

2017

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# Islamic Finance *news*

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## Continued volatility marks a cautious outlook for the coming year

The markets are winding down and the festive season is fast approaching. But with a year once again marked by political turmoil and turbulent trends, performance has been subdued and prices precarious. Against this backdrop of uncertainty, our comprehensive and industry-renowned Annual Guide brings you a comprehensive overview of the past 12 months — shining a spotlight on the global Islamic finance industry and the opportunities and challenges it has faced throughout the course of 2016.

The year has been a challenging one, following on as it did from the turbulence and volatility of 2015 — which saw oil prices crash over 60% and severe commodity unrest. Fast forward one year and at first glance, it could seem that not much has changed. Southeast Asia might be rolling in liquidity but trouble is rapidly appearing over the horizon with ongoing pressure from China's flash crash, plummeting currencies in major Islamic finance markets including Malaysia and Indonesia, and an exodus of overseas investors from Asian bond markets.

In the Middle East, the oil price might have stabilized but governments are still suffering — as demonstrated by the vast sovereign bond issuances of the past year and significant declines in bank deposits. And of course, the twin elephants in the room — are the traditional safe havens of the US and Europe safe no more, following the Brexit decision and the Trump victory?

But it is not all bad news. Strong liquidity in Asia is still attracting investors, with multiple new Islamic funds launching over recent months. The squeezed bank lending situation in the Middle East has benefited the capital markets, and corporate issuance is on the rise with total global Sukuk volumes exceeding US\$40 billion in 2016 — up 22% from just US\$32 billion the previous year. Islamic investment is still flooding to UK as the plummeting pound sterling makes property a cheap bet; while Trump's pro business stance has reassured investors in the stability of the US market.

2016 was the year of the sovereign Sukuk — we saw an extraordinary surge of exceptional deals come to market, of a size and yield that bodes well for the future of the industry. And of course new markets are also providing excitement and entertainment. Iran has taken steady steps forwards in rejoining the global marketplace, while Turkey recently reformed its tax regulations to make the issuance of corporate Sukuk more appealing and Africa offers continued opportunities for growth and development.

We have seen promising updates in the fields of governance and regulation, which should go some way towards standardizing the industry yet further. Another major trend is Islamic fintech, with several major developments in 2016 making this one of the most exciting trends we have seen in some time.

So as we move forward into 2017 the outlook is both uncertain and optimistic; exciting and intimidating. No one can know what the future will bring, but as the performance of the Islamic markets over past 12 months has shown, Shariah compliant finance is flexible, innovative and strong — giving it the capacity to handle whatever the future may bring as long as we remain true to the moral and ethical principles that underpin the industry.

As such, IFN is delighted to once again offer a multitude of material designed to inform, educate and inspire our readers across the world. I hope you enjoy our IFN Annual Guide 2017 and I wish you all the best for the new year.

Lauren McAughtry  
Group Managing Editor

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# Islamic finance 2017: Another difficult year



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## Where are we heading?

The drop in Islamic finance growth that we saw in 2016 is likely to continue in 2017, in our opinion. While we estimate the industry's total assets will reach US\$2.1 trillion at the end of 2016, we think two factors will weigh on the growth in 2017:

1. The impact of policy responses to the decline of oil prices in core markets, and
2. The lack of standardization in the industry, which is still made up of a collection of local small industries rather than a truly global industry.

Still, Islamic finance will have the impetus to continue progressing and maintaining some growth in 2017. The subdued but still positive economic growth of core markets, the continuous demand from an expanding customer base, the broader consensus around the need to standardize legal structures and Shariah interpretation, and the industry's potential contribution to the sustainable development financing goals of the United Nations (UN) are likely to help the industry to somewhat progress in 2017. We are of the view that standardization, if achieved, could put the industry back on track for stronger growth in the coming years. Overall, we expect the size of this industry to reach US\$3 trillion sometime in the next decade.

## 2016 was a difficult year

The Islamic finance growth rate has declined significantly in 2016, reducing to around 5% compared with double-digit growth in the past decade. The industry remains concentrated primarily in some oil-exporting countries, with the GCC countries, Malaysia and Iran accounting for more than 80% of the assets which we estimate will reach US\$2.1 trillion by the end of 2016. The significant drop in oil prices, the ensuing significant reduction of core markets' economic growth (with the exception of Malaysia) and the policy responses being implemented in the form of spending cuts, have reduced growth opportunities.

We observed that banks in core markets are growing more slowly than in the recent past and are suffering from the shift in their environment. In the same vein, the Sukuk market has not played a countercyclical role as an alternative source for governments to close their funding gaps and maintain spending in 2016. When oil price started to drop in 2014, several market commentators predicted a windfall of Sukuk issuance, arguing that governments in core Islamic finance countries will rush to the market. It did not happen, due to various factors including the length and complexity of Sukuk issuance.

Looking at 2016 numbers, we saw that conventional debt issuance has been the biggest winner as it almost doubled compared with 2015. Some market observers have attributed that to the low prevailing interest rates and also the desire of some core countries to preserve the liquidity of their local Islamic banks. However, these observers forgot that a significant portion of investors in Sukuk comes from the same people that invest in conventional bonds, particularly those based in Europe and the US. Also, these observers forgot that there is a large reported gap between Sukuk demand and offer, estimated by some market participants to be between US\$100-300 billion per annum. Finally, despite the tremendous opportunities to grow, the Takaful sector has remained a marginal player in local and global contexts.



## 2017 will likely be equally difficult but will see the stabilization of industry growth

We expect the growth of the industry to stabilize in 2017 at around 5%. We think that the less supportive economic conditions will continue to prevail in some core markets, with Malaysia being the exception thanks to its more diversified economy and its proactive policy response. We also think that the Sukuk market will continue to play a modest role in providing funding to some core countries of Islamic finance (particularly in the GCC due to the cumbersome process of issuance and in Iran due to international sanctions).

We do not rule out a scenario where we might see higher issuance from some governments in the GCC, assuming the efforts on the standardization of legal documentation and Shariah rulings start to show tangible results. Some GCC countries have either introduced new regulations or laws for Sukuk issuance or announced publicly that part of their funding mix will be done through Sukuk in the next 12 months.

In addition, the financing of the UN sustainable development goals could also create some growth opportunities in the future but we see them as modest. Finally, Iran has the potential to be a new significant contributor to the growth of the Islamic finance industry, should the remaining sanctions be removed and its regulatory environment brought up to speed. Yet it remains to be seen when sanctions will be removed and whether issuances from Iran will attract significant interest from traditional Sukuk investors based in Asia and the GCC.

## Conclusion: United and more integrated, the industry will grow stronger

The Islamic finance industry would benefit from more integration and higher support from its standard-setting bodies and regulators. More Sukuk issuance could give Takaful operators less risky investment choices, help banks to manage their liquidity and funds to have some fixed income revenues and invest in profit and loss-sharing instruments. Banks could start to offer Takaful products more systematically. Integration is an achievable goal if regulators create a more supportive regulatory environment and scholars and other technical or legal stakeholders work together to achieve standardization. United and more integrated, the industry would grow stronger.☺

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# Bursa Suq Al-Sila': Growing acceptance of Murabahah and BSAS platform drives performance

**Bursa Suq Al-Sila' (BSAS) is a commodity trading platform specifically dedicated to facilitate Islamic finance transactions such as Islamic interbank placement, Islamic deposit-taking, Islamic financing, Islamic profit rate swap, Islamic cross-currency swap, Sukuk issuance, as well as debt trading with commodity (Bai' Dayn Bi Sila') using the concept of Murabahah and Tawarruq.**

Launched in August 2009 to address Islamic liquidity management challenges facing the industry worldwide, BSAS unveils the collaboration of Bank Negara Malaysia, Securities Commission Malaysia, Bursa Malaysia and the industry players in support of the Malaysian International Islamic Financial Center initiative.

In agreement with the Islamic finance ethos of integrating the financial economy with the real economy, BSAS is a replication of a physical market which has been architected to provide an avenue for the efficient utilization of idle commodity as underlying assets for Islamic finance transactions, while retaining the deliverable attribute of the commodity upon invocation for delivery by the buyer.

BSAS integrates the global Islamic financial and capital markets with the physical commodity market through one single trading engine. It also encompasses a hybrid market whereby participants may opt for either voice broking or the automated web-based electronic system.

As an end-to-end Shariah-compliant, fully electronic and web-based trading platform, BSAS was developed to further enhance the Islamic finance industry in embracing Shariah principles with the efficacy of modern technology in today's sophisticated financial markets.

BSAS is operated and managed by Bursa Malaysia Islamic Services (BMIS), a wholly-owned subsidiary of Bursa Malaysia, which is overseen by an independent Shariah committee. BSAS participants and their trading on BSAS are regulated by a single and defined code of conduct referred as the Rules of BMIS with the objective of upholding the integrity of the industry and providing a fair and orderly market. BMIS undertakes periodical Shariah audits on operational aspects, as well as trades conducted on the platform to ensure that the trading rules governing members which were formulated in accordance with Shariah principles are adhered to.

Together with commercial and operational feedback from the industry, BSAS undergoes constant enhancement in keeping with the dynamic understanding and application of Shariah in Islamic finance, affirming its commitment to remain as a relevant, efficient and effective solution for Shariah compliant transactions that is acceptable globally.

These were made possible with the availability of various commodities on BSAS, namely crude palm oil, plastic resin, RBD (refined, bleached and deodorized) palm olein and timber, which allows for the provision of sufficient commodities to satiate the growing market demand, as well as to accommodate innovative Islamic financial products.

The flexibility of executing commodity trades in 27 major currencies such as the US dollar, the UK pound, the Japanese yen, the Saudi riyal, the UAE dirham, the Kuwaiti dinar and the Malaysian ringgit which fosters cross-border transactions also contributed to the exceptional expansion of BSAS activity.

BSAS participants are more evident on the demand side which exhibits a lineup of Islamic financial institutions, cooperatives, government agencies, central banks and multilateral development financial institutions. Such vibrant participation has allowed Islamic finance, via the BSAS market, to benefit society at large through the issuance of infrastructure and public housing Sukuk by authorities, the extension of trade and franchise financing for budding entrepreneurs and the provision of microfinancing to empower the poor and women in rural areas. Notwithstanding the foregoing, BSAS also caters to small-sized transactions such as retail financing through small-sized trades. Such human development efforts are further supported by BSAS and its market features which are able to facilitate the introduction of Islamic fixed-rate deposit-taking and financing, hence fostering financial inclusion among religious conscious individuals.

Besides being recognized as an end-to-end Shariah compliant commodity trading platform with transparent flows, BSAS is also regarded as a unique commodity trading platform compared to other trading providers. BSAS had in 2015 introduced a tenor-based pricing structure whereby the trading fee on BSAS is chargeable based on the tenor of the underlying transaction performed by the commodity trading participant. The trading fee is as low as RM3 per one million basis in any currencies of trades, part thereof and on a pro-rate basis for each transaction.

The structure of the tenor-based pricing mechanism is as follows:

- Short tenor: one to four days
- Mid-tenor: five to 21 days, and
- Normal tenor: 22 days and above.

BSAS's contributions to the progress of Islamic finance have thus far been acknowledged by the industry through a number of awards and accolades including 'Most Outstanding Islamic Finance Product' by Kuala Lumpur Islamic Finance Forum during the Islamic Finance Awards 2009, 'Market Innovation' by The Asset Triple A Awards 2010 and 'Islamic Innovation Award' by the Ministry of Science, Technology and Innovation in 2010. BSAS's achievements were also recognized by the Global Islamic Finance Awards 2015 which presented the exchange with the 'Best Islamic Exchange 2015' award and it also received the award of 'Best Islamic Finance Facilitation Platform Asia 2015' from Global Banking & Finance Review. The international financial community picked BSAS as the 'Best Interbroker for Islamic Transactions' at the 10th Islamic Finance news Service Providers Poll 2015.

BSAS also recently won 'Best Islamic Finance Facilitation Platform Asia 2016' and 'Best Islamic Exchange Asia 2016' at the Global Banking & Finance Review Awards 2016, followed by 'Best Interbroker for Islamic Transactions' at the 11<sup>th</sup> Islamic Finance news Service Providers Poll 2016. ☺



# The coming challenge: IFRS 9

The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are increasingly becoming the usual accounting framework for Islamic financial institutions. Many jurisdictions that did not adopt the IFRS or AAOIFI standards instead used national accounting standards, often with specific recognition for Shariah compliant transactions. The most developed of these were the Malaysian standards, but Malaysia now uses IFRS. KEN EGLINTON assesses the situation.



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## Review of 2016

AAOIFI is also working on convergence with the IFRS. As part of this process, during 2010, AAOIFI amended its conceptual framework. The amended framework introduced the concept of 'substance and form' replacing AAOIFI's historical concept of 'form over substance'. The framework states that it is necessary that information, transactions, etc, are accounted for in accordance with their substance and economic reality as well as their legal form. In contrast, under the IFRS, transactions are generally accounted for in accordance with their economic substance, regardless of their legal form.

It is interesting in this regard to note that in the policy document 'Financial Reporting for Islamic Banking Institutions' issued by Bank Negara Malaysia in February 2016, it states that in the event of inconsistency, the Shariah places greater importance on substance than form.

## Preview of 2017

IAS 39 has for many years been the principal IFRS standard for financial instruments. In 2014, the IASB issued IFRS 9 to replace IAS 39. While early adoption is permitted, mandatory application is from the 1<sup>st</sup> January 2018. IFRS 9 contains radical differences from IAS 39. Islamic financial institutions that are not already working hard on a project for implementation of IFRS 9 have left it rather late.

The IFRS 9 projects at conventional banks are concentrated on the new impairment model, with work also being done on classification and hedging. In these areas, Islamic financial institutions are in the same position as conventional banks, so instead of covering those subjects, this article will cover some issues that are unique to Islamic finance.

In very simple terms IFRS 9, to a greater extent than IAS 39, requires equity-type products to be accounted for at fair value while, in most circumstances, permitting basic debt-like products to be accounted for at an amortized cost. Apart from the difficulty and cost of determining fair values, an amortized cost produces less volatility to income statements. Consequently, most financial institutions prefer to use an amortized cost as far as possible.

## Sukuk

Prior to 2008, most Sukuk included an obligation by the originator to buy back the Sukuk asset(s) at a future date at a price fixed at the

time of the issuance. This fixed price might be quite different from the market value of the asset(s) at that future date. The buyback obligation provided a fixed maturity date and capital certainty to investors. From 2008, it was concluded that this fixed price buyback obligation did not comply with the Shariah principle that risk should be shared equally between partners to a transaction, because the majority of the risk lay with the originator.

Consequently, AAOIFI and others encouraged subsequent Sukuk issuances to be on the basis that the buyback price of the Sukuk asset(s) is not fixed in advance but is at the market value at the date of maturity.

The practice developed that when marketing a Sukuk facility, rather than offering a fixed price buyback, an expected return would be stated, subject to the performance of the underlying asset(s). The originator selected assets with the aim of generating the expected return.

The resultant lack of capital certainty did not affect the accounting treatment for Sukuk, which continued to be mainly at an amortized cost. This is because IAS 39 requires consideration to be given to 'expected' cash flows.

IFRS 9, however, refers to 'contractual' cash flows rather than expected cash flows. Some argue that this means that without a fixed price buyback, it may be difficult to account for Sukuk at an amortized cost. Sukuk would then have to be accounted for at fair value.

## Mudarabah and Wakalah

For many unrestricted investment accounts-type Mudarabah transactions, it may be that the accounting under IFRS 9 will be the same as under IAS 39. However, because the returns can be characterized as profit-sharing, some argue that Mudarabah transactions fail to meet the criteria for an amortized cost, and therefore will have to be accounted for at fair value. The Malaysian Accounting Standards Board (MASB) is lobbying the IASB to obtain greater clarity, and indeed flexibility, so as to ensure that these transactions continue to be accounted for at an amortized cost.

This situation may also be relevant to some Wakalah structures, although Wakalah has not been the subject of lobbying by the MASB.

## Conclusion

In 2013, the IASB established a consultative group to focus on challenges that may arise in the application of IFRS 9 to Islamic finance. Unsurprisingly, one of the group's main conclusions was that for any transaction or product, an analysis of contractual terms is critical. I can only concur.☺

# Alternative asset classes to the fore in 2017?

Given low interest rates across the globe, the hunt for yield has driven many investment managers to increase their exposure to alternative asset classes. In this article, STUART JARVIS focuses on the asset-backed alternative asset classes of real estate, infrastructure and aircraft and maritime finance.



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Commonly defined as any investment outside of publicly traded long-only equities and fixed income securities, the alternative investment market has enjoyed a buoyant 2016. The question for investors, large or small, is whether 2017 will continue to match investor optimism.

## Real estate

Real estate holds up well when faced with challenged growth and lacklustre returns in more mainstream markets, as witnessed in 2016. The yield spread between property and bonds remains at or above their long-term average, underling the attraction to the sector and with analysts predicting limited risk of values declining.

Traditional headwinds to the real estate sector have not been widespread as follows:

- The oversupply of new build properties relative to the letting market typically leads to lower rents and capital values. However, such oversupply has not been widely apparent in 2016. Part of this is due to restraint on the part of lenders, whose previous excessive lending activity has historically led to higher capital flows as well as softer investment yields. At a macro level, commercial real estate construction and lending activity appears disciplined.
- Economic recessions cause increased unemployment, weaker tenant demand and hence increased vacancy. For the last year however, the major developed markets have seen relatively stable economies and stable to declining unemployment rates. Both have helped support tenant demand.
- Rising interest rates increase the cost of capital in the economy and impact capital values. 2016 was resilient to any rate rises; however, the year ahead may be more challenging. In the meantime, negative interest rates in Europe and Japan may create further capital value upside. The actions of the European Central Bank could broaden to further bolster property markets in France, Germany, Spain and Italy.

Despite the ever-present threat of a weakening in the global macroeconomic environment, real estate should continue to perform well during the near term, supported by sound fundamentals and disciplined investing.

## Infrastructure

An abundance of private finance in 2016 meant, and continues to mean into 2017, that investors are turning to infrastructure as an asset class with reliable income streams. 2016 was not without its negative short-term impacts, with factors such as currency devaluation, oil price decline and the slowdown of Chinese economic growth all playing a part. Looking back at 2016, and projecting forward into the year ahead, key themes include the following:

- Mature economies remain the most attractive for long-term infrastructure investment. North America, with its mature, stable economy, major infrastructure backlog and massive investment gap continues to have massive potential for investors.
- Regional demographic changes affect both the amount and type of social infrastructure spending. Ageing populations in the developed markets like Western Europe and Japan require an increasing provision of healthcare facilities. Conversely, countries in Asia Pacific, the Middle East and sub-Saharan Africa increasingly require more schools for their burgeoning youth.
- Growing urbanization and prosperity in emerging markets will require continued large-scale infrastructure finance into water, power and transportation. Alongside these basics are the equally pressing investments required into consumer-led sectors that provide and distribute the raw and finished materials for consumer goods.
- Emerging markets will need to develop far more effective business environments for investors. Unpredictable regulatory regimes, bureaucratic delays and fungible land rights all combine to stifle much-needed infrastructure investment.

## Aircraft and maritime markets

The aircraft and maritime markets have been affected by the same global macro factors, albeit with differing outcomes as follows:

- Shifts in global demographics and population growth rates, coupled with long-term economic growth in developing markets, have had marked implications for the maritime and aviation sectors. The middle class is growing in the emerging economies of Asia, Africa and Latin America where disposable incomes are driving growth in demand for both outward travel and inward flow of commodities and finished goods.
- A strong dollar and low oil prices have had a favorable impact on the aviation market and boosted profits. Industry margins remain near all-time highs, with cost controls now paying dividends. The shipping industry similarly benefits, with the demand for oil tankers having picked up and the operating costs of ships having gone down due to the lower oil prices.
- Fueled by low interest rates and stretched loan tenors, the container shipping industry especially is, however, reported to be over-leveraged at a low point in the cycle. Industry debt levels have risen sharply, with commentators concerned that many carriers could come under severe stress and remain vulnerable when global interest rates normalize.

## Conclusion

The two overriding trends affecting the alternative asset classes investment market in 2016 and into 2017 are the effects of a low interest rate environment and cheaper oil prices. Both are fueling a flight to alternative asset class investment yields and fueling, more broadly, an economic resurgence. Neither will necessarily remain low and accurately calling when their eventual rise will start is the challenge for 2017. ☺

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# Aircraft financing a potentially win-win proposition for Islamic financiers

The commercial airline industry is a global phenomenon which has been on an exponential growth trajectory over the past half century since mass air travel was first made possible through the advent of large capacity, jet-powered airliners. WESLEY POLLARD and CHARLES YETERIAN dissect the aviation financing sector.



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The industry statistics make impressive reading and are collated by the International Air Transport Association (IATA) which is the trade body for the sector representing 264 airlines or approximately 83% of scheduled air transport services. According to IATA, there are more than 100,000 flights a day carrying 3.7 billion passengers and 50 million metric tons of freight per year on 26,000 aircraft flying on 51,000 routes. The industry generated revenues of US\$718 billion in the last financial year but the economic multiplier effect of aviation means that an estimated 3.5% of global GDP relies on this industry.

One of the fundamental characteristics of the airline business model is its capital-intensive nature given the aircraft, the means of service provision, are very expensive to acquire with unit purchase prices that can be up to US\$300 million depending on the aircraft type. The manufacturing sector for passenger aircraft over 100 seats is dominated by the US Boeing Company (Boeing) and European Airbus Group (Airbus) which have a relatively equal market share. Between them, Boeing and Airbus currently deliver 1,400 new aircraft per year with a cost to airlines estimated at US\$125 billion.

The financing of both these new deliveries and existing fleets draws on financing sources from around the world of which an increasingly important contribution comes from Islamic financing. In fact, the key feature of aircraft as a long-lived asset which has an intrinsic and quantifiable value is particularly suited to this method of financing and it's becoming more attractive to airlines beyond just those with an Islamic connection in their ownership or base of operations. The almost US\$1 billion UK government-backed Sukuk issued by Emirates Airline to finance four A380 deliveries in 2015 is just one example of an innovative product from the Islamic financing stable that has been adapted to the aircraft financing arena. Ijarah of commercial aircraft is a prime example of Shariah compliant financial services offering a good opportunity.

## Review of 2016

The current (2016) year is shaping up to match 2015 as the most successful in commercial aviation history from a profit perspective. The US\$35.3 billion in net profits reported in aggregate in 2015 by the world's airlines was the first time that a 'normal' level of profit, one that exceeded investors' weighted average cost of capital, had been achieved by the industry.

However, certain regions of the world, particularly North America, had more than a fair share of this profit to the detriment of the African and Latin American regions that were adversely impacted by local economic challenges. In 2016, airlines in the Middle East/Asia and Asia regions are expected to show a sustainable level of profits.

A great deal of the profit improvement over the past couple of years has come from relatively low oil prices that began to decline in the latter half of 2014 and efficiency gains as more new technology and fuel-efficient aircraft enter service. Airlines have also become more proficient in driving down non-fuel costs and boosting ancillary revenues but, perhaps, an equivalent contribution has resulted from disciplined (generally speaking) capacity management with record high load factors and aircraft utilization. As a consequence of these factors, the majority of airlines have been generating strong levels of surplus operating cash flows which they have been using to pay down debt or invest in new equipment. This period of improved profitability has also helped to strengthen airlines' financial metrics and make them more bankable to lenders and investors from a credit perspective, especially in the current low cost of financing environment.

## Preview of 2017

Many industry commentators have speculated that the current operating environment for airlines is 'as good as it gets' in terms of profitability and the industry has reached the 'top of the cycle'. Evidence cited is from slowing passenger traffic and weak global GDP growth, the trend for declining yields in both passenger and freight markets and the potential for over-capacity due to Airbus and Boeing increasing production rates on their most popular single-aisle models. This doesn't necessarily mean the industry is immediately set on a down-cycle but there is a growing acceptance that low oil prices and insatiable traffic demand growth will not hold sway indefinitely even though a sudden material change is unlikely.

## Conclusion

The global airline industry consumes an enormous amount of capital expenditure that, for the most part, requires external financing to support aircraft acquisitions. Boeing forecasts the need for approximately 40,000 new aircraft deliveries costing US\$6 trillion over the next 20 years which provides exceptional opportunities for Islamic financing providers to tap into this demand. The need for many European and US banks to accommodate impending Basel III regulations should also reduce some of the fierce competition in the aircraft financing arena thereby helping to improve returns. A financially healthy airline industry, the returns available and a good track record of the asset class in value retention combine to make the aircraft financing sector a potentially win-win proposition for Islamic financiers. (E)

# Crowdfunding: Building on the momentum

There can be little doubt of the impact that crowdfunding has made in recent times. CRAIG MOORE thinks that it's logical that the combination of both Islamic finance and crowdfunding, ie Islamic crowdfunding, has the potential to be a real game changer.



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The global crowdfunding industry was valued at US\$34 billion at the end of 2015 according to the Massolution Crowdfunding Industry 2015 report and is forecasted to grow at a compound annual growth rate of 26% during the period of 2016-20 according to Research and Markets's Global Crowdfunding Market 2016-2020 report. Islamic finance is also enjoying strong growth, with total Islamic banking assets valued at US\$1.35 trillion and predicted to reach US\$2.6 trillion by 2020, according to the State of the Global Islamic Economy 2015/16 report by Thomson Reuters.

**“ It is important that regulations are shaped in collaboration with industry players to build a supportive framework that helps guide and nurture the industry while protecting consumer interests ”**

Islamic crowdfunding is essentially crowdfunding developed and delivered in line with Shariah principles. The growing Muslim population is young, tech-savvy and constitutes around 23% of the global population, according to Pew Research Center. Yet according to the World Bank, around 1 billion Muslims are unbanked so there is significant financial power to be yielded. Islamic crowdfunding is one of the rising fintech opportunities to connect latent financial power with considerable economic and societal impact.

## Review of 2016

2016 has been a seminal year for Islamic crowdfunding and one in which we really saw proof of concept. There has been an emergence of different models of Islamic crowdfunding platforms across a wide geography. Debt and equity-based platforms have provided a new stream of funding to SMEs, while investors have access to a new, diversified asset class and healthy returns. Donations and rewards-based platforms have been a powerful force for good in different communities. The impact has been far-reaching and many of these platforms are already delivering a host of benefits, not only to their users, but to society as a whole. One example is a real estate crowdfunding platform based out of Singapore, which contributed to the building of 5,000 affordable homes for low-income people in Indonesia. This is inspiring

evidence of the influence of crowdfunding platforms and the tangible community benefits they can deliver.

The past 12 months have also seen a dramatic increase in the general awareness of Islamic crowdfunding. For an industry that was unknown two years ago, there has been a real surge in media coverage and conversation. The establishment of the new Islamic Crowdfunding Alliance is evidence of the appetite for global Islamic crowdfunding, as are the awards ceremonies now recognizing the industry's biggest contributors.

2016 has been an exciting and encouraging year, with many new market entrants, greater exposure and several exciting success stories, setting a positive tone for the next 12 months.

## Preview of 2017

2017 looks set to be a year of growth and consolidation for the global Islamic crowdfunding industry. The many platforms that have been established now need to build scale and grow.

As with any new industry, it will be critical to continue to educate the market and build awareness of the societal benefits it can bring. Islamic crowdfunding is based on ethics and values and appeals to an audience of both Muslims and non-Muslims motivated by the broader concept of ethical finance. It will be key to engage and educate the audience so that they embrace the concept, drive word of mouth and actively contribute. A continual frustration to many commentators involved in traditional Islamic finance is the lack of harmonization, especially at a global level, around structures and regulations. While crowdfunding's technology-centric foundations increase the opportunity to expand product offerings across jurisdictions by exploiting operational efficiencies and agile deployment practices, it's important that the same issues affecting traditional providers are minimized, where possible, to nurture the growth of the industry. Moving toward standardized Islamic finance will be an important step to maximizing the comprehension of the concept and optimizing participation.

