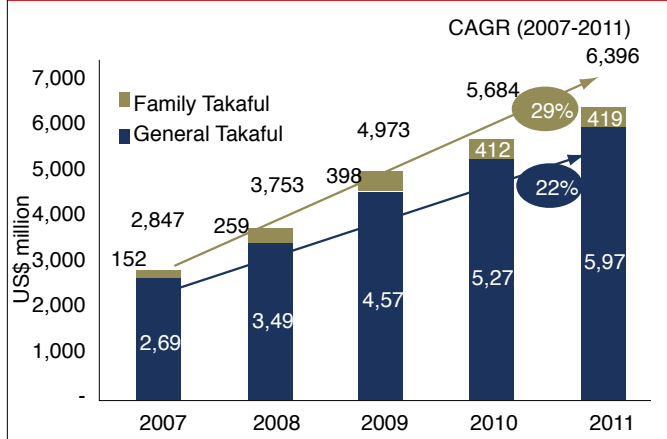
A fragmented market

However, the sector is currently held back by structural as well as retail challenges. According to EY's Global Takaful Insights Report 2013, the Takaful market in the Middle East is heavily fragmented with too many operators. Price competition between firms is therefore intense as operators try to increase gross written contributions. It has been suggested that the industry could benefit from consolidation, especially in light of regulatory requirements imposed on capital and solvency limits. Echoing EY's sentiments, Marcel Papp, the head of re-Takaful at Swiss Re Retakaful, confirmed to Islamic Finance *news* that: "The industry is going through a period of consolidation. More emphasis has to be put on generating underwriting surplus."

Educating the masses

Consumer awareness remains a vital component in enhancing the Takaful market in the Middle East. "The biggest challenge in the Middle East is the lack of awareness and understanding of Takaful. Often people are not even aware about insurance let alone Takaful," said Papp. As many Muslims in the region continue to have the misconception that Takaful is contrary to the principles of Islam, the industry will inevitably suffer from a lack of self-induced appetite for insurance and savings products.

Middle East gross Takaful comtributions



Source: Milliman (World Takaful Report, 2013), EY (Global Takaful Insights, 2013)

Taking into consideration that 90-95% of the population in the Middle East are Muslims, educating consumers on the actual legal status of Takaful in an Islamic perspective as well as its perks and benefits will assist in increasing the industry's market share. "Takaful can also benefit from highlighting the value of insurance as a wealth management and financial planning tool (in addition to protection). Product innovation, such as Shariah compliant pension and savings schemes, can have the effect of creating self-induced appetite for Takaful," suggests Sohail. Therefore, by increasing awareness of Takaful as an alternative to conventional insurance through customer education as well as product innovation, the scale of Takaful in other countries in the Middle East can be elevated.

A cohesive legal environment

Another hurdle that must be addressed is regulatory reform. The difference in regulatory regimes across countries pose a significant challenge for Takaful companies which operate in countries other than where they are domiciled. These operators often face difficulty in standardizing their products and processes as well as in passing on some benefits of economies

of scale to their customers. In this regard, Sohail pointed out that international Islamic standard-setting bodies play a crucial role in promoting international standards and practices for the global Takaful industry. "Through organizations such as AAOIFI and IFSB, local regulators in different countries are encouraged to adopt Takaful regulation that follows international best practice," he said.

According to Noman Mubashir, the manager of Islamic financial services at EY: "A standardized approach to regulations across the GCC could be the game changer for the industry. The ideal approach would be to replicate the 'single passport' system as seen across the EU member states."

Regulatory enhancements possess the ability to act as a catalyst for the industry. For instance, the UAE's circular outlining the marketing relationship between banks and insurers assisted in defining bancaTakaful relations across the UAE. Banks were prohibited from acting as insurance intermediaries, agents, brokers and consultants. Their activities are currently limited to marketing insurance and Takaful policies. In comparison, the Saudi Arabian Monetary Authority required all insurance operators to align with the cooperative insurance model by the end of 2011. As a result, no conventional insurance at all was permitted in Saudi Arabia. This significantly assisted in the penetration of Takaful in the country. Gross contributions in Saudi Arabia are however, like the rest of the GCC region, predominantly procured from General Takaful businesses, with health insurance and third-party motor insurance being the biggest lines.

> **"The market potential for Shariah compliant pension and savings plans is vast, particularly in the corporate sector, where employers would use these plans as part of their employee retention program(s)"**

The end user

In terms of operations and distribution channels, most companies lack Takaful expertise. Staff retention is an important factor in reducing this risk. Particularly for Family Takaful, bancaTakaful remains an important distribution channel, in which boosting one's output hinges on improved training and highlighting the distinctive selling points of Takaful. The Takaful industry in the Middle East would also benefit from customer segmentation and profiling, allowing suitable Takaful products to be offered to target customer segments. In this context, Papp noted: "An additional challenge for Takaful operators is the fact that they tend to be start-up operations and by this often they have not yet reached the necessary size to be economically viable."

It has been suggested that the use of digital applications that allow Takaful contract issuance as well as collection of customer information could result in major improvements in both the quality and persistency of new businesses.

Going forward

Moving on to the initiatives that could be implemented to enhance the growth of the Takaful industry in the Middle East, Papp took the Malaysian government's role as a positive example. "Like Malaysia, governments in the Middle East should play a more active role in promoting Takaful and improving its regulatory framework. Takaful operators should also work closer together in order to offer market solutions or products which they may not be able to offer on an individual basis," says Papp.

Currently Takaful in the Middle East is focused on the retail segment, with little focus on the corporate segment. Developing the corporate segment provides a key opportunity for growth in the Takaful market. "Within the UAE, 75% of the labor force is employed by SMEs. They often design employee retention programs to reduce staff turnover and elevate employee productivity. Shariah compliant pension and savings plans can form an integral part of such employee retention programs. As a result, such innovative product designs can boost demand for Takaful products," explained Sohail.

On the flipside, high disposable income levels and low market penetration in the Middle East provide a significant growth opportunity for Family Takaful. As a rule of thumb, insurance products need to be sold to customers rather than being bought. A recent study by EY suggests that in the UAE, over a third of consumers switch life insurers due to the operator's inability to meet the evolving needs of consumers. While 51% of those who switch operators would stay for loyalty rewards, 72% repeat product purchases simply due to an easy sales process. Hence, understanding the needs and expectations of consumers is the key to unlocking the potential that lies in the Middle Eastern Takaful industry.