As a new industry, regulation will need to be outlined and implemented. While a number of countries have been proactive in providing regulation or regulatory guidelines, many will need to define their regulation of crowdfunding. It is important that regulations are shaped in collaboration with industry players to build a supportive framework that helps guide and nurture the industry while protecting consumer interests. The role of the government is also key in driving growth. Government initiatives and endorsements that facilitate the establishment of crowdfunding platforms, raise awareness and encourage participation will all have a positive impact on the adoption and future success of crowdfunding.

## Conclusion

The Islamic crowdfunding industry may still be in its infancy but there is a good deal of optimism for the future. Activity from the past year alone demonstrates that there is a lot to gain from crowdfunding and the potential benefits to the community, the economy and society cannot be underestimated. With a potential global scope and evident consumer demand, the 2017 outlook for Islamic crowdfunding is looking bright indeed. ☺

# The real deal with Islamic capital market trends

According to some estimates, the Islamic finance industry accounts for US\$2 trillion of assets worldwide, and yet only 1% of global financial assets. IMRAN MUFTI anticipates that the total volume of Sukuk issuance in 2016 is expected to come in under the amount issued in both of the previous two years.



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The mismatch between the huge number of potential investors (approximately 1.6 billion Muslims worldwide) and the small amount of investments actually realized has historically led practitioners to predict a surge in growth. While the market continues to grow, the anticipated spike has yet to materialize. The generally precarious situation for capital markets globally has hampered growth in Islamic capital markets too this year.

## Review of 2016

While 2016 saw a number of high-value Islamic corporate financings, sovereign Sukuk issuances have really taken centre stage. Pakistan returned to the market after an absence of almost two years, Qatar issued Sukuk with a total value of over US\$400 million and Bahrain completed a dual tranche transaction that was heavily oversubscribed.

**“ While practitioners would welcome increased regulation to allow for easier cross-border transactions, a growing awareness of the potential of Islamic finance has led to some regulatory changes ”**

West Africa has seen a particular uptick in the use of Sukuk, with sophomore issuances by the governments of Cote d'Ivoire and Senegal, and a debut issuance by the Republic of Togo, all of which listed on the Bourse Régionale des Valeurs Mobilières with a combined issuance of CFA766 billion (US\$1.24 billion). We expect to see increased Islamic financing activity in the region as the West African market continues to focus on infrastructure sectors like telecommunications, education and health, all of which are well suited to Shariah compliant financing because of their link to the real economy.

Elsewhere, other sovereigns have taken a strong top-down approach to accelerate growth. In August, Indonesia launched a 10-year Islamic finance master plan which includes initiatives touching on

capital adequacy, human resources development, governance and consumer protection, together with a flagship policy of increasing the use of Sukuk of up to 50% of total debt issuance in 10 years' time.

The figure currently stands at around 13% of outstanding government debt. Similar policies have yielded impressive results for Oman. Despite only allowing Islamic finance services in late 2012, in June this year Oman's Islamic banking sector accounted for around 10% of the country's assets. By contrast, it took Turkey and Indonesia over 20 years each to reach a figure of 5%.

Other GCC countries have not shown the same enthusiasm for Islamic finance this year, however, with many preferring to issue conventional debt over Sukuk due to its perceived ability to attract global investors. Qatar's recent Sukuk issuance was overshadowed by an earlier conventional bond of more than double the value, and while Saudi Arabia's US\$17.5 billion bond sale made history, there was a surprising absence of a Shariah compliant instrument. Meanwhile, progress toward the creation of a new UAE wide national regulator to set standards for Islamic finance products is slow.

## Preview of 2017

There are a number of high-profile Islamic finance transactions on the horizon as we look to the year ahead. It is widely anticipated that Nigeria will issue a sovereign Sukuk facility in the first quarter after unforeseen circumstances delayed its planned issuance this year. Similarly, Djibouti is expected to use Sukuk to fund infrastructure development in 2017, and has been working with the IDB to create a framework which will allow government and state-owned enterprises to issue.

In October, the finance minister of Saudi Arabia, Ibrahim al Assaf, publicly stated that the Kingdom is contemplating issuing Sukuk in the future. He did not state, however, whether any further sale would be local or global. In addition, any further market participation by Saudi Arabia will be heavily influenced by the changing price of oil, a market trend that is hard to predict.

Elsewhere in the Gulf, we can expect the government of Dubai to look to the Islamic finance markets for a US\$3 billion financing intended to support the expansion of Al Maktoum International Airport.

## Conclusion

Although the Islamic finance markets have been relatively flat in 2016, particularly in jurisdictions where Islamic finance is more established, there is good reason to be optimistic about the year ahead.

While practitioners would welcome increased regulation to allow for easier cross-border transactions, a growing awareness of the potential of Islamic finance has led to some regulatory changes, such as Nigeria's recent ruling that grants liquidity status to Sukuk. In addition, the aforementioned transactions point to continued interest in, and the buoyancy of, the Islamic capital markets. (2)

# Shariah compliant derivatives – a new era?

The Shariah compliant derivatives market continued to grow during 2016. YUSUF BATTIWALA feels 2017 will be a crucial year for the market. Among the challenges facing the industry are regulatory changes implemented in the wake of the global financial crisis which require certain market participants to put in place margin arrangements for uncleared over-the-counter (OTC) derivatives transactions.



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We saw increased standardization of products in 2016 with the publication of template documentation for Shariah compliant foreign exchange (FX) forwards by International Swaps and Derivatives Association (ISDA) and International Islamic Financial Market (IIFM). With the squeeze on liquidity in the Middle East, 2016 witnessed increased appetite for derivatives-based financing transactions including Shariah compliant repo and total return swap transactions.

## Review of 2016

Further standardization of Shariah compliant derivatives documentation took place in 2016. ISDA and IIFM published template documentation for Shariah compliant FX forwards. The documentation is intended to work in conjunction with the ISDA/IIFM Tahawwut Master Agreement (the TMA), the industry standard Shariah compliant derivatives master agreement. Although we saw an increased uptake and use of the TMA in 2016, the market's approach to documentation remains fragmented, with a number of institutions continuing to use bespoke documentation which inevitably results in increased negotiations and a greater lead time for the execution of deals.

Profit rate swaps and FX forwards provide the core of the Shariah compliant derivatives market, but there was renewed focus on more structured transactions such as structured FX options and commodity derivatives.

2016 was a particularly busy year for the Shariah compliant repo and total return swap market. The lack of liquidity in the Middle East in particular saw Islamic institutions looking for ways to utilize their assets to seek funding. Despite the publication by IIFM of standard

**“ Development of market standard documentation which provides for a title transfer arrangement would be a welcome development for market participants ”**

collateralized Murabahah documentation, the market continued to use bespoke documentation given the need for a title transfer arrangement underpinning the structure as opposed to a security arrangement which the IIFM documentation provides for.

## Preview of 2017

With regulatory changes coming into effect in March 2017 in the US, Europe and elsewhere, a number of market participants will be required to put in place margin arrangements for uncleared OTC derivatives transactions. In anticipation of this, ISDA and IIFM are working on developing market standard Shariah compliant collateral documentation. However, coming up with a universally acceptable structure is a challenge and it remains to be seen how institutions will put into effect their collateral arrangements given the issues with the enforceability of netting and set-off (which Shariah compliant derivatives documentation are premised on) in a number of Middle Eastern and other jurisdictions. One solution to address this issue has been for Middle East-based institutions to set up SPVs in netting-friendly jurisdictions such that US and European institutions can transact with such entities with certainty as to the enforceability of the netting and collateral arrangements underpinning their derivatives transactions.

We expect to see continued appetite for Shariah compliant funding solutions in 2017 and expect an increase in Shariah compliant repo and total return swap transactions. Development of market standard documentation which provides for a title transfer arrangement would be a welcome development for market participants.

## Conclusion

2016 witnessed the further development of the Shariah compliant derivatives market with a wide variety of transactions being entered into and the further standardization of certain products. 2017 is likely to prove a challenging year for the market as it accommodates margin rules for uncleared OTC derivatives transactions. The lack of a favorable legal regime in a number of jurisdictions with an active Islamic finance market is likely to be a hurdle although the hope is that recent legal and regulatory reforms in such jurisdictions are accelerated to allow for legally enforceable collateral arrangements to be put in place.☺



# The Islamic finance education landscape

The approximately US\$2 trillion Islamic finance industry has seen significant growth over the past 20 years. According to Thomson Reuters, in the past decade alone, the Islamic finance industry has averaged double-digit growth. Even though the Islamic finance industry currently is going through a consolidation phase due to low oil prices, it is still estimated to continue on a positive growth trend and by 2020, it is expected to reach US\$3 trillion according to some projections or US\$6 trillion according to others. MUJTABA KHALID scrutinizes the Islamic finance education landscape.

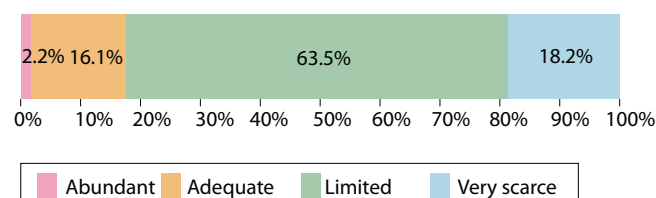


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This is indeed very heartening for all proponents of the Islamic finance industry but this also poses a unique risk – a lack of qualified human resource capital. According to The Islamic Outlook Report 2016, a survey of high-profile Islamic finance practitioners from the Middle East North Africa and Southeast Asia (MENASEA) region, revealed that almost 80% thought that there was limited or very scarce availability of qualified human resource capital. When asked about the threats facing the Islamic finance industry, the biggest internal threat cited was a shortage of qualified personnel.

This is where Islamic finance education and training comes in where in order for the industry to progress in the short to medium term, professional qualifications and specialized short courses are the answer as opposed to a Master's program or a doctorate. Thus, this report will also look at the developments in the Islamic finance professional training space during 2016, with an emphasis on new

Chart 2: Availability of qualified Islamic finance professionals



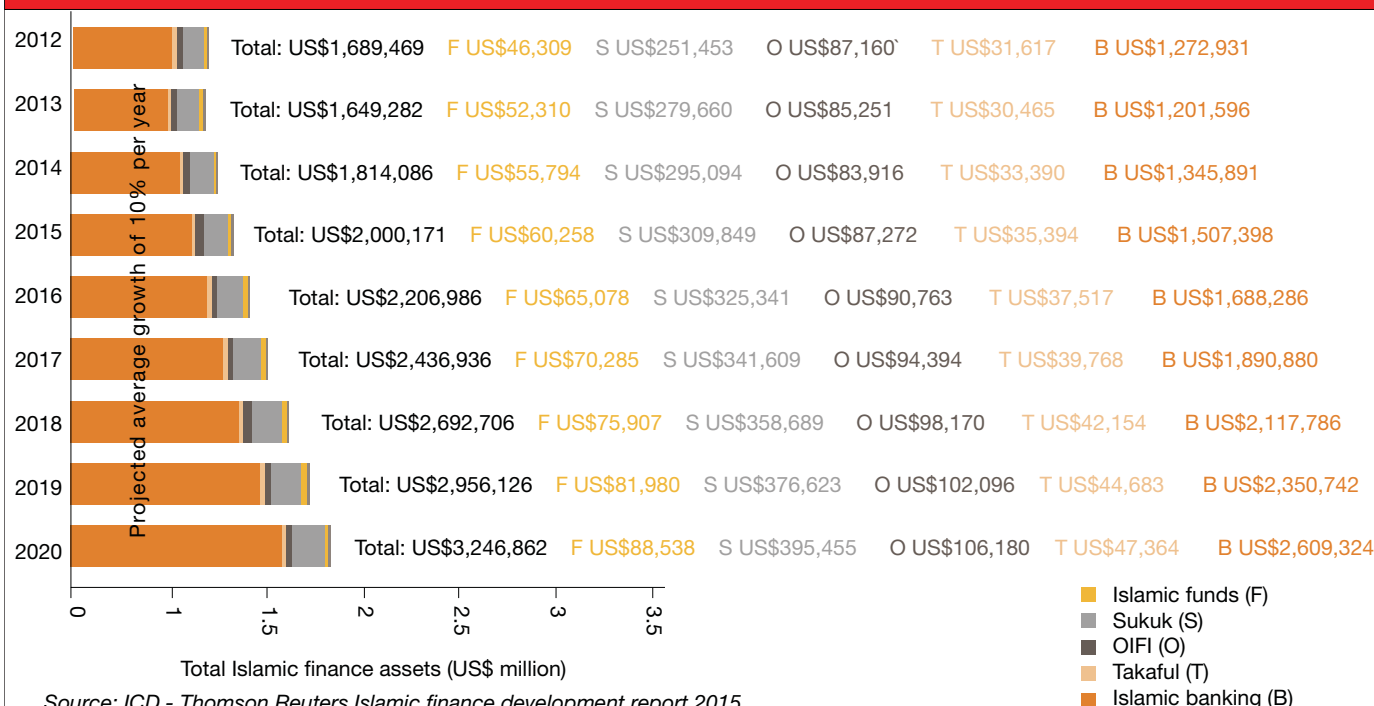
Source: Survey from Islamic Finance Outlook Report 2016 by Finance Forward

developments and innovations in the market.

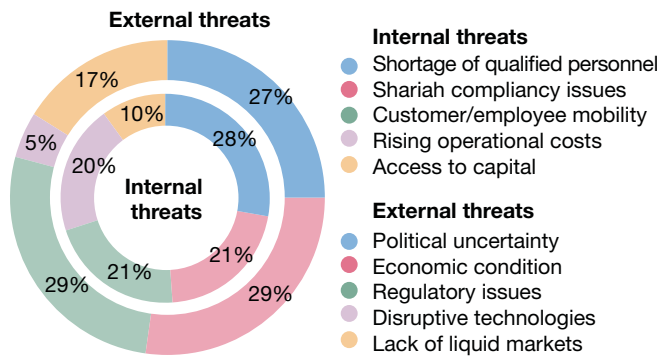
## Review of 2016

A major development in Islamic financial training came from Pakistan (the second-largest Muslim country in terms of population), when the State Bank of Pakistan, backed by the UK's Department for International Development set up three Centers of Excellence in Islamic finance education in the cities of Karachi, Lahore and Peshawar. This was a major step forward in the promotion of Islamic finance in Pakistan and is viewed favorably by the industry. From the three centers, the

Chart 1: Growth trend of Islamic finance industry



**Chart 3: Biggest threats facing Islamic banks**



Source: Survey from Islamic Finance Outlook Report 2016 by Finance Forward

one set up in Karachi in partnership with the Institution of Business Administration seems to be the most active and relevant.

Another major development seen in the professional Islamic finance qualification space was the Bahrain Institute of Banking and Finance (BIBF) and the University of Bolton MBA Islamic finance progression route agreement – the first of its kind in the world. The BIBF is the training arm of the Central Bank of Bahrain and prides itself in launching the first-ever Islamic finance professional qualification, the Advance Diploma in Islamic Finance (ADIF), in 2001. According to the progression route agreement between the BIBF and the University of Bolton, ADIF graduates need to spend four intensive weeks at the University of Bolton UK campus. They will also have to submit an applied thesis, upon completion of which, they are awarded an MBA in Islamic finance from the University of Bolton.

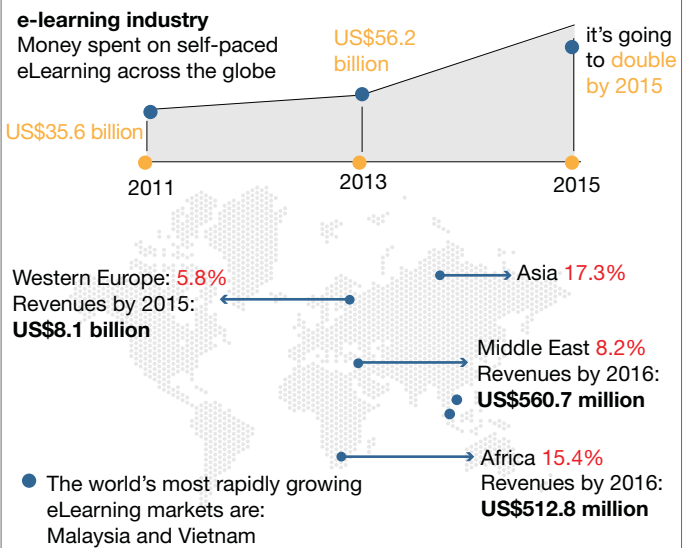
## e-Learning

2016 also witnessed a shift by major Islamic finance organizations toward online courses and programs. The IDB's Islamic Research and Training Institute (IRTI) signed an agreement with edX, an online learning platform founded by the Massachusetts Institute of Technology and Harvard University, to deliver massive open online courses in Islamic economics, banking and finance through edX. The IRTI offers through the edX platform free online courses for capacity development under a project aimed at expanding access to knowledge in Islamic economics, finance and banking to support the development of a dynamic Islamic finance sector.

We also saw the IFSB launch its Standards e-Learning Portal which aims to facilitate the implementation of IFSB standards. The portal complements the current implementation activities being conducted by the IFSB, including the FIS Workshop Series and technical assistance which are aimed at increasing the understanding and adoption of the standards, guidance notes and technical notes issued by the IFSB.

2016 also saw Islamic finance's most prominent standard-setting body, the AAOIFI, partner with the BIBF to bring all AAOIFI

**Chart 4: The e-learning industry**



Source: <http://elearninginfographics.com/elearning-statistics-2014-infographic/>

standards onto an e-learning platform. The BIBF inaugurated the portal in November 2016 at the AAOIFI Conference in Bahrain. The first phase of the launch is planned to be in January 2017 and shall see all Shariah standards in English put on an online e-learning platform followed by accounting, auditing and governance standards.

## Preview of 2017

The next year will see more students and professionals opt for high-quality online e-learning. This is also in line with the general global trend in education. According to the e-Learning Report 2014-16, the fastest-growing markets in this space are Malaysia and Vietnam. The report states that Africa and the Middle East are seeing the highest growth percentage increase in e-learning in the world. All these are mostly Muslim-majority jurisdictions and will have a huge positive impact on Islamic finance training as well as the entire industry as a whole.

## Conclusion

Although there is an acute skill gap in the Islamic finance space, it is very pertinent to understand that there is no lack of graduates with Islamic finance degrees or qualifications. These graduates unfortunately are of little value to Islamic financial institutions as they need to spend time and resources to bring new hires up to speed on the actual applied and operational side. As someone who has been part of the industry as well as the training and education side of Islamic finance, I strongly advise educational and training institutes to concentrate on applied hands-on teaching rather than a heavily theoretical curriculum. Going forward, I would like to see more of this mindset permeate into our system.☺

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# FAMILY OFFICE



## Much work needed to develop Islamic products for Islamic family offices

The three main areas of focus for single family offices (SFOs) are wealth management, administration of the corporate structures and trusts and concierge services for members of the family. The growth of the Islamic family office, which is an SFO managed on Islamic principles, has grown more prevalent especially in recent years. STEPHEN F CUTTS posits that it is clear more will follow as many SFOs change from conventional to Islamic on the foundation of more Islamic solutions being available globally.



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Islamic finance law promotes the use of capital in a way that benefits society in general while keeping in line with Shariah principles. However, Islamic SFOs are no less demanding of returns than conventional ones. As Islamic SFOs grow and become more international, they are colliding with the problem of a lack of Islamic solutions and products.

However, many Islamic SFOs investing internationally do not have Shariah options available to them. Financing interest may be a tax advisor's choice to reduce taxable income but most countries still do not offer tax relief for the Shariah option. What is clear though is that many countries are now focusing on improving infrastructure and encouraging investment at home. Islamic family offices are better able to diversify abroad and support their domestic environment,

“ **Many Islamic SFOs investing internationally do not have Shariah options available to them** ”

especially as many own significant businesses in their home countries.

Malaysia, with its blend of common law and Shariah law, now leads the world in Islamic finance ideas and products. However, it continues to be hampered by the weak offerings of its offshore center of Labuan which could provide a stronger conduit for investment into Malaysia and Asia in general. However, currently Singapore and more lately the UAE (offerings from both the Dubai International Financial Center and Abu Dhabi Global Market) offer stronger solutions for Islamic family offices.

# “Increased internationalization of investments creates its own challenges in ensuring that the SFO retains its Islamic status”

## Review of 2016

2016 started on a negative note with growth slowing in China and falling commodity prices (especially oil) putting pressure on returns. The drive for economic diversification and jobs-for-nationals policies within many GCC countries created an uncertain and mixed environment for many SFO investments. Saudi Arabia is the latest in the line of Gulf countries to attempt to diversify its economy and modernize under the guise of a Vision Statement for the future.

One of the more momentous announcements of the year in the GCC was the declaration that value-added tax will be introduced from 2017. While having no direct impact in 2016 financially, SFOs managing businesses – which most are of course – will have to avail themselves of a whole new skill set.

The range of Islamic products and innovations continued to expand in 2016 although Sukuk market issuance fell to 43% in 2015. Indications are that the level is not yet back to the high levels of 2012 and 2013.

But one of the biggest international events affecting all SFOs, Islamic or otherwise, is the unexpected result of the US presidential elections. This is already having repercussions on how SFOs decide to invest in 2017 and beyond.

2017 will continue to see innovation and consolidation develop. AAOIFI will continue to have a growing role in standardizing Islamic finance structures. Although this is a painstaking progress, progress will continue to be made.

The continued growth of Islamic SFOs should continue as more families in Asia and the Gulf become wealthier. But increased internationalization of investments creates its own challenges in ensuring that the SFO retains its Islamic status.

## Preview of 2017

Two of the greater challenges for Islamic family offices in 2016 with repercussions for 2017 were the US presidency and Brexit votes. Family office investment advisors suddenly find themselves investing for the short term not knowing what lies ahead, and it is likely this tendency will continue for a while.

The growth of Islamic banks in 2015 and 2016 converged with that of conventional banks. Islamic banks are generally more expensive solutions in a competitive environment, especially in the private banking sector. Many Islamic SFOs therefore spread their banking requirements between Islamic and conventional banks. 2017 must see Islamic banks become far more competitive or accept that their role will only be a niche one in the global banking market.

As the world moves toward more transparency and away from trusts as a tax-planning tool, Islamic trusts holding assets onshore will start to be used for purely succession purposes. This will require changes in legislation that probably will start to happen in 2017. Many Islamic SFOs currently use trusts to hold their non-domestic assets. These trusts will hold assets for beneficiaries in accordance

with their rights under Islamic law, but will enable the assets to be held together for all heirs. Malaysia could take a lead in this area.

## Areas of change

Islamic SFOs continue to find themselves hampered by a lack of quality Islamic product and services which, although improving in 2016, remains insufficient. This is partly due to a lack of suitable investment vehicles as shown by, for example, Abu Dhabi Islamic Bank not being able to move forward with its Islamic trust offering. In time the market will provide solutions.

Simple measures such as a national Shariah board like the one introduced by Malaysia would also hugely benefit other countries by paving the way for harmonization and the streamlining of Islamic offerings. There are currently too many Islamic boards each delivering their own interpretation of Shariah.

Other countries too can do much more to put Islamic finance on a level with conventional finance. The UK introduced legislation putting certain Islamic finance structures on the same tax basis as interest on loans. More countries could and will do more in this area.

## Conclusion

In conclusion therefore, more Islamic families are converting their SFOs to Shariah compliant entities. However, much work still needs to be done to develop Islamic products for Islamic SFOs to invest in and work is needed to create new corporate and trust vehicles to hold Islamic assets and conduct business.

Countries too can do more to ensure that Islamic structures used by SFOs to invest are tax neutral when compared to conventional structures. Finally, the uncertainty created by unexpected political decisions will weigh on investment decisions in the short to medium term.<sup>(2)</sup>



# Islamic finance: Delivering actions today for a sustainable tomorrow

An important development in the last two decades has been the growing emphasis on responsible, inclusive and sustainable finance. The recurring global financial crises provided a dramatic reminder of the basic purpose of financial intermediation as a means to create sustainable value in the real economy. ROSIE KMEID writes.



*Rosie Kmeid is the vice president global corporate communications & marketing at Path Solutions. She can be contacted at rkmeid@path-solutions.com.*

**Being consistent with the long term preservation and development of the global economy, society and environment, sustainable, responsible and impact investing (SRI) and environment, social and governance (ESG) considerations are gaining significant momentum in a number of developed countries.**

To meet the world's expectations of gaining traction towards achieving economic stability and growth, Islamic finance is uniquely positioned to champion this cause, guided by the all-embracing Sharia principles which emphasize the protection of interest of mankind. Islamic finance complies with the Sharia rules which govern economic, social, political and cultural aspects of Islamic societies. In other words, the rules of Islamic finance place emphasis on the ethical restrictions underscored by Islamic values. Under this authority, Islamic finance is not only an alternative financial approach but also addresses the issues surrounding us today such as inequality, financial fragility and environmental hazard.

The value proposition of Islamic finance, one that advocates justice, sustainability, inclusion and fair globalization, has extended out to the global community. It is the inherent qualities of this relatively new finance model that have pulled interest from diverse backgrounds, because at the core of Islamic finance lies virtues that encompass both ethical and moral aspects in driving potential solutions to achieve economic stability and environmental protection.

## Crossover with ethics

Ethics in financial services has never caused so much attention. Ethical practices figure today as mainstream considerations in business decisions with regard to competitive advantage and financial performance. In recent times, a number of researches have been increasingly devoted to investigating the advantages of adhering to ethical standards in international finance. This circumstance goes with the fact that the existing standards are to a greater extent disputable. Ethical theories, developed mainly by Western scholars, are the current theoretical framework all financial institutions have at their disposal to ensure compliance with the spirit of the law.

The contemporary steps at introducing ethical principles to the United States' corporate environment through the adoption and integration of the Sarbanes-Oxley (SOX) Act of 2002 into the US financial system are an example of the global imposition of a particular set of Western values that they believe is equally valid and commendable, noting that other financial markets are facing similar levels of regulations with SOX style compliance.

However, compliance with SOX continues to be resisted mainly because of the substantial costs associated with it. Rather than comply, numerous financial institutions opted to "go dark" to avoid legal penalties, and many have chosen to launch their IPOs on foreign

exchanges in lieu of raising capital in the US market. This new regularity environment is burdensome to all financial institutions regardless of geography, as many do not have the infrastructure in place to handle the costs of complying. It is observed that scholars, jurists and analysts from think tanks concurred that governments should revisit the impact of codes of ethics, industry standards and regulations, so that financial institutions, being part of an 'ecosystem', can embed ethics in their decision making and operations at minimal cost.

In Islam, ethics is the fundamental principle that shapes the Islamic financial system. The same principle is criteria shared with ethical or impact investing. As such, ethics and SRI are indistinguishable from the system itself. The ethical behavior here stems from a desire to transcribe the religious beliefs into decent financial practices. Yet, there are considerable benefits in terms of greater relevance and scope shared between Islamic and ethical finance. This is a view that has much merit, as does the point made by the World Bank once that Sukuk can serve as a bridge between the worlds of Islamic finance and that of responsible investment.

## The rise of fintech and its impact on ethical finance

The growing importance of responsible, inclusive and sustainable finance and the preconditions necessary to sustain a value-based financial system required provision of access to a range of ethical financial products supplied through various delivery channels in a well regulated environment.

Evidence showed considerable disparities in access to ethical financial services between populations. With the technological revolution and digitization, we are witnessing the most significant transformational development of our era, one that is certainly positive and inclusive for these populations. Thus, fintech is increasingly emerging not only as a tool that improves financial performance, it is also emerging as an effective tool to increase efficiency and sustainability. Fintech has demonstrated that it can contribute efficiently to financial inclusion and sustainable development, providing new ways for excluded people to be better integrated and have a superior financial and social status, while ensuring that they have access to a wide range of financial products in line with their values. Rather than looking at the fintech revolution as unwelcoming, we ought to leverage on it to advance economic and social goals and to embrace it as an opportunity, because its potential social impact is significant.

## Conclusion

There has never been a better time where a convergence of developments have called for us to transmit the values of Islamic finance in addressing the challenges confronting us today; economic inequality, wealth gap, and environmental damage and degradation. The ideology of purpose that is beginning to dominate our days is one that finds acceptance and participation by society at large in the adoption of ethical behavior. In this game-changing trend creating both disruption and opportunities on a global level, leveraging on technology to accelerate innovation and meet the future needs of Islamic finance of contributing towards a more inclusive and stable global financial system is a growing imperative. ☺

# ASSET MANAGEMENT

## Ample areas for growth and innovation within Islamic asset management

2016 has been a year filled with surprises and in this report, RAMLIE KAMSARI seeks to dissect what these surprises mean for Islamic finance, particularly for the institutional asset management business and to further discuss what the landscape looks like for 2017.



Ramlie Kamsari is CEO of Nomura Islamic Asset Management. He can be contacted at [ramlie@nomura-asset.com.my](mailto:ramlie@nomura-asset.com.my).

### Review of 2016

There were quite a few surprises in 2016 as follows:

#### 1. Unexpected political developments:

- **Brexit:** The Sukuk market rode on the broader bond market rally which followed the 'Leave' outcome of the Brexit referendum. Despite concerns surrounding the fiscal health of GCC economies due to the weakness in hydrocarbon prices, the GCC Sukuk market held up well. Interest in GCC debt is self-evident from the strong demand seen in the jumbo debt issuances by GCC sovereigns. Notably, Saudi Arabia's record-setting issuance of US\$17.5 billion-worth of conventional bonds in October 2016 received bids almost four times that size (Islamic Finance *news*, the 9<sup>th</sup> November 2016). The Saudi finance minister also announced that Sukuk will be part of the country's future fundraising plans.
- **Trump's victory** in the recent US presidential election has thus far resulted in no observable impact on Islamic finance despite the initial rhetoric to limit Muslims' entry into the country. However, given his fluid position on various issues post-election, it remains to be seen if, and how, his administration will craft his campaign pledges into actual policy-making. Despite uncertainty surrounding his administration's social policies, markets appear convinced that his economic policies will result in meaningful fiscal stimulus for the US. The prospect of a wider budget deficit has convinced market participants that US

**Chart 1: Performance of FBM Emas Shariah, FBM KLCI Index and the FBM Top 100 Index**



— FTSE Bursa Malaysia EMAS Shariah index  
-- FTSE Bursa Malaysia KLCI Index – Kuala Lumpur Composite Index  
-- FTSE Bursa Malaysia Top 100 Index

Australia 61 2 9777 8600 Brazil 5511 2395 9000  
Europe 44 20 7330 7500 Germany 49 69 9204 1210  
Hong Kong 852 2977 6000 Japan 81 3 3201 8900  
Singapore 65 6212 1000 US 1 212 318 2000

Source: Bursa Malaysia

growth, and by extension, inflation, will accelerate. While this has been unambiguously good news for the US equity market, this expectation has led to a sharp reversal of US bond yields. Following that, more debt issuers in the Middle East, including the IDB has delayed the issuance of Sukuk to observe the impact of Trump's leadership on the regional bond market in general.

- The benchmark 10-year treasury has risen above 2.3% versus 1.8% just prior to the US presidential election. Rising bond yields in the US have resulted in the rout spreading across global bond markets, with emerging markets being particularly impacted. Sukuk markets have not been spared, and saw yields rising sharply on large emerging market outflows. Sukuk yields are expected to remain elevated in the short term amid a potential Fed hike, with market expectations of higher inflation levels.

## 2. Instability in the oil price:

- The decline in the oil price has shown to be positive for the fixed income market in general, including Sukuk, whereby huge issuance has been stemming out of the GCC region as a debt financing tool. For instance, Qatar in the second quarter of 2016 has seen a vast oversubscription of US\$14 billion for the global bond issued (US\$9 billion of issue against US\$23 billion of orders). (Bloomberg News, the 26<sup>th</sup> May 2016)
- While markets are still awaiting clearer policy direction from the Saudi government on the implementation of Saudi Vision 2030, a Saudi Arabia with a more diversified economy is expected to result in a deeper and wider corporate Sukuk market. At present, the Saudi debt market is dominated by a handful of quasi-government issuances with thin liquidity in the secondary market. A larger private sector typically leads to an increase of corporate issuances. On the demand side, a more matured financial market in Saudi will naturally lead to stronger demand for Sukuk issuances.

## Resilient Shariah equity performance

Shifting the discussion into Shariah equities, the S&P Dow Jones Shariah indices have shown evidence that most Shariah portfolios outperformed their conventional counterparts. For example, in the recent quarter, the exclusion of financial sectors combined with overweight positions in information technology within the index became the positive contributors for the overperformance.

Similar overperformance is mirrored in the Malaysian equity space. The FBM Emas Shariah Index recorded higher three-year returns against the FBM KLCI Index and the FBM Top 100 Index from November 2013 to November 2016 as illustrated in Chart 1.

## Increased interest stemming out of non-Islamic regions for Shariah investment solutions

The recent addition of Sukuk to some global indices put Sukuk on the radar of more investors from non-Islamic regions. JPMorgan's recent decision to include Sukuk in its EMBI Global Diversified, GBI-EM Global Diversified, CEMBI Broad Diversified and JACI indices is expected to boost the growth of the Sukuk industry as a whole from the existing assets under management (AUM) of US\$370 billion, according to Bloomberg News on the 29<sup>th</sup> August 2016. This inclusion comes after the addition of Malaysian local currency sovereign Sukuk into the Barclays Global Aggregate Index in March 2015.

## Notable trends and regulatory changes within the asset management industry

Let's direct our attention to Indonesia where the financial regulator, Financial Services Authority (OJK) has made it mandatory for

**“Islamic investment solutions can be seen as a promising avenue for building the stable nest for the future”**

investment managers to create dedicated Shariah outfits within the respective firms, as reported by Islamic Finance *news* on the 23<sup>rd</sup> November 2016.

This follows the earlier announcement by OJK to approve investment managers to invest between 51-100% of their Shariah mutual funds in overseas securities which has been welcomed positively by asset managers in Indonesia such as Schroder Investment Management Indonesia, BNP Paribas Investment Partners, Manulife Asset Manajemen Indonesia and Aberdeen Asset Management by launching their first global Shariah funds respectively, according to Asia Asset Management on the 2<sup>nd</sup> March 2016.

In Malaysia, the initiative by one of the largest pension funds in the world, the Employees Provident Fund to grow investments into Shariah assets via the introduction of a Shariah compliant savings scheme recorded a 50% take-up rate from the initial RM100 billion (US\$22.4 billion) allocation for the scheme since its launch in August 2016 and is getting the attention of fund managers.

Islamic pensions in Turkey and the rest of Europe, the Middle East and Africa also seem to be showing growth, especially in the privately funded funds. The Global Islamic Asset Management Report 2014 by Thomson Reuters suggested that a much more significant input could still come from state-funded schemes should the political factor be there.

## Preview of 2017

What is in store for 2017? Despite the surprises that have been discussed earlier, global economic momentum has accelerated considerably in the past few months and the current upward trajectory is likely to continue into 2017. We uphold cautiously optimistic views that secular themes in the equity space will drive industries including healthcare and technology to benefit from this economic trend. As for the fixed income landscape, with uncertainty surrounding the recent political changes, global rates may remain elevated into the first quarter of 2017.

## Conclusion

There are still ample areas for growth and innovation within Islamic asset management. Industry players need to figure out ways to attract more institutional investors for the sector to spur growth. In comparison to conventional funds, only 20% of total AUM are contributed by institutional investors whereas for the conventional side, AUM are at 70%. Islamic funds could also become more attractive to some non-Islamic investors that invest in socially responsible portfolios, a subsector that has grown a lot in recent years.

To achieve the aforementioned mission, the potential from Islamic pensions has to be explored. With the expansion of the middle class group and the emergence of a new generation who place heavy emphasis on social security, Islamic investment solutions can be seen as a promising avenue for building the stable nest for the future.☺

# Sukuk: The effective diversification tool in a volatile market

Sukuk continues to be a viable alternative for both Islamic and non-Islamic investors seeking to diversify their investment portfolios. With attractive relative returns to traditional fixed income assets, the volatility of this asset class has historically been less correlated with the global fixed income market. Sukuk issuers typically are from the fast-growing and most financially sound economies in the GCC and Southeast Asia, countries that are often underrepresented in many traditional bond indexes and funds. AHMAD NAJIB NAZLAN summarizes what happened in the past year and what we can look forward to in 2017 with regards to institutional investments.



Ahmad Najib Nazlan is CEO of Maybank Islamic Asset Management. He can be contacted at najib@maybank.com.

## Review of 2016

Global Sukuk issuance has been moderating since 2015 and we expect this trend to remain subdued this year and in 2017, with reference to rating agencies Moody's Investors Service and S&P (see Chart 1). New Sukuk issuance volumes remained subdued for the first half of 2016 at US\$40 billion. This has been driven by more challenging economic conditions in emerging markets and the GCC's move to tap conventional liquidity from international investors, as quantitative easing has been driving yields to zero or even negative rates in various markets.

The year saw low global growth, as markets sought leads to possible growths in the backdrop of weakening BRIC countries with Brazil, China and Russia facing recession. GDP growth has been revised downwards continuously in 2016, which was an uninterrupted trend from 2015 (see Chart 2). The slowdown in economic growth in China has led to overcapacity in many industries including cement, steel, coal and shipbuilding. Commodity prices were also down due to

**Policymakers in developed markets and many parts of Asia are increasing fiscal spending to complement monetary easing and support growth**

weak economic growth. Europe, Japan and China continued to implement monetary easing policies to bolster growth.

In our views, the environment of lower interest rates and high asset prices may see low asset returns in the medium term; developed world equities and fixed income do not offer value, rather relative value can be found in emerging market equities and fixed income over the medium term. 2016 was also punctuated by sharp corrections and equally sharp rallies as macroeconomic data and corporate earnings disappoint. Volatile markets are often a function of low visibility and weak economic growth.

Chart 1: Global Sukuk issuance for the period of 2001 to the first half of 2016

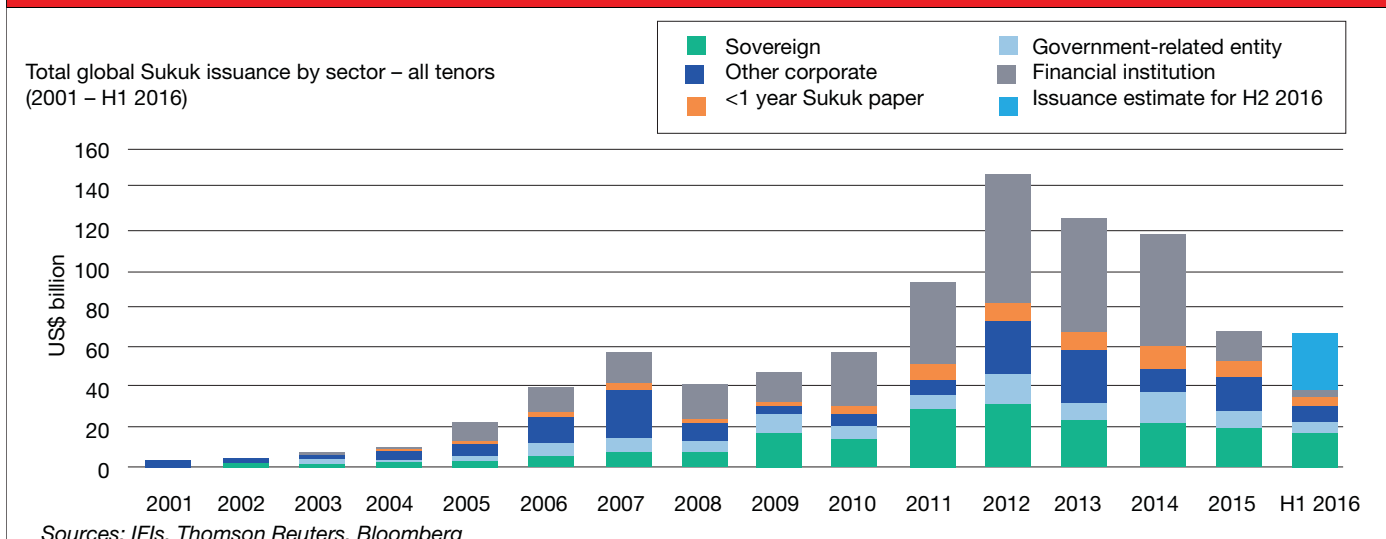
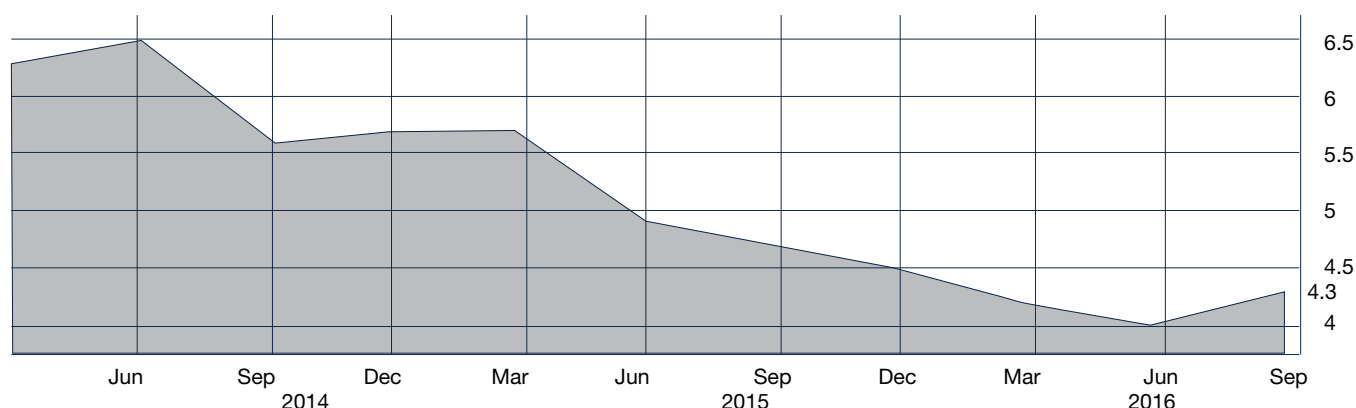


Chart 2: GDP growth for the period of the 31<sup>st</sup> March 2014 to the 30<sup>th</sup> September 2016



### Preview of 2017

The following are what to expect in 2017:

- Developed markets and Asian economic growth are expected to be subdued but stable to moderately better. Asian exports are still declining, albeit at a slower pace.
- Monetary easing in developed markets may have reached limits, eg in the US, Europe and Japan. Meanwhile, market players are expecting 1-2 rate hikes in the US in 2017.
- Policymakers in developed markets and many parts of Asia are increasing fiscal spending to complement monetary easing and support growth. Fiscal stimulus and infrastructure spending will likely pose an upside risk to earnings outlook and government bond supply.

- Binary outcomes could possibly lead to increased volatility, eg the US presidential election and the US Fed hikes. 2017 will see Malaysian elections, the UK to invoke Article 50 in the first quarter of 2017, French elections in April and German elections in September.
- The recent decline in the US bond market coupled with negative yields in Europe could be good news for the Sukuk market, which could see funds flowing in as investors shift their gaze away from developed markets and into this asset class.
- Sharp movement is expected in certain fixed income markets due to the recent increased market volatility, eg Malaysian government securities may provide attractive entry points for investors.

**“ Sharp movement is expected in certain fixed income markets due to the recent increased market volatility ”**

### Conclusion

Market volatility has increased in recent years. From a portfolio allocation standpoint, heightened volatility across asset classes usually coincides with macro turning points. All would agree that a certain level of volatility will continue in 2017 and beyond. Sukuk are increasingly featuring as an effective diversification tool in a volatile market, while showing evidence of low correlation with developed and emerging market US dollar-denominated asset classes. ☺

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# Will challengers come to the fore in 2017?

By the start of 2016, the global Islamic financial services industry had, according to the IFSB, exceeded an overall total value of US\$1.88 trillion. In Europe, Islamic finance continues to grow, particularly in Western Europe where real estate remains highly attractive for investors. According to property firm JLL, around 60% of all Gulf investment into the UK and Germany is now carried out on a Shariah compliant basis. SHAKEEL ADLI and PAULA WILSON delve further.



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*an associate in the same law firm and assisted in the drafting of this report. She can be contacted at paula.wilson@cms-cmck.com.*

## Review of 2016

There have been a number of significant developments in Europe in 2016 that are likely to impact 2017 and beyond. In April, the Islamic Fintech Alliance was launched by eight founding members of crowdfunding platforms with the aim of facilitating the adoption of fintech among Muslims across Europe.

In the UK, the decision to leave the EU has caused the value of the pound to steadily fall. This has been good news for investors, including Islamic investors such as Rasmala which acquired Abbvie House, a 55,958 square feet grade A office building located in Vanwall Business Park, Berkshire, for GBP24.5 million (US\$30.49 million).

Meanwhile, Germany's sovereign Sukuk issuance of US\$1 billion is expected by the end of 2016 (although this had not yet been completed at the time of writing). German real estate also remains an attractive proposition for Shariah compliant investors with Natixis Pfandbriefbank having provided a five-year GBP90 million (US\$112 million) Shariah compliant facility in May 2016 to a London-based investment company, the proceeds of which were used to part-fund the acquisition of an office building in Frankfurt.

In France, which has Western Europe's largest Muslim population, while the penetration of Islamic finance has not been as great as in, for example, the UK, 2016 has seen some notable growth and innovation, demonstrated most recently by SAAFI, an insurance and Islamic finance specialist, which launched its iFIS Islamic Gold Dinar Savings Plan for the French market. Major French financial institutions such as BNP Paribas, Societe Generale, Calyon and Crédit Agricole also all continue to remain active in the international Islamic finance market. In Central and Eastern Europe, the picture is less rosy and there has been very limited activity.

## Preview of 2017

Looking ahead to 2017, the impact of the aforementioned developments and the new Shariah compliant products that will emerge remains to be seen. Perhaps other Shariah compliant financial institutions will launch pension schemes in the UK or elsewhere (as Al Rayan in the UK has done) or crowdfunding platforms will begin offering Shariah compliant products throughout Europe.

In terms of regulation, the Islamic Finance Council UK and the International Shari'ah Research Academy for Islamic Finance are urging governments and Shariah compliant financial institutions in Europe and beyond to implement a mandatory independent audit of Shariah compliance in Islamic finance. It is hoped that this will lead to a greater degree of accountability.

It will be interesting to see how this, as well as the regulation of Shariah compliant financial institutions, develops over the next year or so.

In the UK, the government intends to invoke Article 50 of the Treaty on European Union by March 2017, although this timing may be delayed following the High Court ruling that parliament must give approval before Article 50 is triggered. It remains to be seen, perhaps as early as March 2019, what impact Brexit, and the run-up to Brexit, will have on the UK's dominant position on Islamic finance, although commentators have pointed out that challengers such as Luxembourg have a long way to go if they are to compete with the UK's hold on the market.

In Germany, KT Bank (which became the country's first Islamic bank when it launched in 2015) expects its customer base to include around 20,000 business and private customers by 2017. Three more Islamic banks may be joining KT Bank in Germany soon, as the Central Bank of Iran announced earlier this year that Parsian Bank, Sina Bank and Middle East Bank plan to open branches in Munich.

In addition, the world's largest Islamic financial market, the Iranian Securities and Exchange Organization, and the German financial regulator, BaFin, have agreed to jointly develop areas that benefit their respective capital markets. The collaboration may lead to exciting Shariah compliant cross-border opportunities.

In France, Paris in particular remains a very attractive market for Shariah compliant real estate investment and the expectation is that the growth that France has seen in recent times will continue into 2017.

Islamic finance in Central and Eastern Europe could also come to the fore in 2017. However, this will depend on the extent to which the governments in this region encourage the take-up of Shariah compliant structures and products, be it through tax, regulatory or other incentives.

## Conclusion

2017 should be an exciting year for Islamic finance in Europe, as the impact of constitutional developments such as Brexit, technological developments such as fintech and regulatory developments such as the call for an external audit of Shariah compliance becomes more and more apparent.☺

# Mirror, mirror on the wall...

**As we are leaving 2016 and looking back to where Islamic finance was, one incident took place in 2009 in the boardroom of the Central Bank of Bahrain brought back the memory of how people perceived Islamic banks. DR HURRIYAH EL ISLAMY walks us through on what transpired.**



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**A CEO of one leading institution asked this question: “Do you seriously believe that there is Islamic banking; that it is not just changing the label?” My response was “yes” but there was no opportunity to elaborate on that as the meeting was about to commence. He was not the first person to ask such a question. Back then, at the hearing of my affiliation to an Islamic bank, people often posed similar questions. Today, more than seven years later, we do not hear people asking such questions, not anymore. But there’s this open secret, the talk in the marketplace, that people question if Islamic banks truly offer products which are 100% in line with Shariah and if they operate the business in the manner that makes them truly Islamic banks.**

## Review of 2016

The year 2016 has not been an easy year for the global economy as well as the Islamic finance industry. Falling oil prices had affected the economy in Islamic finance core markets and Islamic finance players had rightly been more prudent in undertaking the business. Both the regulators and the industry were looking at improving the governance. New players and some other countries from emerging Islamic finance markets have introduced or are looking into introducing new laws or regulations to regulate Islamic finance. These include the UK, Uganda, Kenya and India.

The Central Bank of England issued a consultation paper in February 2016 on establishing Shariah compliant liquidity facilities. Its primary focus at this stage is to assess the feasibility of establishing Shariah compliant deposit facilities. In Uganda, the parliament passed the Financial Institutions (Amendment) Bill 2015. In effect, the Financial Institutions Act has been amended and introduced Islamic banking as a system of banking consistent with Islamic law and guided by Islamic economics.

Recently, the Kenyan National Treasury commissioned for the development of Islamic finance policy. Kenya has also set up the Islamic Finance Project Management Office which is expected to put in place a national Shariah governance framework to guarantee standards and compliance with Shariah provisions including a cross-cutting financial sector National Shariah Supervisory Board.

The Reserve Bank of India, in its annual report issued on the 29<sup>th</sup> August 2016, proposed to “explore the modalities of introducing interest-free banking products in India in consultation with the government” in order to mainstream “some sections of the Indian society (that) have remained financially excluded for religious reasons”. Some ASEAN countries introduced more policies and in the Middle East, regulators are looking at the feasibility of introducing new policies on Islamic finance.

The Central Bank of Malaysia has issued a policy on compliance on the 10<sup>th</sup> May 2016 that will be of effect from the 1<sup>st</sup> January 2017. In Indonesia, while the authority is looking at the feasibility

of having an Islamic financial services law, the government has set up the Komite Keuangan Syariah Nasional (National Committee on Islamic Finance) led by the president of Indonesia. In May 2016, the UAE cabinet approved the proposal to form a new Shariah authority with the mandate to set standards on Islamic finance products and to oversee the Islamic finance sectors including to approve Islamic finance products, set rules and principles for Islamic finance transactions.

On the 1<sup>st</sup> September 2016, the Central Bank of Bahrain issued a consultation paper proposing a Shariah governance module containing rules related to Shariah governance within the Kingdom of Bahrain. The standard-setting body is also looking at issuing a new standard on a central Shariah board with the hope that this will contribute toward better Shariah governance of both the institutions as well as the state of Shariah compliancy at the national level.

## Preview of 2017

How about 2017? Mirror, mirror on the wall, who is the most compliant of them all? We may wish that would be a question Islamic finance players would ask themselves. It’s not about winning an award for being the most compliant institution and it’s not about the form. The emphasis should be in the substance. It’s about seriously doing Islamic finance business and doing it right. It’s about not compromising the Shariah values in favor of catching numbers. It’s about having the right people for the jobs and training the existing ones so each and every one of them will appreciate what Islamic finance truly is.

Unlike the conventional institutions, Shariah is the parameter that all Islamic finance players must observe. We should move from just making sure we do not violate Shariah to trying to offer true economic values in line with Shariah. The regulator should be more ready to facilitate Islamic finance as a better way of banking, for example, by not restricting its activities nor imposing an accounting and reporting treatment the way it does on conventional institutions for the former does not operate solely on the basis of loan-taking/ giving the way the latter do.

The Islamic finance industry should stop thinking in the conventional way of doing business but rather embrace Shariah principles that could be more effective in value creation and wealth distribution. By stopping on mimicking conventional products, the Islamic finance industry will gain the public’s confidence too. 2017 should be the year Islamic finance players pay more attention to making the industry more Shariah compliant, to improve Shariah governance and to truly adopt the very essence of the industry, ie be true to Shariah.

## Conclusion

To instill public confidence – that’s homework for the regulator and the industry. Nevertheless, it takes all the three, ie the regulator, the industry and the public to play their respective roles for Islamic finance to flourish. The regulator to better regulate and provide the incentives to create a level playing field or better still to promote Islamic finance; the industry to discipline itself and to offer values to serve the Maqasid Shariah in undertaking the business and the public to better understand Islamic finance and to give it a fair chance.☺

# Global mergers and acquisitions in an unpredictable political and economic environment

**In 2015, global merger and acquisition (M&A) deals set a record in terms of the value of transactions reaching almost US\$5 trillion, through globalization of the M&A market and the emergence of Asia Pacific as a significant factor. BURAK GENCOGLU takes a look at what transpired in 2016 and what to expect in 2017.**



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**Following the record transaction volume in 2015, M&A activity again proved its strong presence in 2016 despite the instability and uncertainty brought about by global economic, political and regulatory conditions. Although deal values decreased by 24% until the third quarter (Q3) of 2016 when compared with 2015's record-breaking number of transactions, it is considered stable compared with the same period in 2014.**

During 2016, M&A deal values in the Middle East also increased and showed a relatively successful performance compared with the previous year.

## Review of 2016

The confidence in the business world during 2014 and 2015 has been affected by the ongoing economic weakness and the UK's decision to leave the EU which have a significant effect on M&A activity. Within the year, some transactions were also blocked because of competition or other regulatory reasons. With regards to the deal value concerning global M&A transactions carried out in 2016, the data indicates that the decline was driven by the European target which fell by 26.5% in terms of 2016 second quarter data.

The number of transactions cancelled or failed to be completed also increased significantly, amounting to a total of US\$687 billion up until Q3 of 2016. The announcement of stricter rules on tax inversions by the US Treasury Department and other restrictions set forth by the competition authorities contributed to the current situation. However, it is not only the stricter regulations and rules of the public authorities that are involved but also the said economic and political concerns, such as the effects of Brexit, the US presidential race and the slowdown in the Chinese economy. It is also another challenge to agree on the provisions of M&A transactions and reach an agreement due to high public company valuations.

In terms of the M&A sector in the Middle East, data until Q3 of 2016 shows that the value of announced M&A transactions with any Middle Eastern involvement reached US\$37.4 billion, a 19% increase when compared with the same period in 2015 as stated by Nadim Najjar, the managing director of MENA at Thomson Reuters. Unlike global M&A deals, in the Middle East the valuation expectations between sellers and buyers are narrow which increases the number of deals within the region.

With regards to country performances in the Middle East, Qatar was the most active country with regards to outbound M&A transactions in the Middle East, achieving 41% of total outbound transactions in the region. Following on Qatar's heels were companies based in

Saudi Arabia and the UAE with a market share of 34% and 11% respectively.

The merger of the National Bank of Abu Dhabi (NBAD) and First Gulf Bank (FGB) was the largest M&A transaction so far in 2016 having a value of US\$14.1 billion within the region. The said transaction was also recorded as the Middle East's largest domestic deal of all time and made a significant contribution to the total 2016 M&A deal value.

## Preview of 2017

M&A activity globally mainly depends on the certainty and confidence of sector players in the world's economic and political stability. Having said that, M&A dealmakers are of the opinion that the UK vote to leave the EU and the US presidential result will have a minor effect on M&A deals in 2017. Additionally, the election of Donald Trump as the 45<sup>th</sup> US president is expected to have a relatively more positive effect on M&A transactions when compared to the other presidential candidate, Hillary Clinton.

One of the obstacles for the execution of M&A deals is tightening global competition law regulations and enforcement, and the need to satisfy competition authorities within multiple jurisdictions. This situation creates the risk of a longer time for M&A deals to complete the transactions and the risk of adverse reception in one of the jurisdictions.

Overall, Europe has been losing its attractiveness where investors from the Middle East are concerned since 2013. In the second half of 2013, while 57% of the deals and 63% of the transaction value were spent in Europe; the figures dropped to 45% and 22% respectively during the first half of 2016. While M&A capital from the Middle East spent in Europe fell, the share of the Americas increased to 29% in terms of the number of deals and 47% in terms of the transaction value. The current trend is expected to continue in the following years.

## Conclusion

In summary, it is likely for the Middle East and international markets to remain active despite global changes in the political and economic environment in the coming months. Additionally, it is expected that North Africa will continue attracting M&A investments due to its growth potential. According to the World Bank, Egypt, Morocco and Algeria – the top three economies from North Africa – grew more than the world average, making them important for Islamic finance-related activities and M&A transactions.

It is also expected that the Middle East region will see more domestic M&A deals since smaller companies may seek M&A opportunities to improve their liquidity and profitability under one larger firm. The NBAD and FGB merger may pave the way for such transactions with this intention.☺

# Islamic microfinance between charity and commercialization: A market outlook

Islamic microfinance has become a rapidly growing market niche, providing access to financial services to poor people who are not served by conventional microfinance institutions or Islamic banks. An estimated 300 financial services providers, mainly NGOs and cooperatives, are now offering Shariah compliant microfinance products, serving around 2.5 million customers of which over 85% are living in Bangladesh, Indonesia, Pakistan and Sudan. DR MOHAMMED R KROESSIN examines the market outlook for Islamic microfinance.



*Mohammed R Kroessin is the head of Islamic microfinance at Islamic Relief. He can be contacted at [mohammed.kroessin@irworldwide.org](mailto:mohammed.kroessin@irworldwide.org).*

## Review of 2016

The last 12 months were significant for the industry and saw the publication of a groundbreaking report by the Gates Foundation, two international conferences and the launch of a first comprehensive online training program by the Frankfurt School of Finance & Management, one of the leading European bank training academies. The UN World Humanitarian Summit in Istanbul in May also featured a strand on Islamic social finance, which also includes Zakat and Waqf but has brought Islamic microfinance to the attention of world leaders as an innovative tool to build the resilience of poor people against external shocks and as an innovative and ethical catalyst for economic growth. This followed the UN General Assembly's re-affirmation of microfinance as a basic right for all in the Sustainable Development Goals Declaration, which replaced the Millennium Development Goals in late 2015.

But the Islamic microfinance industry is still young and market data is still sketchy with very few Islamic providers reporting on the conventional industry standard MixMarket which collects data from over 2,000 microfinance institutions globally. There are, however, a number of frontrunners emerging that could take Islamic microfinance to scale. Among these are Islami Bank Bangladesh's Rural Development Scheme and Akhuwat in Pakistan which both are now touching the one-million client mark each. But according to research by the World Bank's Campaign to Assist the Poor (CGAP), most Shariah compliant financial service microfinance providers are small, serving portfolios of fewer than 1,500 clients. This raises important questions about the sustainability of the sector that is still largely funded by development donors and corporate social responsibility initiatives. But smaller players such as START in Kosovo have also shown that sustainability is possible in small Eastern European markets, which are neither traditionally renowned for micro nor Islamic finance.

## Preview of 2017

Despite its importance, this niche sector of Islamic finance has yet to reach scale as the Islamic microfinance industry accounts for less than 1% of the global microfinance outreach. With 1.2 billion of the global population living below the US\$2 per day poverty line of which 44% are concentrated in Muslim-majority countries, Islamic microfinance is set to record a double-digit growth rate of 20%

over the 2016-18 period with Islamic commercial banks looking to expand their customer base.

The key task for 2017 remains the creation of an environment that allows for the growth required to help Islamic microfinance reach scale. Undoubtedly, for the sector to reach significant numbers of poor people, private sector involvement is critical. However, the current charity business model utilized by most is likely to be off-putting for private sector investors looking for financial returns.

Moreover, the sector relies heavily on Qard Hasan which doesn't allow for sustainability under the current AAOIFI product standard that is tailored to Islamic finance institutions providing benevolent financings in addition to a suite of revenue-generating products. While the use of Murabahah is also widespread in Islamic microfinance, the operational context for most service providers delivering costly out-of-branch outreach to poor people also means that cost recovery, let alone profit generation, remains challenging.

CGAP together with the IDB have sought to address the issue of the business model and product diversification in the 'Islamic Microfinance Challenge', won by Al Amal Bank Yemen in 2010 for its work as a commercial bank with a social mission and the Wasil Foundation Pakistan in 2014 for its Salam product. The industry would greatly benefit from another round of the competition in 2017 but perhaps aiming at industry regulatory and standard-setting bodies. This would promote the development of innovative regulatory frameworks and best practice since the combination of microfinance with Shariah compliance still represents a headache for central banks and other policymakers.

At the same time, Islamic microfinance is still too small and scattered as an industry to be able to both lobby for regulatory frameworks that recognize their special status as social finance providers or have the financial clout to invest heavily in financial and Shariah compliance.

## Conclusion

Intermediary bodies such as the IDB should take heed and bridge the gap between supply and demand. When the conventional sector was faced with a similar challenge in the late 1980s to turn Mohammed Yunus's idea of a village (Grameen Bank in Bangladesh) bank into a reality, a concerted effort between development donors and financial service providers created what is now a US\$200 billion industry. Given the specificity of Islamic finance and the commitment by the global community to eradicate poverty, an IDB-led consortium can develop the data repositories, analytics, standards, rating agencies and technical assistance programs required to create investor confidence.☺

# The use of Shariah-based structures continues its growth in the private equity sector

**Despite a contraction in regional private equity fundraising and deployment, OSAMA AUDI expects to see more expansion in the utilization of Shariah-based structures in challenging/highly regulated sectors such as healthcare and education.**



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## Review of 2016

As a result of continued softness in oil prices, private equity transaction deal flows continued to dip in 2016. The Emerging Market Private Equity Association (EMPEA) reported that private equity fund managers raised US\$420 million in the first half of 2016, representing a year-on-year decline of 21% and deployed US\$563 million in the MENA region representing a year-on-year decline of 14%. While the methodology for the determination of EMPEA's figures is not clear, multiple additional sources as well as market participants have also reported an overall dip in MENA fundraising and deal flows.

While EMPEA reported that the consumer goods and services sectors continued to drive private equity investments, other perennial favorites including healthcare, education, real estate and value-priced oil and gas businesses continued to drive significant deal flows.

A number of prominent oil and gas field services companies are reportedly going through sales processes with Carlyle's transaction with Tunisia-based Mazarine Energy representing one of the largest private equity transactions in the MENA region in 2016.

Transactions structured by utilizing Islamic finance principles (whether through Mudarabah vehicles incorporated in the Dubai International Financial Center or otherwise) continued to feature in restrictive and complex investment sectors (eg healthcare, education, wholesale and retail trade, etc) in the states of the GCC and particularly in Saudi Arabia and the UAE.

Leading MENA private equity firms (including those which are not operated on a strictly Shariah compliant basis) continued to utilize Shariah compliant structures on an opportunistic basis to undertake their investments. Prime examples include Gulf Capital's acquisition of Multibrands Trading Co, one of the largest food and beverage distributors in Saudi Arabia. Media reports stated that the transaction was structured in a Shariah compliant manner. In addition, Investcorp's acquisition of a minority interest in Bindawood Holding, the premier grocery chain in Saudi Arabia which operates both the Bindawood and Danube brands of grocery stores, was their largest MENA acquisition to date, with the acquisition financing carried out on a Shariah compliant basis. Arcapita's acquisition of the first phase of the Saadiyat Beach Residence on Saadiyat Island, Abu Dhabi from Abu Dhabi-based sovereign wealth fund, Mubadala, was also carried out on a Shariah compliant basis.

As with previous years, emerging markets private equity powerhouse Abraaj Capital continued to dominate deal flows with the largest reported number of deals closing across its funds.

Of interest to many regional and global private equity players was the launch on the 6<sup>th</sup> June 2016 of Saudi Arabia's National Transformation Program 2020 (the NTP) which is meant to build the Saudi Arabian government's capabilities in order to achieve the ambitious goals of Saudi Arabia's Vision 2030. Those goals include, among others: (1) reducing the dependence of Saudi Arabia's economy on oil; (2) increasing private sector contribution to GDP from 40% to 65%; (3) the planned IPO of the Saudi Arabian Oil Company (Saudi Aramco) with 5% of the company slated to be listed on the Tadawul and the remainder of Saudi Aramco's ownership to be held by the Saudi Arabian Public Investment Fund (PIF); (4) the transformation of the PIF into a sovereign wealth fund with an anticipated US\$3 trillion under management; (5) the privatization of significant public assets from healthcare and education to airports, power and other key infrastructure; and (6) increased investment in the domestic mining and defense sectors as well as renewable energy. The NTP was launched across 24 Saudi governmental bodies and organizations in its first year. The first phase to implement the program was launched in 2016 and will be followed every year by additional phases which will involve additional public bodies. As part of the NTP, some ministries, institutions and government entities underwent or are undergoing a restructuring process (for example the Ministries of Education and Higher Education were combined into a single ministry).

## Preview of 2017

Regional private equity players and investors are anticipating that the aforementioned NTP, combined with continued softness in oil prices, will lead to an inevitable privatization of many of the Saudi Arabian Ministry of Education and Ministry of Health's education and healthcare related functions which will present ample opportunities for investment in the future. In addition, the use of public-private partnerships (PPPs) has come to the fore as a framework that could be utilized to encourage private sector investment in so-called social infrastructure such as healthcare and education. The first PPP tenders were finally launched at the close of 2016 with 2017 anticipated to be the year in which the privatization program in Saudi Arabia will finally drive significant regional investment.

## Conclusion

While 2016 saw a dip in overall activity in the private equity sector in the region as a whole, private equity sector participants have shown continued interest in the use of Islamic finance-based structures to execute their most complex transactions. In addition, there has been a significant push by MENA-based private equity players to participate in privatization programs which have drawn significant interest in 2016 and will likely continue to draw interest in 2017 as they are implemented. ☺

# Real estate remains highly attractive to Islamic investors

While for many real estate is considered among alternative assets, within the Islamic investment world real estate is certainly mainstream. Evolving from individuals buying properties directly, the industry today has considerable depth and sophistication. PHILIP CHURCHILL writes.



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**While the Islamic structuring is less of a challenge than it was 15 or so years ago when the structures as we now know them were being developed, the challenge nowadays is securing the real estate opportunity in the first place, with local real estate investment managers fulfilling this role.**

For Islamic investors, such real estate investment is not restricted by borders or time zones with a global flow of capital and sellers familiar with seeing purchase offers from Islamic investors, with the association of such offers with underlying wealth still strong.

## Review of 2016

As Islamic investors considered their international real estate allocations for 2016, they had the rather unusual considerations of political instability on the world stage to contemplate, with the UK voting to leave the EU and the prospect, latterly confirmed, of Donald Trump becoming president of the US.

However, none of these events reduced Islamic investor appetite, which increased during the year. The global hunt for yield continued with Muslim investors comparing what they can earn at the bank or with other assets and deciding that real estate should form a material part of their investment strategy.

What limited 2016 activity was a lack of suitable investment opportunities, with supply constrained by sellers either deciding to hold in the short-term while political events stabilize or to refinance, fueled by a historically low cost of senior finance.

As investors sought opportunities, they considered a far wider range of property asset classes beyond the usual office investment. Logistics has been a favorite for a while, but there was increasing allocation to retail and residential properties, particularly multi-family in the US and UK student accommodation saw increasing interest again.

Geographically, Islamic investors continued their voyage of discovery, seen most noticeably in Europe, for while the UK and Germany remain favorites, transactions were undertaken across the continent, with the Netherlands, the Nordics and Southern Europe all witnessing activity.

## Preview of 2017

With political instability at home and abroad, no change is expected in investors being risk averse, with an often binary approach to investment opportunities. If the quality of location, property, tenant and lease length ticks all the boxes, then Islamic investors are willing to pay a full price

**“ Real estate returns remain highly attractive to Islamic investors ”**

to achieve certainty of investment income; without it, Islamic investors would often prefer to wait where such capital is concerned.

What will continue to limit activity is the availability of products, as Shariah compliant investors are not alone on the world stage of hunting for opportunities. Making themselves more attractive to sellers by having committed equity and the ability to move quickly and reduce transaction risk will be important to secure more of the pie for the Islamic investment world.

Changes to tax laws will most likely continue in the same vein on restricting tax deductions and establishing more of a level playing field for domestic and international investors. None of this should come as a shock to Islamic investors who have never sought an advantage and so any changes should be fairly easily accommodated.

2017 could see a bigger return to fund structures. Since the last downturn in 2007-09, investors have typically wanted transactions not fund platforms, but a paucity of opportunities may drive investors to allocate at least a portion of planned investment into fund initiatives if only to get some exposure to the asset class.

The impact of Trump on Islamic investment into the US will be interesting to observe. At the time of writing, thankfully, the previous rhetoric of Trump and bold statements on limiting travel into the US have subsided. With the volume of investment that he plans to undertake across the US, it would seem unlikely that he would seek to dissuade international capital from coming in, not least being a real estate man himself.

Within Europe, as the UK continues to decide how best to leave Europe, investors will likely use such uncertainty and a depressed pound sterling to invest, taking a longer-term view that their investment will look wise once the dust has settled.

Germany has an election itself later in the year and while Angela Merkel looks to have a comfortable lead at the moment, recent history has taught us to take nothing for granted. All this could encourage Islamic investors to increasingly look outside of their traditional comfort zones. Alternative countries may be more stable than the established western favourites of the US, the UK and Germany.

## Conclusion

Real estate returns remain highly attractive to Islamic investors, but no increase is expected in the volume of opportunities and the new world order of change needs to be taken into consideration.

Should be interesting. ☺

# Are Islamic banks better regulated than conventional banks?

**Why is it that Islamic banking and finance products cannot be introduced in a jurisdiction straight away, similar to conventional banking products? What takes a country to 'prepare the ground' for providing Shariah finance solutions to its people? Do the regulatory bodies of a country need different skill sets in order to monitor Islamic banks and financial institutions? SOHAIL ZUBAIRI tries to find out.**



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**The legal systems of countries around the world are based on either one or a mix of civil law, common law, statutory law and religious law in light of the country's socioeconomic environment and historical background. Then there are other supplementary laws, such as taxation law, banking law, insurance law, mortgage law and others.**

The taxation law deals with numerous types of levies including value-added tax (VAT), goods and services tax (GST), customs duties, stamp duties, land registration, mortgage fees and such. These are applied on transactions related to trade (sale and purchase of goods, assets and services) and investments. Contrary to conventional banking and finance products which originate from interest-based lending and borrowing, the Islamic banking and finance products use trade and investment contracts since lending or borrowing on interest is forbidden in Islam.

While no tax is applied on interest-based conventional banking products (in fact, most of the jurisdictions provide tax relief/rebate on the amount of interest paid by an individual or entity), Islamic banking and finance products by nature invite taxation since these are developed as a means of trade and investment activities and do not have any element of interest payment or receipt.

As such, if a country wants to introduce Islamic banking and finance, it becomes essential for it to first amend the relevant laws in order to provide a level playing field to Islamic banks and financial institutions whereby the trade and investment transactions undertaken by them shall be exempted from VAT, GST, double stamp duty on property financing in addition to the other charges.

More and more countries (including Islamic countries) are now eager to amend the regulations in order to welcome Islamic banking and finance transactions.

The Islamic banking and finance industry works under a three-pronged regulatory environment that focuses on the following:

- The very nature of Islamic financial institutions, which require them to be self-regulated to a great extent
- The country's neutral regulations based on local and international laws and standards being applied on the banking and finance industry, irrespective of the nature of the financial institution being Islamic or conventional, and
- The country's own Islamic banking and finance regulations mostly based on AAOIFI and IFSB standards and guidelines.

## Review of 2016

The global financial crisis of 2008 amply demonstrated that the regulators' inattentiveness to remain ahead of the game turned out to be extremely disastrous and a costly affair for the world.

Pursuant to the crisis, the Financial Stability Board (the erstwhile Financial Stability Forum) based at the Bank for International Settlements in Switzerland took it upon itself to guard the global financial stability through the coordination for development of new regulatory and supervisory policies for the financial sector.

In addition to applying the local and global regulatory standards meant for the financial services sector, not many are aware that Islamic financial institutions have two additional corporate governance layers which have kept them at bay from the harm suffered by their conventional counterparts. These are the Shariah supervisory board and the Shariah audit.

2016 saw regulators taking notable steps to ensure the desired outcome from the Shariah supervisory board and the Shariah audit functions. In March 2016, the UAE cabinet approved setting up a new higher Shariah authority — a national regulator — to set standards for Islamic finance products and services in the UAE. The Central Bank of Bahrain also proposed a mandatory external Shariah audit and Oman and Pakistan sought stricter requirements for Islamic financial institutions.

## Preview of 2017

I expect to see a combination of global and national regulators further tightening up the financial services sector regulations toward enhanced disclosure and best practices.

In the coming years, the pressure shall also grow on Islamic banks from customers to demonstrate in practical terms what they claim to be — for example, to show that they are different from conventional banks by applying transparency and fair play in their products and services.

## Conclusion

Islamic finance has evolved enough during last four decades to now take the centre stage in the mainstream financial system of the world. A lot has been done by national regulators and standard-setting bodies such as AAOIFI and the IFSB to discipline the industry toward claiming its due role in the global financial scene.

I saw a rainbow during my visit to Beijing to attend the first Islamic finance conference in May 2016. My Chinese colleagues attending the event termed it as the good omen for Islamic finance in China. To them, the colors of the rainbow demonstrated the different strings of Islamic finance such as banking, insurance, Sukuk, funds, trust, microfinance and charity. I could not agree with them more, having started to see rising interest from China for Islamic finance.☺

# Islamic banking and risk management

**Islamic banking is slowly moving to become an integral part of the traditional banking industry. As it grows in significance and as regulations change, there are increasing challenges to risk management which DENNIS COX addresses in this article.**



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## Review of 2016

2016 has been an unusual year in many respects and the impact on risk management has been a consequence of this. We continue to implement slowly the regulations drafted rapidly after the last financial crisis. There is also the long-term continuation of the low interest rate environment. Indeed, during 2016 most interest rates did not vary and this was an advantage for Islamic banks.

In an environment when interest rates do not vary, floating rate and fixed rate facilities look much the same. Of course, a fixed rate of interest can also be considered as a fee since it is the same amount paid or received over the lifetime of an asset or liability. That resulted in the potential rate issue for an Islamic bank being of less significance and indeed many Islamic banks are increasingly offering similar products to what might be termed traditional banks.

With Islamic banks coming of age, there is increasing regulatory focus. Too often, regulations emerging from Basel do not really consider the impact that they might have on Islamic finance. In the course of 2016, we have seen a greater recognition that regulations need to address the entire banking industry, not just traditional banks.

One other trend we have identified during the year has been the integration of the Shariah board and internal audit into the mainstream of the Islamic bank. Too often, internally the banks appeared identical to traditional banks with Shariah appearing as an add-on. Shariah is fundamental to the operation of an Islamic bank and should be at its core and we have noted greater integration in this respect.

## Preview of 2017

2017 will be in the post-US election environment which would suggest an increasing funding requirement for the US economy.

Why is this relevant for the risk management function in an Islamic bank? The US debt continues to increase at an alarming rate and everything that the new regime in the US is currently proposing would exacerbate this. Rising interest rates are already being priced into the yield curve.

There is a realistic expectation that interest rates will start to rise significantly during the course of 2017. Rising interest rates are a challenge for all banks but in particular for banks that have what is essentially a fixed rate book, such as Islamic banks although the fixed rate is effectively disguised as either a fee or a profit share. Rising interest rates will increase the cost of funding and accordingly would need to be passed on to customers in some way. The challenge for the Islamic bank is that there are limited options available to it to offset this risk.

We are expecting the Islamic ISDA to be reissued in early 2017, but this is mostly due to the requirement to refer directly to the central counterparty rules. What will be needed is a new style of instrument which has some insurance-based characteristics and will be inherent in many of the instruments that are to be sold.

Another key concern is volatility. 2017 will lead to the creation of a new upward interest rate trend, but the road to its creation will not be smooth. Islamic banking has never operated in a rising interest rate environment and it is difficult to assess the likely impact on behavioral analysis of depositors and investors. It is likely that Islamic banks will lag in the market in reflecting the new funding paradigm.

While it is always clear that interest rates are not directly reflected within Islamic finance, the indirect impact and probable attractiveness of traditional banking over Islamic banking will be significant.

The excess liquidity environment which has been both an advantage and a challenge for Islamic banks will also come to an end. The changing regulatory requirements will require additional capital and liquidity to be held to support increasing business activity. The sophistication of the risk management functions will also need to be enhanced to meet this challenge.

Finally, we are expecting a greater focus on corporate governance within the Islamic banks. The requirement to enhance the senior management team and incorporate additional quality risk management independent advisors will become clear during the year as will the need to upskill existing executive and non-executive directors.

## Conclusion

We conclude that 2017 is likely to be a year of significant challenges to Islamic banks and to their risk management. The perfect storm of rising interest rates, increased volatility, increasing capital requirements, changing liquidity and increasing regulatory and customer expectations provides the backdrop for the year. Since much of this is new to Islamic banking, risk managers will need greater foresight and modeling to adequately support the needs of the business and to ensure that Islamic banking continues to flourish through 2017 and beyond.☺



**Shariah governance and corporate governance are unique institutional structures in Islamic banks and financial institutions. Their function is to ensure that the operations of such institutions are Shariah compliant. Shariah governance ensures that the industry is at all times in accord with the Shariah by ensuring the legitimacy of the products offered and supervising the products sold and applied in the market. PROF DR MOHAMAD AKRAM LALDIN and DR HAFAS FURQANI probe further.**



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The significance of the Shariah governance and corporate governance framework transpires via their role in ensuring the confidence of the Islamic finance industry in the eyes of the public. In conducting its business, Islamic finance has to address a number

of problems, including those matters relating to credibility, regulatory enforceability and Sharlah compliant issues. A proper governance framework is expected to be able to facilitate those concerns and guide the industry in order to ensure that the entire operations of Islamic financial institutions are Sharlah compliant.

### Review of 2016

For the Islamic finance industry, global Shariah governance and corporate governance have been mainly dominated by two multilateral standard-setters: AAOIFI and the IFSB. Both institutions continue to issue various standards that govern major Islamic finance jurisdictions. AAOIFI this year has issued three additional Shariah standards, increasing their Shariah standards to 57 with 26 accounting standards, five auditing standards, seven governance standards and two codes of ethics.

A major push for AAOIFI this year would be the gold standard in collaboration with the World Gold Council (WGC) and Amanie Advisors. AAOIFI has held three public hearing sessions on the gold standard with the third held in Kuala Lumpur in collaboration with International Shari'ah Research Academy for Islamic Finance (ISRA) and it has recently approved the Shariah standard for gold-based products.

Similarly, the IFSB continues to tighten its corporate and Shariah governance by issuing standards and guidelines. The IFSB has highlighted the components of a sound Shariah governance system that should be in place in any Islamic financial institution in order to facilitate a better understanding of Shariah governance issues and provide enhanced transparency in terms of the issuance of Shariah rulings and the audit/review process for compliance with those rulings.

**“ A proper Shariah governance framework would not only support the development of the industry but would make the industry more effective and efficient in ensuring strict Shariah compliance ”**

It also provides a basis for the greater harmonization of Shariah governance structures and procedures across jurisdictions. Earlier this year, the IFSB issued a standard on re-Takaful (re-insurance) and it is expected to issue another standard, such as the Disclosure Requirements for Islamic Capital Market Products, by the end of the year.

A key component of Shariah governance that gained greater focus this year was the area of external Shariah audit as a means to ensure compliance and maintain credibility. Both Oman and Pakistan within their central bank guidelines have made external Shariah audit mandatory. A lack of qualified external Shariah auditors, an unclear scope of the external Shariah audit and a lack of public disclosure were among the issues and challenges associated with implementing an external Shariah audit as highlighted in the External Shariah Audit Report jointly produced by ISRA and UKIFC.

### Shariah governance in various jurisdictions: observations in 2016

We have observed that in most jurisdictions, the framework for a Shariah governance system has been put in place. The Shariah governance framework in each jurisdiction is designed in line with the domestic legal and regulatory framework. In some countries, the

Shariah governance framework has been designed also to be in line with international standards and best practices as envisaged by the IFSB and AAOIFI.

In general, the Shariah governance framework is designed with the following dimensions:

- A Shariah governance structure at the higher level by a centralized body or by independent bodies having differing areas of authority or a combination of both.
- A Shariah governance process in terms of the appointment and resignation of Shariah advisors; the composition of the Shariah advisory board; qualification requirements; restrictions, such as, whether there are any restrictions on a Shariah advisor being appointed to more than one financial institution and the effect of decisions made; and whether a Shariah advisor can be appointed to the board of directors of the Islamic financial institution and such, which will reflect the process of Shariah governance in Islamic financial institutions.
- A Shariah governance function which describes the roles and functions of Shariah advisors, management, the board of directors and other stakeholders in an Islamic financial institution.

Each jurisdiction has a particular position on those dimensions in a Shariah governance framework. With regards to the structure of Shariah governance across jurisdictions, we can classify it into three main models:

1. A centralized Shariah governance authority, which refers to countries that have their own central body to govern Islamic banks and financial institutions, for example, Malaysia, Indonesia and Pakistan
2. An exclusive central Shariah body, which refers to countries that have their own central body to govern Islamic banks and financial institutions but strictly restrict them to their central banks, for example, the UAE and Bahrain, and
3. Self-regulatory Shariah governance, which refers to countries where Shariah decisions are made at the institutional level with no final authority (central Shariah committee at the central bank level) established such as Singapore, the UK and Kuwait. The Shariah committees are appointed at the institutional level, and their decisions only bind their respective Islamic financial institutions.

### Preview of 2017

The level of development of the Shariah and corporate governance framework varies across jurisdictions in accordance with the level of Islamic financial industry development. Some countries have developed a well-structured Shariah governance framework such as Malaysia. However, in certain jurisdictions, such frameworks or guidelines are not well structured which creates some uneasiness among industry players and leaves Shariah advisors without clear guidelines to be followed.

Therefore, Islamic finance industry practitioners should push forward this agenda and request for a Shariah governance framework to be established. This is because a proper Shariah governance framework would not only support the development of the industry but would make the industry more effective and efficient in ensuring strict Shariah compliance.

### Conclusion

For further development of the industry, it is recommended that a comprehensive framework of Shariah governance and detailed or explicit provisions on Shariah governance and corporate governance should be in place so that we can ensure a totally Shariah compliant industry. (2)

# Accelerating change

**In KAVILASH CHAWLA's 2016 comments on the state of SMEs and entrepreneurship within the global Islamic finance industry, he laid out an expectation that, in 2016, we would continue to see the development of SME and entrepreneurial clusters, but at an accelerated pace from 2015. In this article, he continues from where he left off and invites us to dive in together to see how 2016 unfolded.**



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## Review of 2016

If there was one word I would choose to characterize 2016 it would be 'uncertainty'. From macroeconomics to geopolitics, 2016 was a year of surprises. Markets, as a rule, don't like surprises. In finance, markets operate on the logic that higher risk activities require, and should generate, a higher return to compensate for that risk. As financiers, successful engagement within the SME and entrepreneurial space comes down to one's ability to accurately price and mitigate the risks associated with the space.

Even at the best of times, pricing risk is more of an art than a science, and in 2016, we were in a gallery surrounded by abstract rather than figurative art. This resulted in a flight to quality. Whether it's assets, partners or customers, in uncertain times, markets and market players seek to find certainty in the known and in the quantifiable, and 2016 for the SME and entrepreneurial space was no different.

With this context in mind, 2016 still turned out to be quite remarkable when it comes to the acceleration of the disruptive forces I commented on in 2015. Before turning to these, however, it is important to also highlight the significant negative impact the uncertainty of 2016 has had on the SME sector. Firstly, 2016 saw a marked increase in accounts receivables and a continuing deterioration in average terms of trade, and in some markets the deterioration has been as pronounced as going from 45 days to 200 days-plus for average payment terms. This means that SMEs are not only having to compete on price, but are increasingly having to compete on their ability to operate without getting paid. The second impact has been a deterioration in access to both trade and growth-related finance, as financial institutions (both Islamic and conventional) have tightened their internal requirements for extending finance to SMEs.

While deteriorating terms of trade and a broadly negative cash flow outlook for SMEs may, from a financial institution perspective, justify the tightening of internal requirements, it leaves SMEs with a very real cash flow shortage issue that they need to solve to remain viable.

In returning to the forecasted acceleration of disruptive forces in the SME and entrepreneurial space for 2016, as anyone who has been involved in the Islamic or conventional financial markets in 2016 can attest, the fintech industry is now part of the global financial landscape. In 2016, we saw every element of fintech, from blockchain and payment systems through to capital-raising and social finance, surface within Islamic finance. Many of these platforms and businesses were at the seed stage in 2015, and 2016 saw both growth and the beginnings of the institutionalization of these disruptive businesses into the Islamic finance landscape.

As aforementioned, the Islamic SME and entrepreneurship space in 2016 was not immune to the broader flight to quality brought about by global macroeconomic and geopolitical uncertainty. The flight to quality led to a concentration of investor capital into high-quality entrepreneurial ventures and platforms, pushing lower quality assets out of the marketplace. Having capital and support focused on high-quality businesses and assets has facilitated the acceleration of disruptive businesses into the marketplace (eg Finocracy) in 2016.

Simultaneously, the flight to quality has driven the recognition by both private and public sector players that the long-term, successful development of the SME sector and entrepreneurship requires an ecosystem approach. To develop high-quality investable assets, government, industry, civil society, education providers and a host of other stakeholders need to work in concert within a productive framework and environment. In 2016, we saw the realization of an ecosystem approach start to manifest with the emergence of incubators, accelerators and other SME and entrepreneurial communities within the Islamic finance space.

## Preview of 2017

2017 is going to continue to be a year of uncertainty, but perhaps less so than 2016. If there was one word that I would use to describe the expectations for 2017, it is 'scalability'. For the SME and entrepreneurship space, the flight to quality of 2016, with all its positive and negative impacts, will continue, but with two big differences. Firstly, 2016 saw high-quality SMEs and entrepreneurial ventures within the Islamic finance space attract capital and support. In 2017, we will see some of these start-ups scale and move on to successful series A and B fundraising rounds. 2017 will deliver a successful track record of businesses built off of these disruptive forces, and will better capture what is resonating and succeeding with investors and consumers alike. This sets up 2018 for the mainstreaming of disruption.

The second big difference between 2016 and 2017 is the acceptance of the ecosystem approach. Whereas 2016 was about accepting and starting to invest in an ecosystem approach, 2017 will be about growing and scaling the ecosystem. To be sure, an ecosystem approach is time-consuming and complicated, as it requires disparate stakeholders to cooperate around shared outcomes. But the commitment by many OIC economies to diversify their economies by investing in entrepreneurship and SME development provides fertile ground for carrying the ecosystem approach forward.

## Conclusion

SMEs and entrepreneurship are the engines of economic growth. While traditional wholesale banking, capital markets and retail finance will continue to dominate the Islamic finance landscape in 2017, the SME and start-up space represents the future of the industry. 2017 will help to determine which innovations from 2016 will create the new architecture of global finance, and 2018 will determine if, and how that architecture can contribute to economic diversification, economic growth and a shared economy.☺

# GCC sovereign issuance in 2016 paves the way for continued growth

Oil exporters in the Middle East are becoming an important source of the flow of international bond issuances at the emerging markets level. With oil prices reaching historical lows in February 2016, several governments turned to the bond and Sukuk markets for funding. According to the Bank for International Settlements, overall, Africa and the Middle East contributed 32% of total net issuance in emerging markets, close to the 37% contribution from emerging Asia-Pacific and Latin America contributed 23% as of the first half of 2016. This is a new trend for such markets. BASHAR AL NATOOR explores.



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## Review of 2016

In 2016, we saw the return of Saudi Arabia, Abu Dhabi and Qatar to the sovereign international bond markets with issuances of US\$17.5 billion, US\$5 billion and US\$9 billion respectively. This could be perceived as a shift from Sukuk to bonds; however, only Bahrain and Oman of all the GCC countries have issued both Sukuk and bonds at moderate levels in the past few years. We also saw Bahrain, Oman, Qatar, Malaysia, Indonesia, Turkey and Pakistan (seven out of the 10 key Sukuk markets) tapping the Sukuk market in 2016, with other GCC nations indicating that they would issue Sukuk, or a mix, in the future.

Many factors determine a government's decision, whether to issue bonds or Sukuk, or indeed, a combination of these instruments. One of these factors is the intended investor and funding base. This plays a big part in the decision to select a Sukuk facility or a bond or both. The important variables are usually whether to issue Sukuk (or bonds) domestically or internationally, using either local or foreign currency denomination. These two features are often interlinked, as many issuances are denominated in the currency of the market in which they are issued. If the target is predominantly international investors, bonds may be the preferred instrument, as international investors are usually more familiar with bonds over Sukuk. On the other hand, if local and regional investors are the target, and there is a significant presence of Islamic investors, then Sukuk or both Sukuk and bonds may be the preferred choice.

The second consideration is the existence of a Sukuk-supportive infrastructure and an Islamic finance strategy for the issuing sovereign. Both factors could pose significant challenges in the selection of bonds or Sukuk. Of particular importance is the existence of an established legal framework that is acceptable to a government, investors and the Shariah boards (which is a prerequisite to issuing Sukuk).

Third is the size and requirements of the Islamic finance industry in the country of issuance. As Islamic banks are not allowed to invest in traditional bonds, the lack of high-quality liquid assets continues to be one of the key challenges Islamic banks face. Sovereign Sukuk plays a big role in bridging this gap, and a Sukuk facility could become a worthwhile option to help the Islamic finance industry overall.

We have seen some growth outside the key markets in 2016. For example, we saw Jordan and countries in Africa issuing Sukuk, which shows positive momentum. However, structural challenges remain. Reuters reported that in 2016, Togo's initial Sukuk facility was XOF150 billion (US\$242.42 million). This comes after Senegal launched its second XOF200 billion (US\$323.23 million) Sukuk facility toward the end of June and Côte d'Ivoire issued the second phase of its XOF300 billion (US\$484.84 million) Sukuk program.

## Preview of 2017

Taking into consideration the shift in oil prices and our expectation that they will only recover to around US\$65 a barrel in the long term, Fitch believe sovereign issuance (both bonds and Sukuk) from GCC members will become a more regular feature of these markets. Interestingly, the lack of a sovereign yield curve has been one of several factors holding back corporate bond issuance but we are beginning to see these dynamics change, and corporate issuance could also gradually start to take off in 2017.

Outside key markets, we still believe the short-to-medium-term prospects are positive but limited, owing to challenges from a lack of standardization in the industry. This prevents the establishment of legal structures and legislation to accommodate the issuance of Sukuk and therefore structuring Sukuk remains a relatively complex and time-consuming process compared to issuing a traditional bond.

Challenges lie ahead for the Sukuk market despite continued momentum. The time needed to tackle these obstacles will impact on how long it takes to implement Islamic finance and potentially lead to higher costs in relation to more conventional forms of funding until a standardized framework is established. However, several important trends could provide the necessary impetus for the development of Islamic finance in new Sukuk markets. This includes the growing government support for Islamic finance, the increasing acceptance of Sukuk and Islamic finance more broadly and the existing large investment and financing requirements.

## Conclusion

Sukuk harmonization initiatives, in parallel with GCC funding needs and a return to capital markets; efforts to improve the capital markets and legal structure and improving regulatory environments support our expectation that Sukuk issuance will increase gradually over the medium to long term in key and emerging Sukuk markets. This increasing issuance in sovereign bonds and Sukuk is crucial because the yield on sovereign debt creates a pricing benchmark from which all other debt instruments in the same market can be priced, thus creating a pricing benchmark and growth for the GCC corporate bond market. <sup>(5)</sup>

# The outlook ahead

**In spite of a reduction in the pace of expansion in the global Islamic insurance market in previous years, SUSAN DINGWALL and MARTIN SCHNEIDER opine that growth remains significant, and a number of recent strategic developments should provide strong foundations for further growth in the market.**



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## Review of 2016

During 2016, we saw a number of general themes emerge as follows:

- A focus on greater cooperation between markets. For example, the London market has reached out to markets in the Gulf region and Malaysia. The Islamic Insurance Association of London has visited Bahrain and Dubai to increase collaboration in promoting the development of Islamic insurance solutions. It has also been involved in discussions between the City of London and Malaysian regulators to help support Malaysian investment and growth.
- A continued push by London to establish itself as an important hub for Islamic finance and insurance. Lloyd's of London has recently announced it has provided in-principle approval for Cobalt Underwriting to establish a Shariah compliant syndicate at Lloyd's. Coupled with the establishment of Lloyd's platform in Dubai, this development potentially offers significantly increased re-Takaful capacity for commercial risks.
- Enhanced regulation has been introduced in a number of markets which will, in the long term, lead to better capitalized and more stable Islamic insurance providers. It is also likely to encourage better technical underwriting and more realistic pricing and may result in merger activity as smaller Islamic insurers require stronger capitalization to continue to operate in a more stringent regulated environment.
- The establishment of learning programs to educate market participants on Islamic insurance. One of the recurring criticisms is that intermediaries do not offer their clients Islamic insurance products as they do not fully understand them. This deficiency will hopefully soon be a thing of the past in the London market as the Chartered Insurance Institute has developed a course which will enable both underwriters and brokers to obtain a solid understanding of the principles of Islamic insurance.
- A drive to create standardized Islamic insurance policy wordings. There have been a number of calls by market commentators for harmonized global regulation of Islamic insurance products and for a standard operating model to be used. It is unlikely that either of these demands can or will be met in the near or medium term but focus can be brought to bear on standardizing Islamic insurance policy wordings so that they are on an equal footing with their conventional counterparts. The advantages of standardizing policy wordings will be that

policyholders will have greater confidence in the product being offered and they will be better able to make an informed choice. Standardized wordings also provide certainty – certainty in their interpretation and market understanding. Intermediaries will be able to approach policyholders with a product which is every bit as good as its conventional counterpart.

## Preview of 2017

We anticipate that 2017 will bring the following:

- Further re-Takaful capacity from the Lloyd's market as the Lloyd's Dubai platform matures and Lloyd's is successful in securing an onshore reinsurance licence in Malaysia. We can expect Lloyd's to continue its strategy of accessing the world's fastest-growing economies and developing its brand, for example, in Africa where there is a real demand for Islamic insurance solutions.
- Greater consolidation in Middle Eastern markets leading to fewer Islamic insurers with stronger balance sheets and a more substantial market presence.
- A continued emphasis on strengthening regulations and their enforcement. This is likely to lead to a focus for Islamic insurers on better risk management and internal controls, which will in turn be good for the market as stronger Islamic insurers emerge.
- More potential for growth in the life and health sector in the Middle East where a number of governments are introducing mandatory health insurance programs for employees.
- More opportunities for the Islamic insurance sector in the Middle East if low oil prices become the new normal. Governments may have to accelerate the diversification of their economies and Islamic insurance can play a major part in what is likely to be the start of a long-term shift away from a dependence on oil exports.
- Greater use of Islamic insurance in transactions financed Islamically and a drive by governments on their own projects to require Islamic insurance solutions.

## Conclusion

It is easy to forget that the Islamic insurance industry is less than 40 years old, such has been its rapid growth and development during that period. There are real opportunities to take a quantum leap forward, particularly in developing Islamic insurance solutions for commercial risks, and in offering products which are every bit as good as their conventional counterparts. Islamic insurance should not be seen as a niche product but one which is very much in the mainstream.☺

# Strengthening global connectivity and cross-border trade in OIC member countries

Despite the growing enthusiasm for Islamic finance, trade exchanges are still relatively underdeveloped in the member countries of the OIC. The major impediment is related to supply side constraints for developing a diversified economy. As a result, many OIC member countries still rely on exports of commodities and raw materials, hence, trade exchange is prone to swings based on the commodity market. ENG HANI SALEM SONBOL reviews the trade finance space.



Eng Hani Salem Sonbol is CEO of ITFC. He can be contacted at [itfc@itfc-idb.org](mailto:itfc@itfc-idb.org).

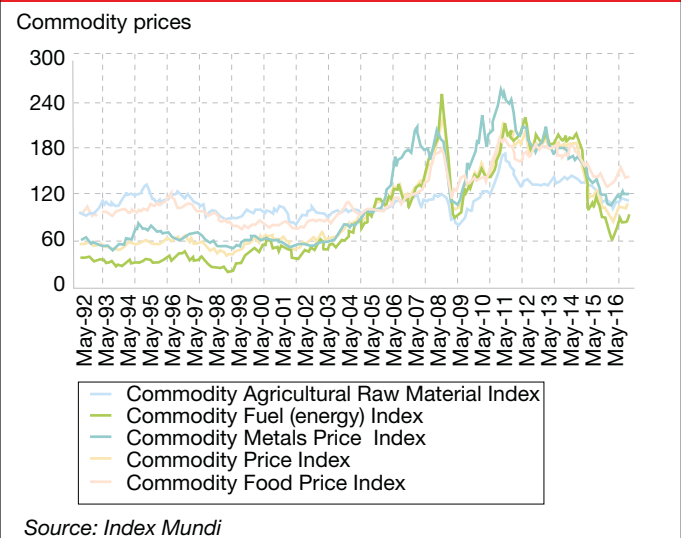
Similar to trade exchange, the Islamic finance industry is relatively dependent on commodities, particularly oil, and their prices for resource mobilization. During high oil prices, OIC member countries were able to accumulate funds, which as a result boosted the growth of the Islamic finance industry. The first Islamic banks were established during the oil hike of the 1970s and the industry witnessed immense growth since then; however, the weak commodity market and the instability of some countries present a gloomy outlook for the industry.

Islamic finance with a more conservative business model and risk management framework than its conventional counterpart has a greater potential to mobilize funds and channel them to the countries and companies in them, including SMEs that need the funds to grow and create jobs. OIC member countries enjoy a diverse economy, which provides an opportunity for regional integration and hence supports the existence of SMEs. At the same time, many OIC countries still suffer from underdeveloped infrastructure and production capacity to blossom their SME sector.

## Review of 2016

Both the Islamic finance industry and international trade witnessed many challenges in the last 12 months. As indicated in Chart 1, commodity indices dropped dramatically; this sudden drop in the prices resulted in budgetary problems especially in the oil-exporting countries and led to the slowdown of infrastructure projects. For some OIC countries, high leverage companies suffered from the currency revaluation exchange rate that resulted in losses in US dollar loans and losses due to stock revaluation because of decreased stock value.

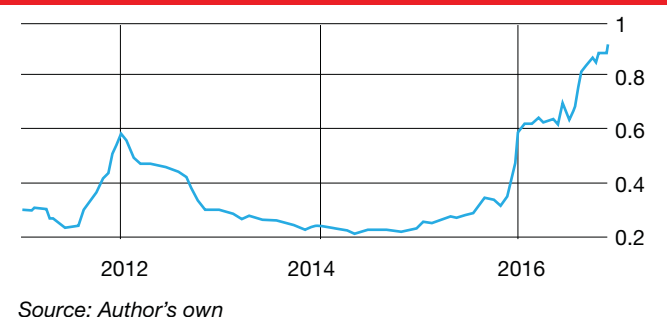
Chart 1: Commodity indices



Trade finance gaps were still high particularly for the least developed countries. Low interest rates forced many financial institutions to venture into long-term finance projects to benefit from relatively higher returns. As indicated in Chart 2, the 3-month LIBOR rate was up until recently, with the incentive to venture into short-term trade finance very limited.

The low interest rates also had implications for SME support. The inclination of financial institutions for long-term lending decreased the working capital access of SMEs. This also negatively affected the profitability of Islamic financial institutions particularly those merely involved in short-term trade finance. In the last 12 months, interest rates started to increase and provided a more profitable working environment.

Chart 2: 3-month US dollar LIBOR

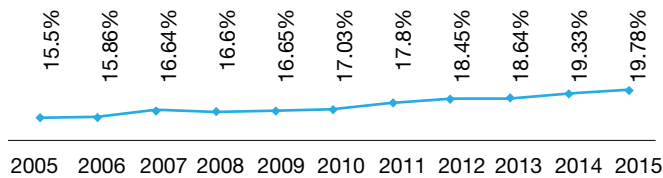


Regardless of these challenges, intra-OIC trade performed well. Net intra-OIC trade was around US\$878 billion in 2015, up from US\$802 billion in 2014. One main factor is the efforts exerted in OIC member countries to eliminate trade barriers related to regional integration and the WTO Trade Facilitations Agenda: port efficiency, custom modernization, standard and conformity assessment, etc. Academic work shows that the major determinants of the intra-OIC trade ratio are oil prices and the US dollar index due to the dominance of oil in intra-OIC trade and the negative correlation between the US dollar index and oil prices. High oil prices and a strong US dollar boost the ratio. The intra-OIC trade ratio is calculated by dividing the intra-OIC trade value to OIC countries' trade with the world. As indicated in Chart 3, the ratio has performed well up until the end of 2014. A drop

# TRADE FINANCING



Chart 3: Intra-OIC trade ratio



Source: ICDT

in oil prices starting from the last quarter of 2014 will be reflected on the ratio in upcoming years.

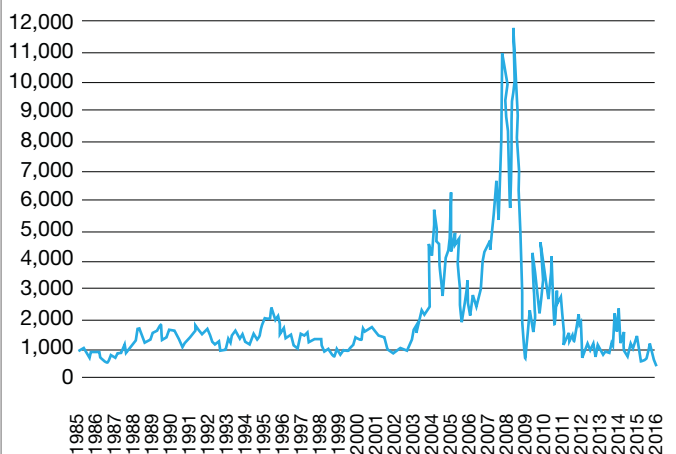
## Preview of 2017

The recent economically introverted trend in developed countries is expected to negatively affect international trade. The Federal Reserve is expected to increase the lending rate, hence, a strong US dollar is expected to keep the pressure on commodity prices. This would decrease trade finance volumes and aggravate foreign exchange earning capabilities of commodity-exporting countries. However, increased interest rates would benefit Islamic financial institutions by a higher markup, which can contribute to profitability. On the other hand, the recent sharp movement in commodity prices, interest rates, and the US dollar value would increase credit risk of countries and companies in member countries.

For sustainable growth, the Islamic finance industry should rely less on funds mobilized from oil trade and oil financing. More focus should be on the promotion of Islamic trade finance solutions and the development of strategic commodities which are the two main pillars that will help create a grassroot development impact through providing technical assistance support and organizing sector and market-specific trade promotional activities. Supporting the development of strategic commodities in OIC member countries such as cotton, coffee, cacao and wheat will have a direct impact on alleviating poverty and empowering local communities, which are the other two strategic new millennium development goals.

In addition, focusing on providing integrated trade solution programs will also achieve complementarity among member countries. Programs that focus on developing trade linkages and creating

Chart 4: Baltic Dry Index



Source: Business Insider

south-south cooperation opportunities can contribute tremendously in the economic development of member countries. Such programs not only promote trade among the regions, but also create trade and investment opportunities for SMEs in member countries.

## Conclusion

Islamic finance and OIC member countries are not immune from general economic developments in the world. In 2008, many Islamic financial institutions performed well compared to conventional financial institutions due to the Shariah prohibition of controversial financial products such as derivatives. However, Islamic financial institutions are prone to risk associated with the local economies they operate in. Chart 4 shows the Baltic Dry Index, which is below 2008 levels and requires careful reading of global trade and its possible upcoming implications for Islamic financial institutions and the trade finance industry.

Overall, the International Islamic Trade Finance Corporation believes that building strong human and institutional capacities in trade is essential to foster trade and development and will in turn improve the lives of the common people and alleviate poverty.☺

# The challenge of limitations

The growth of the global Islamic finance industry in 2015 was low at only 0.7%, compared with the previous year which was 15.6%. In fact, the global Islamic capital market was undergoing a negative growth, -2.3% whereas in the previous year it was 17.9%. Global Sukuk growth decreased by -43%, as well as mutual funds by -6% and all global Islamic indices showed negative performances. How do we accelerate growth in the Islamic capital markets to bring it back to where it was in 2014 in the future? According to IRWAN ABDALLOH, the key is to develop a number of Islamic brokerages and Islamic securities as well as infrastructure.



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## Review of 2016

In 2016, the global Islamic capital markets showed positive but insignificant growth. Although the performance of the global Islamic stock indices improved, the growth of the Islamic securities market was still slow. Malaysia, which has the biggest market share in global Sukuk, is still facing negative growth while Indonesia on the other hand continued to increase its market share and Saudi Arabia is still dominating the global funds market. Nothing has been significant in the development of infrastructure nor in products of the Islamic capital market. During 2016, the global Islamic capital market focused on internal consolidation.

### Islamic brokerages are limited

Currently, the trading of Islamic securities is dominated by non-Islamic brokerages. These brokerages will immediately switch to trading in non-Islamic securities in the event there is a decline in the returns of Islamic securities which will ultimately create an unstable Islamic securities market. This happens because of the limited number of Islamic brokerages. For example, Malaysia has only one fully-fledged Islamic brokerage and nine Islamic window brokerages though it has the largest market share in Islamic securities in the world. Indonesia, having the biggest potential in the Islamic capital market, only has 12 Islamic windows and no fully-fledged Islamic brokerage. Likewise, Islamic brokerages are very limited in other countries as there are no global standards specifically for managing Islamic brokerages.

### Islamic capital markets need more products

Investors have limited products for investing in Islamic securities which are limited to Islamic stocks, Sukuk and Islamic funds. Although some countries have developed Islamic exchange-traded funds (ETFs), Islamic securitization or Islamic derivatives but the amount or value is still insignificant. Malaysia has only four Islamic ETFs, four Islamic REITS and one Islamic futures while Indonesia only has one Islamic ETF. To accelerate growth, the Islamic capital markets should increase the number of Islamic securities.

## Preview of 2017

The Islamic capital market will still show high potential growth in 2017. Global Sukuk will tend to increase in terms of value and numbers. Some countries will issue new Sukuk like Indonesia



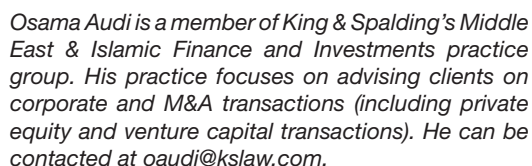
whose government has a commitment to finance infrastructure development through the capital market. The global Sukuk market share of Malaysia is expected to decrease approximately below 50% and Indonesia's market share will increase above 20%. The global funds market will still be led by Saudi Arabia and Asia will still dominate the global Islamic capital market.

## Conclusion

The Islamic capital market should aim for some breakthroughs in terms of the number of Islamic brokerages, infrastructure development and the number of Islamic securities. To increase volume and Islamic capital market capitalization and also reduce market fluctuation, Islamic brokerages should be multiplied in terms of numbers. Brokerages should create a tool or system to help investors trade easily in the Islamic way. Furthermore, the Islamic capital market needs new issuance of Islamic securities and to create new Islamic-based products.

What has been done by Indonesia to accelerate the growth of the Islamic capital market is quite interesting. The country created an online trading platform which complies with Islamic principles to help investors trade stocks in the Islamic way. As a result, the number of Islamic-based investors in Indonesia has increased significantly – more than 1,000% in the last five years. (5)

**The venture capital sector has showed continued sustained growth with significant public initiatives to grow the sector and continued record fundraisings for regional start-ups and out-bound investment by regional asset managers, venture capital funds and leading business figures. OSAMA AUDI surveys the venture capital landscape.**



Following a strong 2015, MENA-based venture capital investments showed surprising strength in 2016. The continued strength in venture capital investments is driven by high mobile use penetration and little competition when compared to more developed markets. The success of regional venture capital investors in platforms as diverse as online food ordering website Talabat.com which was acquired by Rocket Internet and subsequently acquired by the world's largest food-ordering platform, Delivery Hero, is testament to souq.com's ability to complete a funding of a reported US\$275 million – the largest e-commerce funding in the Middle East to date, and has spurred additional focus on the venture capital and technology sectors.

2016 was a banner year for venture capital and e-commerce investing in the MENA region and included headline grabbing deals such as the Saudi Arabian Public Investment Fund (PIF) announcing an investment of US\$3.5 billion in ride-hailing service, Uber. This was followed by an announcement that rival ride-hailing service Careem has closed in on US\$300 million in funding.

In addition, the PIF announced plans to invest approximately US\$45 billion into a US\$100 billion tech fund which will be established with Japan's Softbank. Smaller scale venture capital funds have also set up in the MENA region and are executing transactions. Among such funds, Leap Ventures raised approximately US\$75 million and closed two publicly announced deals including the acquisition of Uturn, a popular Arabic-language Youtube portal.

More recently, the PIF announced a series of investments or joint ventures with various ventures linked to Dubai-based Mohammad Al Abbar, the chairman of Emaar, the listed real estate developer responsible for, among others, the Burj Khalifa and the world's largest mall, the Dubai Mall. Dubai-based venture capital player Wamda invested a reported 40% of the US\$60 million it raised in regional funding in 11 different technology ventures.



## Regulatory update

From a regulatory perspective, 2016 was also a banner year with a number of new pieces of legislation being announced which will likely have an impact on the growth of a lively and sustainable venture capital market in the MENA region. New or proposed legislation includes: (i) a new bankruptcy law for the UAE which, it is hoped, will limit some of the serious risks entrepreneurs take when their ventures fail; (ii) draft rules for listings of small-cap companies in Saudi Arabia; and (iii) the announcement of a low-cost regime to establish so-called intermediate SPVs in the Dubai International Financial Center (DIFC).

### New UAE bankruptcy law

Taking the new or recently announced legislation in turn, on the 20<sup>th</sup> September 2016, the new bankruptcy law for the UAE was enacted. The law comes into effect on the 31st December 2016 and will be supplemented by procedural regulations to be issued in the near future.

The primary purpose of the law is to promote the rescue of businesses, either of individuals or companies, facing financial difficulties. This will be done through an insolvency procedure supervised by a competent court (eg Dubai courts). The court will have wide powers to oversee the reorganization of the relevant debtor's business, including appointing a trustee (at the cost of the debtor) to oversee the implementation of the insolvency procedure, being either a preventative composition arrangement, a restructuring plan or, as the case may be, a liquidation procedure.

The law will apply to: (i) companies subject to the Commercial Companies Law (ie most companies incorporated outside of the UAE free zones); (ii) decree companies which are totally or partially owned by the federal or local Emirati governments and which stipulate in their bylaws, memoranda of association or articles of association that they are subject to the law; (iii) free zone companies except for companies incorporated in the financial free zones (ie the DIFC or Abu Dhabi Global Market); (iv) traders; and (v) professional civil companies (eg consultancies).

### Draft Capital Markets Authority secondary market listing rules

On the 3<sup>rd</sup> November 2016, Saudi Arabia's Capital Market Authority (CMA) issued draft rules for a new secondary market. This will prove useful for parties seeking alternative sources of funding and potentially listing at an earlier stage in their lifecycle than has been typically available. Under the draft secondary market rules,

companies with a minimum share capital of SAR10 million (US\$2.67 million) will be permitted to list. Notwithstanding the foregoing, the CMA may approve listings at a smaller value. In addition, companies which list on the secondary market will be permitted to list only 20% of their shares.

### DIFC – intermediate SPV regime

The DIFC announced that it will soon issue regulations in relation to a new corporate form called an intermediate SPV (ISPV). The reference to 'intermediate' implies that ISPVs will not be the primary holding entity nor will they be actual operating entities further down the line in any relevant structure. In addition, only entities with a substantive presence in the DIFC will be permitted to establish ISPVs.

A party with a substantive presence in the DIFC can establish an ISPV as a joint venture vehicle so long as the entity with a substantive presence maintains control of the ISPV. Accordingly, ISPVs may be useful to regional family offices, holding companies or funds, with a presence in the DIFC, in order to structure shareholder arrangements in respect of their various joint ventures or subsidiaries which are not wholly owned. The use of an ISPV will enable such parties to entrench enforceable shareholder arrangements without moving such arrangements offshore. The use of an ISPV could enable parties with a substantive presence in the DIFC to take advantage of the DIFC's flexible corporate laws, which are based on English law, and the common law legal system while maintaining GCC nationality.

### Preview of 2017

We expect that the groundwork laid during 2016 will lead to continued expansion in venture capital investing in the region during 2017, with a focus on both early stage investments and start-ups as well as later stage investing such as the investments in, among others, Uber, Talabat.com and Careem. It's also hoped that recent government initiatives to benchmark regional laws and regulations and global best practices will lead to a legal environment that encourages the growth of venture capital businesses.

### Conclusion

2016 was a banner year for regional venture capital investing with venture capital investors, governments and start-ups working closely together to grow the relatively nascent sector. With reports from online payment platform Payfort projecting that the e-commerce sector will grow in the MENA region to US\$13.4 billion by 2020 from US\$7 billion in 2014, there have been quite a few initiatives announced which are hoped to lead to continued strength in the sector in 2017 and beyond.<sup>(2)</sup>

# NBF Islamic: New products, new services, new markets

**National Bank of Fujairah (NBF) has had an impressive run in 2016, particularly its Islamic finance business which will continue to be the bank's main focus going into 2017. CEO Vince Cook gives us an insider look at NBF Islamic's performance and achievements over the past year and shares with us the bank's Islamic banking growth strategies, product pipeline and aspirations for 2017.**

## **How did NBF Islamic perform in 2016? What were your biggest challenges and biggest achievements of the year?**

Since NBF Islamic launched in 2014, we have seen an extremely encouraging response for our proposition and on the whole, it has continually been one of the strongest performing divisions of the bank. While we cannot discuss full-year results for 2016 yet, in the first nine months, customer financing was up 81% compared to the previous year, while Islamic customer deposits rose 28% compared to previous year-end.

In terms of the biggest challenges we faced, these are consistent with those the broader banking industry sees today. Margin compression, increasing costs of regulation, a more complex credit environment, and broader macroeconomic concerns such as the ongoing impact from the drop in oil prices, are all issues that banks will need to take into consideration.

However, we are confident of achieving continued business growth and believe that what we have achieved puts us on a strong footing for expanding NBF Islamic customer base and ongoing success next year. Reflective of our success, we recently won the 'Best New Islamic Window – UAE' award at the recent Islamic Business & Finance Awards 2016.

## **What are the range of products offered by NBF Islamic and has the product suite expanded over the past year?**

As you know, when we launched NBF Islamic at the end of 2014, our first offering was our suite of retail banking services in Fujairah. This allowed us to test the waters and determine customer appetite, as well as our ability to compete with some of the larger Islamic financiers while maintaining the highest level of compliance with Shariah guidelines.

In turn, we launched our Shariah compliant corporate banking and trade finance products and services which have been well received in the market.

Central to these developments has been our focus on strengthening our Islamic capabilities in fulfilling customer needs quickly and effectively. This included implementing systems and building processes to support our infrastructure; as well as investing in the ongoing development of our staff and bringing experts on board.

## **What are your top predictions for the domestic Islamic finance market? What will be your biggest challenges and key opportunities?**

I think competition from fully-fledged Islamic banks in an environment where liquidity is tight, is the biggest challenge we envision. However, at NBF, we believe that our greatest opportunities come from our

tireless focus on catering to our customers' needs and adopting the highest standards of Shariah principles. Given this commitment, we do see pockets of opportunity that we are nimble enough and better suited to capture, particularly with the UAE's ongoing drive towards becoming the capital of the Islamic economy.

As we enhance our infrastructure and invest in resources and expertise, we are confident that NBF Islamic will further establish our position as a reliable and trusted banking partner in the UAE. Furthermore, as our Islamic balance sheet has grown rapidly, we see no reason why we cannot compete with larger and more established Islamic financiers in the near future.

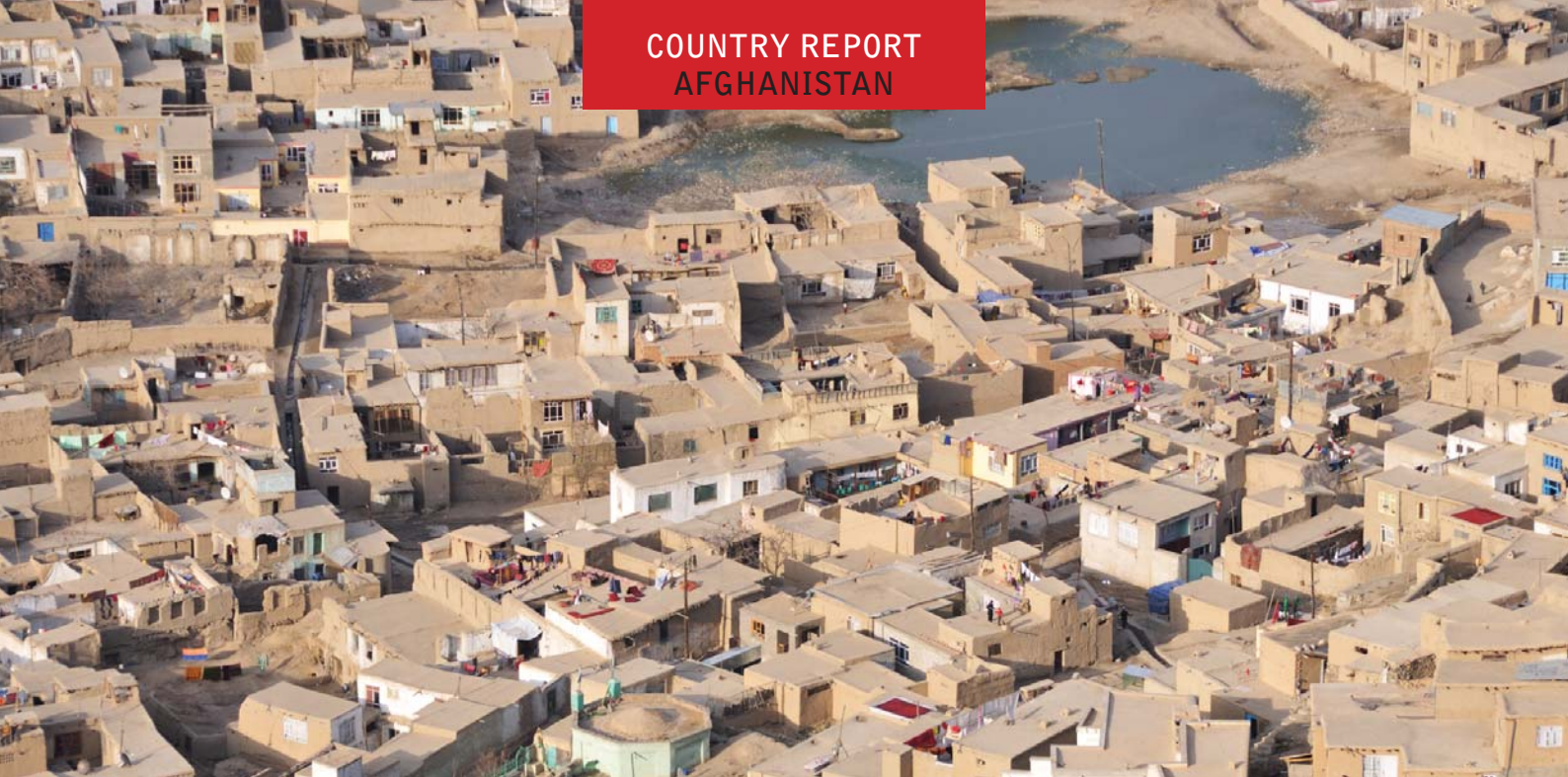
## **What are the targets and focus areas for NBF in 2017? Where do you see growth, and where will you be scaling back?**

Our top goal for 2017 remains to continue expanding our Shariah compliant customer base and improving our customer service levels, as it will enable us to develop long-term relationships with clients that will in turn drive our long-term growth. Over time, we would like to see our Shariah compliant business grow and eventually reflect the local banking sector as a whole, with a 75:25 split between conventional and Islamic banking. To achieve this, our expectations of annual growth are still around 20% and we believe we will soon be able to capture a 1-2% share of the market.

## **What new products and/or pipeline do you have for the coming year?**

We have a full suite of Shariah compliant treasury products now and we continue to grow our retail product base including a planned launch of Mudarabah instruments in 2017. On a bank-wide level, investment in technology is a priority, and we continue to enhance our digital channels to improve our clients' banking experience. We have just launched a mobile banking app and are currently upgrading our online banking service for our corporate and business banking customers. This will see the introduction of new features such as corporate cheque printing. All such developments are now accommodating both Shariah and conventional customer needs.

Moving ahead, once we have grown our core business and our market share, we may look to expand into areas such as capital markets. Another area in which we are keen to expand into relates to the recent development of a Shariah standard for gold-based products. The establishment of a new set of standards by AAOIFI means that there are now a whole range of Islamic banking services we can provide in this space. We are keen to leverage this and build on our existing expertise and long-standing business in the precious metals and jewellery sector, in order to provide the most innovative Shariah compliant services to businesses in this industry. (2)



# Positive year ahead for Islamic finance in Afghanistan



*Manezha Sukhanyar is the head of Islamic banking at Maiwand Bank. She can be contacted at hoib@maiwandbank.com.*

**While it has been more than three decades since the practice of Islamic banking began around the world, this system is only at its initial stage in Afghanistan and is considered a new concept. In a country with a more than 99% Muslim population, Islamic banking is practiced in the daily lives of the people, but it's not systematic. For instance, when people deal with each other they are concerned about the involvement of Riba and thus they mostly lend money based on Qard Hasan and they also practice Mudarabah and Murabahah but their practices are not as per the banking system.**

A point to note is that around 20% of the Afghan population is banked while the remainder avoid this facility due to the involvement of Riba. Islamic banking was introduced in Afghanistan between 2008 and 2009 and the first draft banking law was prepared by Da Afghanistan Bank which is the central bank of Afghanistan. Da Afghanistan Bank established the Islamic banking section that operates under the technical support of the Shariah Council consisting of famous religious scholars from Afghanistan as well from some other countries. Banking is one of the main sectors in Afghanistan and a healthy banking system is considered as the heart of the economic system of a nation. Due to the lack of an advanced banking system, a great portion of capital remains idle in the country.

## Review of 2016

During 2016, Afghanistan's economic situation remained difficult. Security instability held back growth and employment. Despite the central bank's efforts to address the vulnerabilities, the banking sector had to face many challenges during the year. As per available data from the World Bank, during the first half of 2016, the investment level was low.

The absence of Islamic banking regulations has been one of the biggest challenges for the banking sector and was resolved during

in 2016. The central bank extended great support toward the further improvement of the Islamic banking system and the recent regulatory progress can be considered as an enormous achievement for the banking sector. In the new Banking Law of Afghanistan, there is a dedicated section for Islamic banking.

Moreover, 46 manuals of regulations and guidelines have been developed by the central bank which will have a positive impact on attracting more deposits into the banking sector, ease the further implementation of Islamic banking and assure that the system is consistent with Shariah rules and regulations.

Currently, only seven out of 17 banks are offering Islamic banking services via the window system and the services and products offered by these banks are limited to Mudarabah, Murabahah, Musharakah and Ijarah. Bakhtar Bank, one of the private banks in the country, is in the conversion process from a window system to a fully-fledged Islamic banking system and will be the first bank with fully-fledged Islamic facilities.

During 2016, most of the Islamic windows faced high liquidity, with the main reason being the shortage of investment opportunities. Due to the involvement of Riba, Islamic financial institutions are restricted from investment/placement opportunities such as capital notes and overnight placement offered by the central bank.

## Preview of 2017

As per the World Bank report, economic growth is expected to increase over the coming years from 1.8% in 2017 to 3.6% in 2019 in view of the improvements in security, political stability, continued aid and the progress of reforms. The banking industry seems to be positive of 2017 and most banks plan to introduce new facilities such as long-term home financing, Sukuk and non-funded facilities. Furthermore, the problem of excess liquidity might be resolved to some extent during 2017, in view of the aforementioned economic growth, where ultimately investment opportunities will rise.

## Conclusion

In view of international aid and positive thoughts for 2017, it is hoped that there will be a peaceful and productive year ahead. ☺

# Australia awaits tax reforms for Islamic finance



Asad Ansari is the Islamic finance tax leader of financial services and investments at Deloitte, Australia. He was also appointed to the Board of Taxation's review on Islamic finance. He can be contacted at [asaansari@deloitte.com.au](mailto:asaansari@deloitte.com.au).

Australia's potential as a destination of choice for Islamic investment has never been fully realized. Its abundance of real assets – real estate, commodities and infrastructure assets would be well suited to Islamic investors. However, investment to date has been modest and disparate – partly due to prevailing conditions in the global economy, the effect of which is compounded by the uncertain legal and regulatory regime for Islamic finance. However, there have been some developments in this space which hold promise for better things to come.

**“The industry awaits the release of material by the government supporting the proposed tax reforms which should provide the certainty that investors have been seeking”**

## Review of 2016

This year holds some very promising news for Islamic finance with the most significant being the federal government's intent to implement the recommendations of the Board of Taxation's enquiry on Islamic finance. Back in 2010, the then Treasurer charged the board to undertake a comprehensive review of Australia's tax laws to ensure that, wherever possible, they do not inhibit the expansion of Islamic finance, banking and insurance products. In its most recent budget, the Australian government announced its intent to change tax rules from the 1<sup>st</sup> July 2018.

The budget papers made reference to tax reforms associated with 'asset-backed financing' which the government conceded was a reference to Islamic finance. To date, no detail has been provided nor has any draft legislation been released for comment. However, the government had indicated that these measures would be directed to support infrastructure investment and large and long-term projects, which would indicate the types of Shariah compliant instruments that the government intends to address.

On the deals front, things have been slow with the perception from most Islamic investors that the Australian government must first resolve the uncertainty of tax treatment. That said, the Australian Taxation Office has issued a number of income tax rulings on Islamic finance which is another avenue by which Islamic investors have obtained certainty (minus specific legislative amendments).

The favored asset class in Australia for Islamic investors is still real estate with a number of commercial asset acquisitions in the course of 2016. The low cost of debt in Australia combined with



well-tenanted, fully-leased assets make commercial office assets attractive. The most significant enabling factor has been the forays of National Australia Bank (NAB) as a provider of Shariah compliant debt in Australia. Imran Lum, an associate director at the NAB, has driven the NAB's business in this space through its Islamic capital markets division, and this which has opened the doors to some significant investors.

There are a number of Islamic investors who are still undertaking residential real estate development, but as supply is becoming quite abundant, particularly for central business district residential apartments, this activity has waned over the last year.

## Preview of 2017

The most significant area for investment potential in Australia remains infrastructure, but to date, no Islamic investor has participated in any of the high-profile infrastructure projects in Australia.

It may well be that we need to wait for the proposed legislative amendments to attract investors; however, there is still the prospect of these Islamic infrastructure investors opting for the income tax ruling path (as their real estate counterparts have already done) to obtain certainty of tax treatment.

This may create renewed interest in 2017 in this space among Islamic investors, with their conventional counterparts from the GCC and Malaysia already heavily and actively participating in Australia.

## Conclusion

The industry awaits the release of material by the government supporting the proposed tax reforms which should provide the certainty that investors have been seeking. This development will also be welcome by the consortia of infrastructure partners who thus far have been reluctant to interfere with existing structures to cater to Islamic investors (in the absence of specific tax reforms).<sup>(2)</sup>

*The views expressed in this article are the author's own.*



## Bahrain places a large bet on growth



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**The Kingdom of Bahrain, the Gulf's smallest economy, sets yet again another mark of continued growth in its economy with much emphasis on SMEs and their role to spur growth in the tiny economy. Oil and gas, traditionally the leading industry, generated over one-quarter of economic output until the oil price slump of 2014-15 drove its contribution down to about 13%, according to 2016 data from the Economist Intelligence Unit.**

According to the Bahrain Economic Development Board, the country recorded an overall GDP growth of 2.2% in the second quarter (Q2) of 2016, and forecasts for the next couple of years are estimated at 2% as shown in Table 1.

Bahrain's financial sector, which is the second-largest sector after the hydrocarbon sector, continues to dwarf the size of its domestic economy. According to the Central Bank of Bahrain (CBB), at the end of 2015, the aggregated balance sheet of the banking system – retail and wholesale banks – was US\$191 billion, about six times the GDP.

Islamic banks continued to play an important role in the financial sector and the overall economy. The financial soundness indicators show that capital positions increased for Islamic retail to reach 15.8% while it decreased for Islamic wholesale banks to reach 19.5% in March 2015. Non-performing facilities for Islamic retail

**Table 1: Economic outlook of Bahrain**

	2015	2016f	2017f	2018f
Real GDP growth, %	2.9%	2.8%	2%	2%
Non-hydrocarbon sector	3.6%	3.2%	2.4%	2.3%
Hydrocarbon sector	-0.1%	1%	0.5%	0.5%
Nominal GDP growth, %	-6.8%	4.9%	6.6%	5.1%
Inflation (CPI %)	1.8%	3.8%	2%	2%
Current account (% of GDP)	-0.3%	-1.9%	0.1%	0.8%
Fiscal balance (% of GDP)	-13%	-12.3%	-9.7%	-7.9%
Crude Oil Arabian Medium (US dollar)	50	45	55	60

*Source: Bahrain Economic Development Board*

banks increased to 12.4% in March 2016 from 11.7% in March 2015 while that for Islamic wholesale banks also increased to reach 4.9% over the same period, according to the CBB's Financial Stability Report, July 2016.

Despite the rise and fall in asset prices in Bahrain and the tightening of liquidity due to the fluctuation of oil prices, the banking sector remains well regulated, with 2015 seeing a unification of Shariah compliant banking regulations and the adoption of new capital adequacy laws in adherence to Basel III.

The Takaful industry (Shariah compliant insurance) in Bahrain has shown a 3% growth in terms of gross contributions to register BHD63.22 million (US\$166.08 million) in 2015. Gross contributions of Takaful firms represent around 23% of total Bahrain gross premiums/contributions in 2015.

The government has also expanded revenue-raising measures, including the introduction of a GCC-wide value-added tax (VAT) in 2017-18.

According to the Bahrain Economic Development Board, the social and personal services is the fastest-growing individual sector with year-on-year growth at 9.9% in Q2 of 2016 followed by the construction sector.

## Review of 2016

The Bahrain Bourse had obtained the approval of the CBB regarding the Bahrain Investment Market Rules. The new rules will create new landmarks in providing additional financing alternatives to SMEs with a reasonable financing cost, as well as providing more investment alternatives to investors.

The CBB has also proposed new governance rules that would require Islamic banks in the Kingdom to conduct external Shariah audits of their operations, representing a shift away from the long-held practice of self-regulation.

The Bahrain Chamber of Commerce and Industry has finalized a draft law for investment. The new draft law aims “to reinforce the competitiveness and attractiveness of the Bahraini market, remove impediments for foreign and domestic investments and enhance trust in the investment and business climate of Bahrain”.

In June 2016, the International Islamic Financial Market and the International Swaps and Derivatives Association published two new standards for Islamic forward foreign exchange products for use in Islamic hedging transactions.

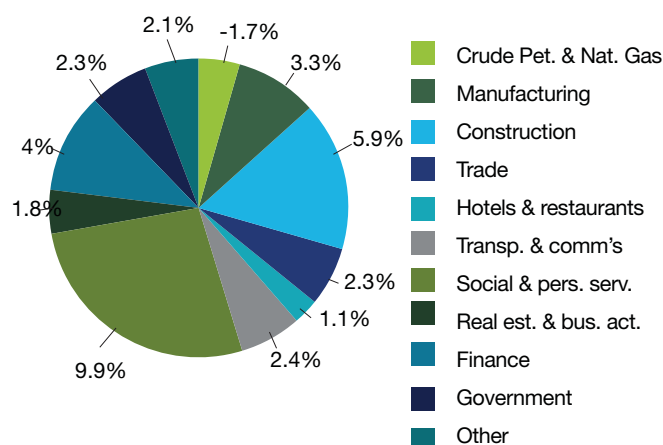
In April 2016, Al Baraka Banking Group unveiled details about its ‘Al Baraka Goals for 2016-2020’, which are linked to the UN’s Sustainable Development Goals 2030. The recently developed strategy aims to create over 51,000 jobs by 2020 through financing a number of businesses and projects in countries where it operates.

In February 2016, AAOIFI and the Bahrain Institute of Banking and Finance signed a cooperation agreement to commence an e-learning platform project for standards issued by AAOIFI.

## Preview of 2017

In the current uncertain climate, it is always difficult to make a forecast or prediction on economies and growth. However, what is most certain is that the continued low oil prices are likely to challenge

Chart 1: Year-on-year growth for key sectors in Bahrain (Q2 2016)



Source: Economic Development Board, Bahrain economic quarterly report, September 2016

the government into greater spending restraint in the near term. The budget is projected to record a deficit of 9.7% of GDP in 2017.

It has been reported that the real GDP growth is expected to average 2.2% in 2017-19 and inflation will rise in 2017-18, averaging 3.7% a year, on the back of subsidy cuts and new taxes. Inflation will moderate thereafter to an average of 2.6% in 2019-20, owing to lower import costs.

It is also widely believed that the government will look to tap the international and domestic debt markets to finance its budget deficits.

## Conclusion

The revenue-raising strategies are likely to be seen throughout the GCC region. The introduction of VAT is inevitable. Government agencies in the Gulf have started awareness efforts and policy changes to facilitate implementation as early as January 2018.

It is also hoped that oil prices will pick up in mid and late 2017 and onwards. This will likely ease budgetary pressures on the government of Bahrain and allow for socioeconomic and investment projects to continue as planned. ☺



# Islamic finance in Bangladesh



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**Attributed to its intrinsic value, uniqueness of distinctive banking and sustainability aspects, Islamic finance has been growing fast in Bangladesh. Not only banking but other segments of Islamic finance like insurance and non-bank financial institutions (NBFI) are also enjoying strong positioning among customers and shareholders with the growth of the country's economy.**

## Review of 2016

Among 57 scheduled banks working in the country, eight are fully-fledged Islamic banks with 966 branches and 15 are conventional banks with their 21 branches and 15 windows with Shariah banking operations. Some six banks are known to be in the process of converting into fully-fledged Islamic operations. Those banks altogether contribute about one-fifth of the banking industry in terms of assets. The banking industry in Bangladesh is largely dominated by private commercial banks with two-thirds of the market share in which Islamic banks hold about one-third. In the case of financial inclusion, Islamic banks are doing better through their small size deposit and investment products. Islamic banks have maintained a growing market share in all major business segments in 2016.

In addition to the General Index and Blue Chips Index, both the stock markets (Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE)) in Bangladesh have separate Shariah indices. Around one-third of 293 companies listed in the DSE from different sectors are in the Shariah index. Out of the CSE's 258 companies, 63 companies are included in the Shariah index. These Shariah indices are mostly dominated by banks, insurance companies, mutual funds and NBFIs.

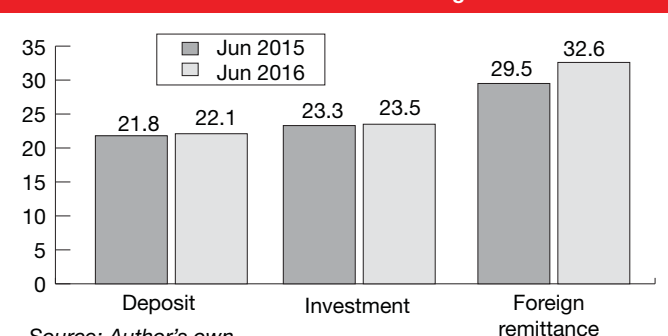
Takaful has been growing steadily in Bangladesh as a Shariah-based segment of financial products since its inception in 1999. At present, 78 insurance companies are in operation of which 32 are life and 46 are non-life or general. A total of 11 (eight life and three non-life) Takaful companies are now running and more than a dozen conventional life and non-life insurance companies are offering Takaful products through windows or projects. The asset base of the Takaful industry has stood at US\$929 million which is around 17% of the insurance industry in Bangladesh.

The NBFI sector in Bangladesh plays an important role in financing various sectors such as manufacturing and service industries, trade, housing, transport, information and communication technology and capital markets. With 33 companies, this sector consists of specialized financing companies, leasing companies, investment companies, merchant banks, etc. Two Islamic NBFIs with assets of US\$221 million have a 3% market share.

Of the 34 mutual fund companies under both the DSE and the CSE, three are Islamic financial institutions. Market capitalization of those funds stood at BDT2.26 billion (US\$27.97 million) in November 2016, which is 7.7% of the total mutual fund market. Recently, the Bangladesh Securities and Exchange Commission approved the prospectus of the SEML IBBL Shariah Fund, a closed-end mutual fund. The size of the Shariah mutual fund will be BDT1 billion (US\$12.37 million) and the offer price of the units will be BDT10 (12.38 US cents) each.

Islamic microfinance institutions working for the poor on the principles of equity and justice have proved their worth in contributing toward poverty alleviation in Bangladesh. Of the 697 microfinance institutions (licensed with the Microcredit Regulatory Authority) operating in the country, some 13 offer Islamic financing. In addition, three Islamic

**Chart 1: Islamic banks' market share in Bangladesh**



banks, ie Islami Bank Bangladesh (IBBL), Social Islami Bank and Al-Arafah Islami Bank, conduct Islamic microfinance through specialized divisions.

Though the bond market is very small in the financial market of Bangladesh, several subordinated bonds have been issued in recent times. The importance of Islamic bonds or Sukuk is also drawing the attention of different stakeholders. The biggest issuance of Islamic corporate bonds, amounting to BDT3 billion (US\$38.12 million), was first issued in 2007 by IBBL to support its Tier 2 capital. This Mudarabah perpetual bond facility has a market capitalization of BDT2.92 billion (US\$36.13 million) in the DSE.

## Preview of 2017

In terms of asset quality, capital adequacy and profitability, Islamic banks are outperforming their conventional peers. However, they still have scope to explore further alternative banking products like mobile banking, internet banking and e-commerce.

The DSE has already initiated steps to launch various new tradable products starting with exchange-traded funds to be followed in the long term by the expansion of current product offerings to include convertibles, bonds, Shariah compliant products including Sukuk, exchange-traded funds and REITs.

Takaful has ample room to grow in Bangladesh. Industry experts see its rapid growth as a welcome phenomenon. The formulation of appropriate rules and regulations is required for the healthy development of Takaful. Sound regulatory and supervisory mechanisms based on a Takaful act would serve as a vehicle for a thriving Takaful business. Stakeholders need to work together to develop standard practices and a regulatory framework to make the Takaful industry in Bangladesh more efficient and vibrant.

In Bangladesh, Sukuk could be an alternative source of financing for infrastructure projects such as bridges, a deep-sea port and vast road and rail river crossings that link the southwest of the country to the rural northern and eastern regions. The issuance of Sukuk in Bangladesh is expected to receive a positive response from Middle Eastern investors. The government of Bangladesh can raise the required funds by issuing cross-border Sukuk under a syndication process as well.

## Conclusion

Islamic finance still has ample room to flourish in Bangladesh, a country of 160 million people who are largely Muslims. For a sustained growth of the Islamic finance industry, scholars and practitioners feel it is necessary to have separate Acts for different segments of Islamic finance like banks, insurance companies, NBFIs and Sukuk, etc. These will facilitate the industry to grow further in terms of volume and product innovation and will protect the interests of stakeholders with adequate legal support. ☺

# Bosnia: Strong Islamic banking growth despite regulatory challenges



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**Bosnia and Herzegovina submitted its formal application for EU membership in February 2016. The application is the first step in the process and opens the door to new EU pre-accession funds which will be utilized for economic growth.**

The only Islamic bank in Bosnia, and the fastest-growing among both conventional and Islamic financial institutions, is Bosna Bank International (BBI). Together with the IDB, BBI is a shareholder of BBI Real Estate, a very successful Islamic leasing company in Bosnia. The IDB continuously invests and assists with different projects in Bosnia.

The Bosnian banking market remains highly competitive with 24 banks. Due to accumulated risks, several banks reported significant losses in their business. As a result, two mergers and one bankruptcy occurred in Bosnia and Herzegovina's banking sector during 2016.

## Review of 2016

Islamic banking assets in Bosnia have been experiencing strong growth in 2016, where total growth from October 2015 to October 2016 amounted to 17.1%. At the same time, profitability has increased by 37%.

The first Shariah compliant stock market index in the region was launched in October 2016. The index is a product of the collaboration between the Sarajevo Stock Exchange (SASE) and BBI. In addition, BBI made publicly available a list of all 117 Shariah compliant companies on the SASE.

The Sarajevo Business Forum (SBF) 2016, organized by BBI and the IDB Group, gathered more than 1,600 participants from 45 countries, and once again confirmed its position as the 'Balkan's Davos'. The forum attracts significant investments from the GCC to the Southeast Europe (SEE) region. As a result of the SBF, the Investment Corporation of Dubai invested in Hepok, one of the largest agriculture companies in the country.

Islamic finance public education projects are continuously implemented in Bosnia through newspapers, radio and now even TV shows, sponsored by BBI. The bank also collaborates with the academic community. The University of Sarajevo and the University of Bolton enrolled a new generation of Islamic banking Master's students in the 2016/17 academic year, this being the only study of this kind in the SEE region. The third partner in this educational project is BBI which provides scholarships and professional training to students. Around 100 students have received BBI scholarships for Master of Arts studies in Islamic banking thus far. In the beginning, it was very difficult to secure a Shariah governance framework due to a lack of expertise but today, a large number of well-educated Islamic banking specialists who maintain different positions in BBI provide an extra layer of Shariah compliance in this institution.

BBI collaborates with other important institutions worldwide with the aim of facilitating the mutual exchange of know-how and experience. The Istanbul Stock Exchange (Borsa Istanbul), in partnership with

Kuveyt Turk Bank, has launched a comprehensive training program for employees of BBI. As a result, 50 employees of BBI will pass through this valuable three-month training course.

At the University of Sarajevo's annual graduation ceremony, the CEO of BBI addressed students and announced that BBI will offer employment to the best students among those 5,491 who graduated during the last academic year from the largest university in Bosnia. This represents a great opportunity for these young people since the bank traditionally receives the country's renowned 'The Most Desirable Employer' award for the finance sector.

**“ The outlook of Bosnia's Islamic finance industry remains positive based on economic growth projection ”**

## Preview of 2017

In late 2016, BBI initiated cooperation with the government aimed at supporting entrepreneurship and formed a special line of financing for SMEs with extremely favorable conditions, which will be utilized during 2017. At the same time, with the SBF and continued efforts at strengthening business ties with the Middle East, India and Malaysia, Islamic banking will open new horizons for these companies.

Forthcoming changes in the Bosnian banking legislation landscape represent a great opportunity to adapt the laws to Islamic finance which would enable Islamic banks to use all available Islamic models of financing. This was also one of the conclusions of the 7<sup>th</sup> International Conference on Islamic Banking and Finance: Risk Management, Regulation and Supervision which took place in Sarajevo and was organized by the Islamic Research and Training Institute and the European Association for Islamic Economics, Banking and Finance. BBI has already prepared the appropriate amendments to the law.

In 2017, BBI will continue developing its use of Islamic models of financing, promoting foreign direct investments, interconnecting the business and academic communities, granting scholarships and employment opportunities to the best students, educating the public about Islamic finance and supporting entrepreneurship. All of these activities arguably render BBI the most socially responsible financial institution in the country.

## Conclusion

The outlook of Bosnia's Islamic finance industry remains positive based on economic growth projection and the fact that Islamic banking plays a very significant role in the promotion of new foreign direct investments. Islamic banking in Bosnia has increased influence despite regulatory constraints and Sarajevo now serves as a hub for Islamic finance in the SEE region. Besides its Shariah compliance, BBI has succeeded in building several unique features which help to create one of the strongest brands in the Bosnian finance industry. With its business club, social responsibility and public education projects, BBI can serve as a role model for other Islamic banks in a conventional regulatory environment. (2)

# China's 'Belt and Road' initiative – how Islamic finance can play a part



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As we look forward to 2017, we see many interesting things emerging from China's 'Belt and Road' (B&R) initiative also called the New Silk Road Plan as part of China's ambitious strategy to target the economies along the B&R which account for approximately 63% of the world's population and 29% of global GDP.

The 'Belt' shall target infrastructure connectivity through investments in a network of overland roads, high-speed railways, oil and natural gas pipelines that shall stretch from central and western China through Asia and ultimately reaching London. The 'Road' refers to a 21st century Silk Road maritime equivalent consisting of a network of ports and other coastal infrastructure projects that dot the map from Southeast Asia to East Africa and the Mediterranean Sea. Thus, the B&R initiative allows China to promote investment and trade facilitation, financial cooperation and renminbi internationalization with countries across Asia, the Middle East and Africa.

**“ The 'Belt' shall target infrastructure connectivity through investments in a network of overland roads, high-speed railways, oil and natural gas pipelines that shall stretch from central and western China through Asia and ultimately reaching London ”**

Infrastructure development is the key emerging need of many countries in Asia, the Middle East and Africa and requires significant investment and tapping into every available pool of liquidity. Islamic finance can play a significant role in providing alternative means of financing. In addition, many countries along the B&R have well-developed Islamic financial systems, thus it is anticipated that Islamic capital markets will receive a boost from these initiatives. The initiative is also likely to provide a channel for China's savings and construction expertise to be shared with the countries along the B&R and help resolve their infrastructure needs.

The UAE and in particular Dubai, is already recognized as a regional financial hub and has made great strides toward achieving its target of becoming the capital of the Islamic economy, exemplified in 2015, when NASDAQ Dubai overtook Malaysia and London as the world's leading center for international Sukuk listings. The UAE's expertise in Islamic finance provides China with the ability to access regional liquidity and strengthen ties with Muslim-majority countries in terms of inbound investments from China. The B&R initiative offers China a gateway to use Islamic finance to build business relationships



*Shanghai World Financial Center*

and foster increased cooperation on infrastructure projects with the Middle East and the Muslim-majority Southeast Asian and African countries. In particular, export credit agencies and multilateral organizations are already well-versed in Islamic finance and can provide political risk insurance and guarantees which broaden the scope and allow new issuers to diversify their investor bases.

Furthermore, the B&R initiative offers the prospect for Chinese entities to raise financing offshore through previously untapped markets and the UAE is ideally positioned to act as a hub through which both Islamic and conventional investments into China can be routed through from the wider Gulf region. Similar to the UK, Hong Kong made its first foray into Islamic financing through its inaugural Sukuk issuance in 2014 and again less than a year later in 2015, demonstrating it is possible for non-Muslim majority countries to take the steps to establish an Islamic financing framework in order to be a player and participate in Islamic investments in the region and the global platform as a whole.

The B&R will likely have a transformative economic impact on Asia and Africa, especially for smaller, less-developed countries with high infrastructure requirements. In addition, it can offer Chinese entities an opportunity to raise financing offshore through an untapped market, which will help to strengthen its relations with some of its most important trade partners and spur inter-regional trade and economic openness among countries adopting the B&R strategy.

As China further opens up its cross-border capital movements and client needs in renminbi grow, Standard Chartered Bank with its long 150-year history in China and presence along key renminbi offshore centers, is ideally placed to capitalize on the B&R initiative. Combined with Standard Chartered Saadiq, an established leader in Islamic banking, with a presence in core Islamic markets and solid experience in cross-border, project finance and capital markets, we are the perfect partner to advise on B&R opportunities to sovereigns, corporate and institutional clients and we look forward to realizing its full potential. ☺

# Islamic finance finds a perfect market in France



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In 2008, the then French minister of the economy, Christine Lagarde, announced that: “We wish to make Paris a better market for Islamic finance, particularly in this background of crisis, credit excess, volatility and cupidity.” Since then, numerous transactions in France, particularly in the real estate market, have been financed by Islamic products (generally offered by foreign banks and governed by foreign laws). However for the time being, most of the investors, acting through Islamic finance products in France, are not French residents.

Islamic finance started to emerge in France toward the end of the millennium and, to date, no specific set of rules concerning Islamic finance has been issued. The concepts of Islamic finance, though, can be implemented in France and foreign institutions may enter into the banking, insurance or capital markets on the condition that they are licensed to operate (unless they can rely on the European passport). Indeed, the French legal system is quite Shariah friendly. The concept of contractual freedom facilitates the transfer of the core concepts of Islamic finance. Therefore, no specific amendments to French regulations appear necessary to accommodate Islamic transactions. However, the French tax regime still needs to be adapted to Islamic transactions, for instance, with respect to transfer taxes incurred in Ijarah arrangements.

## Review of 2016

At the beginning of 2016, Azurite Courtage created Takaful insurance products for French residents, adding to the already existing Shariah compliant products in the French market. Moreover, Noorassur, a company that used to offer online Shariah compatible products, has now opened several offices around the country; Noorassur offers Takaful insurance products (the protection can cover the Hajj) and Shariah-compatible savings (for weddings, studies, pensions and such).

A recent reform of the French contract law (Ordinance n°2016-131 dated the 10th February 2016 reforming the French Civil Code), which entered into force on the 1<sup>st</sup> October 2016, has reaffirmed and specified some of the core concepts of French civil law, such as good faith (*‘bonne foi’*) and, like the Haram principle, the existing rule of *‘public order’*. This reform also introduced a new rule, in line with the Maysir principle, according to which a court can force the parties to an agreement, the enforcement of which has become substantially unaffordable for one of the parties, to renegotiate the agreement in order to find a new economic balance; otherwise, the parties can agree to terminate the contract.

Also, the reform reasserts that any civil contract will need to have content that is certain (*‘contenu certain’*) or at least determinable (by indicating the quantity or the quality of the goods), which is a rule *‘ad valitatem’* (for example, a court would rule that a purchase contract that does not sufficiently determine the elements of the purchase is null and void). All of the aforementioned principles have common values with Islamic finance rules and allow the reaffirming that Islamic transactions have good roots for growing in France. More particularly, Mudarabah can be implemented under French law through a limited partnership, Musharakah through a joint venture-type arrangement or a partnership company, Ijarah through a leasing



transaction and a Wadiah can take the form of a deposit agreement governed by the Civil Code. Murabahah, however, is treated under French law as a credit transaction, and thus particular attention must be paid to the compliance of the financier with the regulations for financial institutions, credit transactions and the package securing the repayment. Furthermore, Shariah funds make up a significant part of ethical funds in France and the French government, as well as the Financial Markets Authority, has promoted Sukuk type securities to attract Islamic investors.

## Preview of 2017

With nearly six million French Muslim citizens, France is one of the European countries with the biggest growth potential in terms of Islamic retail banking. French residents are more and more active in the Islamic finance market, for instance, some *‘VIP-customers’* working in the sport or media industries. In view of this, various foreign Islamic banks are considering the establishment of a direct subsidiary in France, more particularly in the context of Brexit.

## Conclusion

Professionals of Islamic finance in France are suggesting the implementation of several reforms such as greater publicity, establishing legal and fiscal certainty for Islamic finance instruments, a stock exchange index of Islamic funds created by the NYSE Euronext similar to the US’s S&P Shariah indices, or a strategy for the collection of savings, making it easier for Islamic finance institutions to obtain banking licences. The creation of such a welcoming Shariah business environment is a challenge for the French market. The integration of Islamic finance training in the French higher education system is also crucial and is currently provided in particular by the prestigious University Paris-Dauphine. With all this potential, there is no doubt that the French market is really a windfall for Islamic investors. (2)

# Hong Kong: Proactive approach needed to take Islamic finance to greater heights



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The promising prospect of Islamic finance is well recognized by the Hong Kong government and the financial sector as a very significant factor in Hong Kong's maintenance of its international financial center status when encountering fierce competition from countries like Singapore and Malaysia.

However, after the changes in tax rules that provided a level playing field for conventional bonds and Sukuk as well as two sovereign Sukuk issuances totaling US\$2 billion from 2013 to 2015, the pace of Islamic finance development in Hong Kong has slowed down for the entire 2016, which needs more catalysts from both governmental bodies and financial institutions to strengthen this specialized segment of the market.

**“ If Hong Kong is proactive enough, there will be ample opportunities in Sukuk financing for OBOR infrastructure projects ”**

## Review of 2016

Since the Hong Kong government announced on the 1<sup>st</sup> March 2016 that its third Sukuk issuance will be happening sometime in the second half of the year, the market has been looking forward to its implementation, but it is yet to happen in the city as of today; the same goes for corporate Sukuk offerings. Apart from the aforementioned long-awaited Sukuk issuance, there are still no clues or updates regarding other areas such as Islamic REITs, Islamic exchange-traded funds and Takaful in Hong Kong.

## Preview of 2017

Some local brokers have said that, although some government efforts existed during the past few years, a small Muslim population of 270,000 people and a lack of understanding of Islamic finance products in Hong Kong have contributed to the sluggish outcome. Nevertheless, the Hong Kong Monetary Authority has said that it is endeavoring to examine practical issues in order to formulate a Sukuk issuance plan that takes into consideration market conditions. Further, it would definitely encourage corporates to consider issuing Sukuk, although it will depend very much on demand and pricing eventually.

On the other side of the coin, the Hong Kong government should consider offering tax incentives, for instance, the exemption of interest income on profits tax, for those companies which hold debts. The incentives should include the extension of a tax exemption on interest income and profits derived from debt instruments issued by governments and multilateral agencies in various currencies.



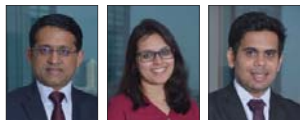
Nowadays, it is widely accepted that Islamic finance plays an essential role in 'One Belt, One Road' (OBOR) project financing. The Hong Kong government did a great job in providing equivalent tax treatment for conventional bonds and Sukuk by amending its tax laws in 2013. However, more tax incentives on Islamic debt securities are also expected to pave the way for Hong Kong to become a flourishing Islamic financial center.

## Conclusion

Hong Kong has the potential to position itself as the super-connector between China and OBOR countries. To make it happen, Hong Kong should speed up its process in Islamic finance development by making the best use of its tax regime advantage to strive for those Chinese companies, which are planning to issue their dollar Sukuk in overseas jurisdictions, to come to Hong Kong, especially when it is fiercely competing with Singapore and other counterparts to be the top international financial center in the Asian region. If Hong Kong is proactive enough, there will be ample opportunities in Sukuk financing for OBOR infrastructure projects, which will be worth tremendous economic benefits in the long run.

In addition, Hong Kong should start to formulate relevant policies and holistic solutions to help promote other Islamic financial products such as Takaful, in order to make its Islamic finance portfolio more comprehensive and robust. Most importantly, Hong Kong should also fully support its financial talents to receive Islamic finance education in renowned tertiary institutions such as the International Center for Education in Islamic Finance (INCEIF) in Malaysia, since a pool of seasoned experts can make a huge difference in shaping Hong Kong's Islamic finance development. ☺

# Inceptive period for Islamic finance in India



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After proving its usefulness in the US, Europe and the Far East in Asia, Islamic finance has now been knocking on Indian doors. With a compounded annual growth rate (CAGR) of 17.3%, it is the fastest-growing sector in the financial industry. The Islamic finance market currently falls in the range of US\$1.66-2.1 trillion, with an expectation of becoming US\$3.4 trillion by the year 2018 according to estimates by the International Shari'ah Research Academy for Islamic Finance. According to the IMF, Islamic finance's risk-sharing features and ban on speculation could pose less systemic risk than conventional financing. Globally, interest-free banking, also known as Islamic banking, has witnessed a significant increase, especially in the wake of the 2008 financial crisis.

**“ India needs reforms and quick. To develop the Sukuk market, India will need to reform policies relating to project execution and long-term funding ”**

## Review of 2016

Piloting Islamic finance into India was also helped by the execution of an MoU between the IDB and the Export Import Bank of India (EXIM). The MoU's terms permit the IDB to open its foremost branch in India to offer Shariah compliant financial and banking services. A commercial line of credit amounting to US\$100 million is to be extended by the Islamic Corporation for the Development of the Private Sector to EXIM pursuant to the MoU. A state-of-the-art rural mobile network in Gujarat worth US\$55 million has also been promised by the IDB. The SME sector appears to be the primary focus of the IDB's funding and investments into India.

In 2016, India's first fully Shariah compliant and Securities and Exchange Board of India (SEBI)-registered fund launched its third investment fund, the Realty AIF 1 (Alternative Investment Fund). The fund is focused on the real estate sector. Promoted by Secura Investment Management (India), the fund's investments and operations are in compliance with the principles of Islamic finance. The fund is expected to have a lifespan of seven years with the first close on the 31<sup>st</sup> December 2016 and a target to raise INR2 billion (US\$29.53 million) with a green shoe option of INR1 billion (US\$14.76 million). The minimum investment under the scheme is INR10 million (US\$147,636).

The primary objective of the fund is to carry out investments as permissible under the regulations of SEBI and raise resources to provide venture capital assistance to portfolio companies operating

in the Indian real estate and allied sectors to generate superior risk-adjusted returns. In the broader market, a number of asset management companies such as the Taurus Mutual Fund and Tata Mutual Fund have offered Shariah compliant investment schemes in India. These were not specifically marketed as Islamic but rather as 'ethical funds' in order to attract non-Islamic investors as well.

Another step in providing thrust to Islamic finance as a mode of banking and finance in India has been the setting up of the Lokmangal Cooperative Bank in Solapur, Maharashtra. This bank offers interest-free deposits and other similar products. The approach sought to be taken by the opening of this bank is essentially to promote the financial inclusion of the masses and minority sectors. Reports suggest that the bank has so far managed to distribute INR250,000 (US\$3,690.91) to those financially in need. The bank is aiming to follow a 'participatory approach' model, where participation is being encouraged by the state government

In addition, we now also have Jammu and Kashmir Bank (J&K Bank) reassessing to offer Islamic banking to its customers in the state. It is looking to examine the proposal after taking the Reserve Bank of India (RBI) on board. In the past, J&K Bank has considered setting up a subsidiary for Islamic finance.

## Preview of 2017

Keeping in mind the upward trajectory of the global Islamic finance industry, India is also working toward broadening its potential to become a preferred investment destination for Middle Eastern and Southeast Asian investors looking for Shariah compliant investments. For public investments, for example in much-needed infrastructure improvements, Sukuk have been increasingly seen by the Indian government as an alternative source of funds to allow issuers and investors to participate in major infrastructure projects. A report released by the Economist Intelligence Unit acknowledges the fact that the GCC's trade and investments are flowing toward emerging markets like China and India instead of the US and Europe.

The agricultural sector could benefit from Islamic finance which would assist to pause the cycle of debt and interest payments which often regresses the progress of farmers. Observers say that with the Indian government's approach toward Islamic finance having turned neutral, if not positive, the introduction of a respective framework could be set in motion quickly since the central bank has been working on a way for the entry of Islamic banking into India for nearly a decade now.

## Conclusion

In countries where Islamic finance is prevalent, it is seen as an ethical and socially responsible way of encouraging investments.

India needs reforms and quick. To develop the Sukuk market for infrastructure development like in Malaysia, the Middle East and Europe and to introduce interest-free Islamic finance and banking for inclusion of the marginalized and the minorities, India will need to reform policies relating to project execution and long-term funding. There is nothing that restricts India from becoming the hub of Islamic finance and banking.

The government of India, the finance ministry and the RBI will need to consider the impact of Islamic finance on the markets and permit/create regulations to ensure that there will be a conducive environment for Islamic finance investors to participate in the market.☺

# Indonesia: Growing dominance of government Sukuk



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**Similar to the year of 2015, the growth of the Islamic banking industry in Indonesia is still continuing on a decelerating trend. In 2014, the Islamic banking industry grew 12.4%. The growth then dipped in 2015 to 8.8%.**

As at August 2016, it recorded a 3.1% growth. It is, of course, a tentative growth figure for 2016 but it at least indicates persistent slow growth experienced by the Indonesian Islamic banking industry. The same also applies to the Islamic rural bank industry that has so far recorded slower growth compared with 2015 although it still recorded higher growth compared to its Islamic bank counterpart.

However, comparatively speaking, it is important to note that there has been a small increase in the market share of the Islamic banking industry to 4.95% in August 2016 from 4.71% in August 2015, meaning that the growth of Islamic banking is still faster than conventional banking.

Contrary to the growth of the Islamic banking industry, the year 2016 saw the acceleration in the growth of government Sukuk issuance. Sovereign Sukuk issuance up to August 2016 (from December 2015) reached 45.05%. It maintained a fast growth momentum and is most likely to surpass the full year growth of 2015 which was at 54.23%. Government Sukuk issuance has now become the most dominant player in the Indonesian Islamic finance industry.

The Islamic insurance industry is another component of the Islamic finance industry that has also shown encouraging growth in 2016 (as at August 2016) although its asset size is still small compared to Islamic banking. The Islamic life insurance industry and general (and reinsurance) industry recorded growth of 22.9% and 22.2% respectively.

Corporate Sukuk have still not made any major progress so far. The same can be said for the Islamic mutual fund industry. It even recorded negative growth as at August 2016 although it has yet to be seen how it will perform until the end of 2016.

Apart from the aforementioned industry perspectives, a general slowdown in the global economy also contributed to some extent to the slower economic growth in the country, which in turn, also affected the growth of the Islamic banking industry.

## Review of 2016

Despite the fact that the growth of the Islamic banking industry is still comparatively faster than conventional banking, the growth is historically reaching a record low. Two major Islamic banks, Bank Syariah Mandiri (BSM) and Bank Muamalat Indonesia (BMI), whose assets accounted for 43% of total Islamic banking assets in 2015, have entered their slowest growth periods since 2014. BMI even experienced negative growth in 2015, experiencing a 7.4% decline in assets to IDR57.8 billion (US\$4.28 million) in 2015 from IDR62.4 billion (US\$4.62 million) in 2014. Worse still for BMI, by August 2016, its total assets went down further to IDR52.6 billion (US\$3.89 million).

In fact, the market share of BSM and BMI have declined over time; in 2010, their market shares were 33.3% and 22% respectively and by 2015, their market shares declined to 23.7% and 19.3%

**Table 1: Selected figures from the Indonesian Islamic finance industry (IDR trillion)**

	2011	2012	2013	2014	2015	2016
Assets of Islamic commercial banks and Islamic windows	145.47	195.02	242.28	272.34	296.26	305.29*
Assets of Islamic rural banks	3.52	4.7	5.83	6.57	7.74	8.59*
Sovereign Sukuk issuance <sup>^</sup> (cumulative)	81.53	138.62	186.22	250.17	385.85	559.67**
Corporate Sukuk issuance (cumulative)	7.92	9.79	11.99	12.96	16.08	17.33***
Islamic mutual funds (net asset value)	5.56	8.05	9.43	11.16	11.02	9.93***
Assets of Islamic life insurance	7.25	9.83	N/A	18.05	21.61	26.57*
Assets of Islamic general insurance and reinsurance	1.91	3.23	N/A	4.31	4.91	6*

Sources: Alwyni (2016), Financial Services Authority (OJK), Ministry of Finance, and calculated further.

Notes: \*As at August 2016; \*\*As at the 6<sup>th</sup> October 2016; \*\*\*As at July 2016; <sup>^</sup>includes all government Islamic securities issuances; US\$1 = IDR13,640 (22<sup>nd</sup> October 2015).

respectively. While these two largest Islamic banks experienced declining market shares, second-tier Islamic banks such as Bank Negara Indonesia Syariah (BNIS), Bank Rakyat Indonesia Syariah (BRIS) and Permata Syariah (the Islamic window of Permata Bank) increased their market shares.

BRIS, BNIS, and Permata Syariah increased their market shares to 8.2%, 7.8% and 5.1% respectively in 2015 from 7%, 6.5% and 2.3% in 2010. It is most likely that this trend will continue by the end of 2016.

While the Islamic banking industry is facing a slowdown, Islamic government securities are continuing their upward trend. In fact, according to data from the Ministry of Finance, as at the 6<sup>th</sup> October 2016, total issuance of government global Sukuk is the largest in the world amounting to US\$10.15 billion, followed by the Emirate of Dubai (US\$7.07 billion), Malaysia (US\$6.85 billion) and Turkey (US\$4.86 billion).

In 2016, the Indonesian government issued two global Sukuk facilities with two different tenors and pricings. The first one has an issuance size of US\$750 million with a five-year tenor and a 3.4% pricing while the other issue of US\$1.75 billion had a 10-year tenor and a 4.55% pricing. The government also issued its first savings Sukuk facility intended for local retail investors in 2016, mobilizing around almost US\$200 million in local currency. This saving Sukuk facility offered a 6.9% return under the Wakalah structure with the minimum order at around US\$150.

On the corporate side, the progress has not been like its sovereign counterpart. Up to the end of July 2016, there was only a 7.8% increase in issuances compared with 2015. However, it is expected that more Sukuk can be issued by the end of 2016. In fact, in November 2016, BRIS issued its first Sukuk Mudarabah in the amount of around IDR1 trillion (US\$74 million).

The other segment of the Islamic finance industry that recorded a significant increase in 2016 is Islamic life insurance. Considering that the market penetration of the insurance industry as a whole is still low, Islamic life insurance has the potential to grow further. According to the Indonesian Islamic Insurance Association, only 9.4% of the Indonesian population know that there are Islamic life insurance products.

Although it is still small in absolute value, similar progress can also be seen in the general insurance and reinsurance segment where it recorded growth of 22.2% up until August 2016, surpassing the full year growth of 13.9% in 2015. Unfortunately, Islamic mutual funds experienced an almost 10% decline in terms of the net asset value up until July 2016.

## Preview of 2017

Government Sukuk have continued the trend to be a dominant player in the Indonesian Islamic finance industry and this is expected

to continue in 2017. It is most likely that government Sukuk will also play a more important role in the global Sukuk market, especially considering the fact that the government has looked into Sukuk more and more to plug its budget deficit and finance many infrastructure projects.

The challenge for Indonesia is now more on how to make other components of Islamic finance such as Islamic banking, corporate Sukuk, Islamic insurance and Islamic mutual funds more competitive and grow further.

Although the intention is actually there by the authorities to support the growth of Islamic finance as a whole (see IFN Annual Guide 2016), it seems that there is a lack of understanding on what actions to take to really stimulate the growth.

Officials in Indonesia's OJK claimed that it has created a comprehensive infrastructure to support the growth of Islamic finance by issuing many regulations. However, it is high time to discuss whether those regulations are simplifying the businesses or complicating them. The issue here is not about how many regulations are issued, but how effective they are in stimulating the development of Islamic finance.


Like any other business, the Islamic finance industry needs a less bureaucratic environment to grow. Government Sukuk, taking advantage of its sovereign status, may not have as much bureaucratic barriers than those faced by its private counterparts.

Apart from bureaucratic issues, the government may need to encourage its state-owned enterprises to place more of their funding into Islamic banks and/or Islamic mutual funds. Alternatively, they may also be encouraged to issue more Sukuk instead of conventional bonds.

Last but not the least, fiscal incentives is the area that has not been touched by the government to promote the growth of Islamic banking and corporate Sukuk. As an infant industry in the country, giving fiscal incentives to Islamic finance is to put it on a more level playing field with its conventional counterpart.

## Conclusion

Notwithstanding the aforementioned issues, Indonesia needs to consider Islamic finance as a way to attract more funds into the country in view of the current global political climate, especially in the US and Europe which are not perceived to be very friendly with Muslim countries and further exacerbated by the election of Donald Trump as the US president-elect and the growing influence of 'far right' politics in Europe.

However, it is imperative for the country to create a more business-friendly environment with less bureaucracy, fewer unnecessary regulations and better rules of law. All of these factors are critical to attract capital, including Shariah compliant capital. 

# Iran's financial system: The development of Shariah compliant instruments and institutions



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In Iran, all financial instruments should comply with Shariah rules and regulations. Thus, it is unlawful in the financial system to trade in any conventional financial instruments or to establish any financial institution where its performance contradicts Islamic rules and regulations.

## Review of 2016

Table 1 shows some areas of major developments witnessed in 2016 in the capital market.

**Table 1: Major developments in 2016 in the capital market**

Islamic financial instruments	Islamic equity market	The lifting of many parts of the financial sanctions after nuclear talks brought some hope for investors. Investors are still looking for more results despite more or less achieving their goals. The market cap value in securities exchanges exceeded US\$130 billion.
	Islamic derivatives market	Like in previous years, gold coin futures contracts played a major role in the Islamic derivatives market. Under the spotlight were currency derivatives and also agricultural futures.
	Sukuk market	Sukuk Ijarah, Musharakah, Murabahah, Salam and Istisnah are the five types of Sukuk issued in the Iranian capital market in 2016. The Sukuk Manfaah structure faced important discussions for issuance and has been finalized. In 2016, a debut sovereign Sukuk facility with an Ijarah structure was introduced to investors and the state of Iran was funded by this type of Sukuk.
	Islamic treasury notes market	Following the resolution of the Shariah Board of the Securities and Exchange Organization of Iran (SEO), the government used Islamic treasury notes for fundraising with tenors of less than a year. From the beginning until the end of 2016, the notes were issued in the market more than 10 times. Contractors who delivered projects to the government received some notes and had the option to discount them in the capital market and obtain financing through Islamic treasury notes.
	Islamic mortgage-backed securities	After long negotiations, Islamic mortgage-backed securities debuted. Islamic mortgage-backed securities are mainly used for securitizing residential receivables from Bank Maskan in Iran. The bank was authorized to guarantee payments for investors in order to protect investors as there were no ratings for the securities.
Financial institutions	Investment banks	There are nine investment banks active in the Iranian capital market. Except for one specialized investment bank which operates in the housing sector, the other eight investment banks provide a general range of services to clients.
	Brokerage companies	As at the end of 2016, there were 108 licensed brokerage firms officially active in the market. However, they provide different services depending on their capital adequacy as well as permission from the SEO.
	Islamic funds	In 2016, more than 180 funds provided different services including fixed income and variable income and index tracking services.
	Rating agencies	The SEO announced regulations for the establishment of rating agencies. As at the end of 2016, no rating agency has yet been officially established and started operations.

**Table 2: Potential developments in 2017**

Islamic equity market	There is a positive outlook for the future performance of corporations. New IPOs in the equity market might strengthen this trend.
Islamic derivatives market	In the Shariah compliant derivatives market, it is hoped that there would be a portfolio futures market as an alternative to conventional index futures. Currency futures might be another newcomer in the Iranian Islamic derivatives market.
Sukuk market	Iran plans to introduce a Sukuk Manfaah structure to finance authorized companies in 2017.
Islamic treasury notes market	The government found an important alternative fundraising method through Islamic treasury notes and this is expected to be a continuous process in 2017 with new phases.
Islamic mortgage-backed securities	Islamic mortgage-backed securities debuted in 2016 and the market needs more support and cooperation in this area with more convergence between the capital market and the banking system.
Investment banks	No newcomers are expected in this segment but there should development in the range of services in 2017 for Iranian investment banks.
Brokerage companies	An Islamic model for margin trading is being mulled which could facilitate many procedures in 2017.
Islamic funds	The development of funds and their client diversity will hopefully happen in 2017. Specifically, construction funds as well as new exchange-traded funds are expected to attract more attention in 2017.
Rating agencies	Hopefully, 2017 might be the year for the official establishment of a rating agency in the market.

## Preview of 2017

Iran's financial system is trying to strengthen current available mechanisms and introduce new structures. In this regard, some innovations and modifications are expected in 2017. A snapshot is provided in Table 2.

## Conclusion

While 2016 saw many good innovations namely, Islamic mortgage-backed securities and the development of the Islamic treasury notes market, 2017 might witness the emergence of the Sukuk Manfaah structure in the market. For derivatives, the SEO and the Central Bank of Iran should cooperate to launch Islamic currency futures. Regarding financial institutions, it is hoped that there will be the establishment of a first rating agency in Iran. Overall, there is huge potential for the Iranian financial system to find more diversity in Islamic financial instruments and derivatives as well as financial institutions. ☺

# Italy: Huge potential but slow implementation



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**Italy is the world's ninth-biggest economy, an economy which is mainly based on services and manufacturing. In particular, the country is specialized in manufacturing high-quality goods and its backbone is mainly made up of SMEs. The country is divided into a highly industrialized and developed northern part, where approximately 75% of the nation's wealth is produced and a less developed and more agriculture-dependent southern part.**

As with almost any European country, Italy suffered the consequences of the economic and financial crisis; during the period from 2008 to 2015, Italy's GDP decreased significantly and it will take a few years before the same, pre-crisis, levels of wealth will be reached again. However, after years of recession, the economy is now recovering. Such a positive trend is confirmed by the forecast of the 2017 GDP growth, which is assumed to be at a rate of 1.4%.

To support and expand the positive recovering trend, the Italian government has recently approved the country's draft budget for 2017, which was sent to the EU Commission to get its green light according to EU rules, and which is based on measures such as the reduction of the corporate tax rate for small businesses and the increase of public investments. However, the expansive fiscal policy reflected in the draft budget will trigger an increase of the debt to GDP ratio, which is forecasted to be 2.3% in 2017, ie 1.8% higher than the limit set by the EU. Indeed, being part of the EU and the eurozone, in setting its fiscal policy Italy must comply with the limits established by the EU. However, the Italian government has recently asked the EU to accept such a ratio on the basis of the costs which Italy is bearing as a result of the assistance given to thousands of immigrants escaping from the wars in the Middle East and North Africa and also as a result of the recent earthquakes in central Italy.

## Review of 2016

Looking back to the Islamic finance-related events in the last 12 months, a first step taken to make the Italian tax framework Islamic-friendly was the appointment of a working group of tax experts by Maurizio Bernardo, the president of the VI Finance Committee of the Chamber of Parliament, with the aim, inter alia, of implementing the so-called 'level playing field', therefore putting Islamic finance, from a taxation point of view, on the same level as conventional finance, in particular by removing the double taxation which may affect those contractual structures based on the purchase and subsequent resale by the lender of a specific asset like Murabahah and Ijarah.

Furthermore, in consideration of the growing Muslim community in Italy, which has now reached some 1.8 million residents, and of the interest shown to the country by Islamic investors, the possibility of setting up an Islamic bank has also been discussed. This could happen in the form of a retail bank, providing bespoke financing Shariah compliant banking products to the general public or, alternatively, in the form of a commercial and investment bank, acting as a bridge between Middle East investors and Italian SMEs. In particular, the bank could in the latter case, inter alia, advise Islamic investors in the purchase of controlling and minority interests in Italian Shariah compliant companies and businesses, advise Italian Shariah compliant companies in their expansion into Islamic and Halal markets by entering into commercial agreements, joint ventures and amalgamations, advise Italian Shariah compliant companies and businesses on IPOs, secondary offers and private

placement of shares by researching actively Islamic investors as well as arrange Shariah compliant financings in conjunction with equity investments.

The Bank of Italy, which is the Italian banking supervisory authority, has been approached, in order to discuss how to set up such an Islamic bank in Italy. Indeed, such a goal could be reached (i) through a fully-fledged Islamic bank operating according to the principles of Shariah; (ii) by authorizing the set-up of a branch or subsidiary of a conventional bank, specialized in offering of Shariah compliant financial products; or (iii) through an Islamic window, inside conventional banks, offering Islamic financial products.

## Preview of 2017

Looking ahead to the upcoming year, it is hoped that the working group appointed by Berardo could come up soon with a clear and definitive proposal that will put Islamic finance on a level playing field with conventional finance from a taxation prospective.

Further to the aforementioned initiative, other ongoing projects include one with regards to the structuring of Islamic mini-bonds. The idea derives from the Italian law reform process started in 2012, which aimed at simplifying the legal and tax framework for the issuance of bonds and similar securities (known in the market with the non-technical name of 'mini-bond') by unlisted companies like SMEs. Indeed, the structuring consists of working on the aforementioned legislation to elaborate on a product that, because of its profit-sharing nature, complies with Shariah.

With respect to the possibility of establishing an Islamic bank in Italy, it is worth noting that it would be easier to reach this goal if a harmonization process involving the national regulators takes place, with a view to elaborating on uniform solutions at the European level, taking into account that on the one hand, following the entry into force of the single supervisory mechanism, the final competence to grant banking licenses within the eurozone rests with the European Central Bank, and on the other, that there are retail Islamic banks already operating in other European countries such as the UK and, most notably, as far as the eurozone is concerned, Germany.

Finally, it is worth mentioning that Italy could easily, in line with what has already been done in the UK and Luxembourg, issue sovereign Sukuk, through the amendment of the actual legal framework, following the model already used in the past for the securitization of public real estate assets. In particular, a pool of assets belonging to and used by the public administration could be identified and transferred to an SPV issuing Sukuk, and then leased back to the selling entities based on Ijarah. Sovereign and semi-sovereign Sukuk could be particularly useful to finance public projects and infrastructures considering the high level of indebtedness of the country and its regions and municipalities and could eventually open the door for the use of such instruments in the private sector.

## Conclusion

Taking into account the initiatives carried out by other European countries, it is clear that Islamic finance is a sector with huge potential for Italy as well. There are many initiatives pursued on a spontaneous basis, and sometimes not properly coordinated among them, to promote Islamic finance in Italy, but the general environment does not yet appear to be ready to 'open the door' to this alternative and ethical form of financing. Probably, for this to happen, it is necessary that the decision-makers at different levels take a strong view that this is actually an opportunity for the country that deserves to be pursued, and politically and technically endorse its implementation like what is happening in other countries within the EU.<sup>(2)</sup>

# Japan: Small head but great wit



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In the enlightening book titled 'Shariah Minds in Islamic Finance' written by a prominent Shariah scholar, Chapter 1 starts with his experience in Tokyo, where he talked about Islamic finance with Japanese bankers. As seen in this article, it is no longer relevant to regard Japan as a barren land of Islamic finance. All major banks have already had track records, the government has appropriately prepared a regulatory system, including banking regulations and a J-Sukuk legal framework, and more corporates have used Islamic financial products for their fundraising.

When oil prices continued to surge in the mid-2000s, many newspaper articles picked up introductory Islamic finance, although it is not the case in recent years. Still, more practical developments are seen in the islands of the Muslim-minority market, as well as the fact that the Japanese book titled 'The very first step to Islamic Finance', authored by myself with many examples of Japanese financial institutions and corporates, was published this year and has been selling very well.

## Review of 2016

A prominent transaction occurred in November this year. An internet-based financial business group named SBI Holdings established an Islamic private equity fund, together with the Ministry of Finance of Brunei Darussalam and including the IDB. The fund is expected to amount to US\$100 million. This is not the very first deal for SBI, as they already have an Islamic private equity fund with the Bruneian finance ministry, which did quite well, including the exits of investment from an Indonesia-based distribution company and another IT company.

ORIX, a Japan-based leasing and finance company, has acquired a Pakistani subsidiary of Standard Chartered called Standard Chartered Services of Pakistan which holds a 10% stake in Standard Chartered Modaraba. This will allow ORIX to get more involved in the Islamic financial business in the second-largest Muslim populated country.

It is also reported that Bank of Tokyo-Mitsubishi UFJ (Malaysia) has started to offer Islamic securitized products.

Not just limited to major deals in the private sector, various types of developments were seen in the Islamic finance industry in Japan in 2016. Firstly, the law of a government-owned Japan Bank for International Cooperation was amended and Islamic finance was included in its financial activities. Technically, the wordings followed the example of the regulations for banks, which had been amended in 2015.

Secondly, Japan International Cooperation Agency assisted the Sukuk issuance of the Jordanian government, as part of their bilateral assistance to the Kingdom.

Thirdly, in the academic field, the Japan Society of Monetary Economics established a session for Islamic finance in its annual conference, composed of three presentations. It was the first in its history since the 1940s.

To wrap up, we have witnessed developments of Islamic finance of Japan-related entities in various fields.



## Preview of 2017

It is expected that major financial institutions will continue their efforts to include Islamic finance in their product suites. On top of that, a Japanese technology firm, Softbank, has recently established an investment fund with the Public Investment Fund of the Kingdom of Saudi Arabia, and this has a potential to create another stage of Islamic finance in the country. Softbank has bought companies of various sectors in many countries, and their investment skills are expected to contribute to Saudi Arabia's shift from being an oil-dependent nation to a more well-balanced market with more manufacturers and various services providers, in its pursuit of a more diversified economy.

Another trend is inbound Halal business in Japan. More Muslim tourists come to Japan in recent years, and more Halal-based services are coming up. Not just Halal food and establishing prayer rooms in hotels and airports, but there are already a Halal hair salon and even a Halal karaoke place. This trend of Halal business will lead to a high demand of Shariah compliant financial services.

Another big move in the Japanese financial industry is fintech. Fintech, or financial services largely supported by internet technology, is not limited to Islamic finance and is a global and very recent trend. The emergence of Islamic fintech services is not expected to target the Japanese market due to its scarce Muslim population, but Japanese firms in overseas markets are expected to offer them. As an example, the aforementioned Softbank and SBI Holdings have contacts with Muslim markets, and this will enhance their incentives to offer Islamic fintech services.

## Conclusion

As discussed previously, Japan is not a barren land of Islamic finance. It is expected to contribute significantly to the development of Islamic finance in the coming years, considering its unique nature in a global context of international finance. Although the volume of deals is not large and its presence in the market is not big, Japan will well to utilize the 'little head, great wit' strategy in Islamic financial markets.☺

# Kenya heading in the right direction



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Kenya's decade-old Islamic finance sector includes two fully-fledged Islamic banks and several Islamic windows being operated by other banks. However, Islamic banking has been operated by way of exemptions, and a lack of clear rules has led to stunted growth. Currently in Kenya, conventional banking and Shariah compliant finance are subject to the same set of laws (save for exemptions granted to institutions providing Islamic finance). It is worth noting that Shariah compliant finance is only exempt from some of the provisions of the Banking Act and other laws that regulate the conventional banking system.

Despite this, the potential of Islamic finance in Kenya remains undoubted. Under the Capital Markets Authority (CMA)'s master plan for Kenya Vision 2030, the CMA aims to create a vibrant and globally competitive financial sector by the year 2030. Kenya has ambitions of becoming the Islamic finance hub of East Africa and wants to establish itself in this niche market within the region.



**“ The government recognizes the need for a national Shariah supervisory board and this may be established in the near future ”**

## Review of 2016

2016 has been a mixed bag of fortunes for the Islamic finance market in Kenya. It has recorded steady growth in the Islamic financing sector in Kenya, widely seen as an attractive alternative to the risky practices of conventional banking.

The first East Africa Islamic Finance Summit was held in Nairobi in February 2016 and was organized by, among others, the East African Business Network and GBS Africa. Participants included key regulators and influential figureheads from the local and international scene which provided participants with a platform to exchange their views and opinions on the issues affecting Islamic finance development in East Africa. The summit specifically focused on the opportunities and challenges that are shaping the Islamic banking, finance, and investment landscape in East Africa.

During the year, several banks were been placed under receivership by the Central Bank of Kenya (CBK) which is the regulator of the banking sector. One such bank which was placed under receivership had an Islamic window. A misunderstanding between the former directors and their auditors on how to classify Islamic banking assets led to a restatement of the financial reports of the bank. The former directors argued that the auditors misunderstood the principles of Islamic banking.

In a separate instance, a bank in Kenya which offers Shariah compliant financing was taken to court by one of its borrowers over the nature of the facility that the borrower was granted. The borrower alleged that the bank changed the facility that he was granted from a fixed term financing to a revolving Musharakah financing which had the effect of raising the interest rate from 18.5% to an Islamic profit-

sharing equivalent of 19.5%. This increased the borrower's payment obligations considerably. The bank argued that the borrower was aware of the nature of the facility he was granted and that the bank had explained the terms to the borrower on several occasions.

These instances show the lack of understanding of Islamic finance terminology and documentation across the board. It also highlights that in some instances Islamic financing is expensive in Kenya compared to its conventional counterpart.

An important development this year which demonstrated Kenya's commitment to the growth of Islamic finance has been the establishment of a Project Management Office (PMO) made up of various regulators. The PMO will regulate the industry, help develop industry awareness and human capital. The government has also engaged the services of various experts in the field of Islamic finance to provide a technical and advisory role to the PMO. These are all positive steps which will contribute toward the growth of Islamic finance in Kenya.

## Preview of 2017

In remarks attributed to the principal secretary in the Treasury, Kenya will in the coming year seek to join the 57-member OIC, which will allow it to tap into financing from the IDB.

Players in the Islamic finance industry have called for the establishment of a national Shariah advisory board to ensure uniformity across the industry and to provide guidance on matters of Islamic finance. The government recognizes the need for a national Shariah supervisory board and this may be established in the near future. Now that a PMO has been established and with Kenya's National Treasury looking at the possibility of a debut Sukuk issuance, the coming year promises to be an exciting one in terms of the development of Islamic finance in the country.

## Conclusion

Though the regulatory framework is still a work in progress, it is hoped that the necessary legislative amendments will be made soon to enable Kenya to experience growth in this sector and to issue its debut Sukuk, following in the footsteps of other African countries like South Africa and Senegal. ☺

# Kuwait to continue growth trajectory



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**Kuwait's revenue has long been underpinned by oil which makes up approximately 95% of its exports, in similar fashion to its GCC neighbors. After a decade of high oil prices, Kuwait's revenue generation took a hit owing to the volatility of global and Kuwaiti crude oil prices, which peaked at US\$117 per barrel in June 2014, and subsequently precipitously falling to US\$31 per barrel in February 2016. Thus, Kuwait is facing a vastly different fiscal position in 2016 as the country is expected to post its first fiscal deficit following two decades of budget surpluses. This has led to the government sanctioning new initiatives to adjust to the current low oil price environment which is expected to persist in the coming years.**

## Review of 2016

The prevailing economic environment will place added pressure on the government's pervasive national welfare benefits extended to its citizens which include access to free healthcare and education, public sector jobs and housing. While the elimination or reduction of subsidies in utilities and energy remain very sensitive and fragile issues, the government has acknowledged that cuts are imperative for the overall benefit of the economy over the long term especially if the low oil price environment perseveres. Nevertheless, the economy of Kuwait remains stable largely due to the lack of government expenditure over the last decade despite enjoying a bonanza of revenue stemming from high oil prices – in stark contrast to other GCC countries who increased their public spending accordingly. However, the vast surpluses accumulated over the past decade, which the state can tap into should it be required, is not a sustainable fiscal solution to the country's budgetary challenges throughout prolonged periods of low oil prices.

Consequently, the government is adopting several fiscal policies to maintain its historically robust fiscal position which include a reduction of fuel subsidies and the adoption of taxes such as value-added tax. More importantly, in view of invigorating private sector activity as a parallel strategy to maintaining future fiscal positions, the government has implemented changes within the country's regulatory and legal framework which have encouraged private sector participation in the funding of large public infrastructure projects and the privatization of certain service-based government activities. Examples include the ratification of laws pertaining to public-private partnerships (PPPs) and the creation of the Kuwait Authority for Partnership Projects and new Sukuk bylaws through the Capital Markets Authority (CMA), all of which were carried out in mid-to-late 2015.

With the advent of the new PPP regulations, large projects such as the Al Zour Independent Water and Power Project and the Kabd Municipal Solid Waste Project, which will implement the latest technological advancements to treat waste and generate alternative power for the Ministry of Electricity and Water, have quickly attracted both private local and foreign investors and project operators. The development of PPPs in Kuwait cannot be understated as it extends to the government the ability to lessen its capital expenditure and reallocate upfront costs onto the private sector.

On the other hand, hinged by continued government spending on new projects and significant capital expenditures which it perceives fundamental to sustaining the country's economic growth in the short term, multi-billion fiscal reserves from past years and low debt levels have fueled non-oil GDP growth in 2016 which is expected to reach 3%. The government's spending on infrastructure and utility projects,

in line with Kuwait's development plan, has gained strong traction in the current year which should produce greater business opportunities and bolster economic diversification in 2017 and beyond.

2016 was also a major milestone for the development of Kuwait's capital market. Boursa Kuwait Securities Company (BKSE), which was incorporated in 2014 to essentially privatize the Kuwait Stock Exchange (KSE), officially took over the management of the KSE. This, indeed, marks the commencement of a new age for Kuwait's capital market as BKSE intends to list the KSE publicly through an IPO to Kuwaiti nationals in the forthcoming years with the aim of enhancing the capital market's performance and value.

## Preview of 2017

The outlook for Kuwait's banking system in 2017 remains healthy due to the continued expectation of government spending as subdued oil prices linger. Supported by an increasing demand for Shariah compliant financial products and facilities from wholesale and retail customers, the Islamic financial sector in Kuwait is regarded as an integral constituent of the country's path to development. Islamic banks in Kuwait hold approximately 45% of banking sector assets, according to data from the Central Bank of Kuwait (CBK).

From a regulatory vantage point, the CBK has plans to enhance the local retail banking competitive environment by eliminating branch expansion restrictions on foreign banks which would grant them the ability to open branches in numerous locations, positioning them to compete directly against local institutions for a share of the retail banking market, especially considering that Kuwaiti banks are in parallel reducing their branch network to reduce costs.

Notwithstanding the subdued levels of Islamic debt capital market issuances (Sukuk) by Kuwaiti issuers since the global financial crisis of 2008, steps undertaken by the CMA through the adoption of new Sukuk bylaws which became effective in November 2015 have created tangible results in 2016. Islamic commercial banks like Boubyan Bank and Ahli United Bank have taken advantage of the long overdue regulatory developments and successfully issued the first publicly listed Sukuk by Kuwaiti corporates since 2007.

Sukuk issuance by the aforementioned Islamic banks are part of their efforts to reinforce their Tier 1 capital base in compliance with Basel III standards. The outbreak in Kuwaiti Sukuk issuances, especially by local commercial banks, is believed to have a wide-ranging effect on Kuwait's Islamic financial sector and the economy at large. Similarly, Kuwait's government will look toward the Islamic debt capital market for funding to bridge forecasted budget deficits should low oil prices persist as expected. Consequently, Kuwait will be well positioned to compete for a piece of the global Sukuk market in the future.

## Conclusion

Kuwait's Islamic finance sector is expected to continue its growth trajectory and support bank operating conditions over the next 12 to 24 months as unremitting levels of government expenditure, assisted by considerable accumulated reserves estimated to be in the range US\$600 billion, and low debt levels endure to push growth in the non-oil economy. Record amounts of government capital spending tied to planned or ongoing infrastructure, healthcare, oil, power and housing projects will provide new business opportunities for Islamic banks. By contrast, fiscal reforms such as the adoption and implementation of corporate and value-added tax and the decrease in fuel subsidies will have minimal impact in the short term as such policies will be enforced steadily over a protracted period, which means that government job opportunities will remain abundant for Kuwaiti nationals, supporting consumption and boosting credit growth for Islamic banks in the short term. ☺

# Luxembourg and Islamic finance



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During the last decade, cross-border financing was an inevitable path with outgrowing globalization of financial businesses around the world. Through this shift in global dynamics, some financial centers emerged to become the hub and the reference for fundraising. In fact, Luxembourg in particular is considered the largest domicile for Islamic funds in Europe, and the third-largest domicile worldwide after Malaysia and Saudi Arabia. It currently hosts 44 domiciled funds that are labelled as Islamic theme/strategy funds with total assets under management of US\$2.27 billion.

Being rated as an 'AAA' economy in the last decade, Luxembourg's economic, political and social stability attracted countless new businesses, investment funds and major banking and insurance companies. Furthermore, Luxembourg's regulatory environment permits the establishment of diversified investment vehicles that are suitable to investors from different countries with different investment strategies. For example, with regards to tax regulations, Luxembourg has signed over 75 treaties with other countries including many Islamic finance markets to avoid double taxation on cross-border business.

As mentioned by CEO of PwC, John Parkhouse, in PwC's 2016 annual review: "The market in Luxembourg is export-focused. Pretty much everything we do is designed to go across the border. That fixes our mindset and makes sure that we look at things globally."

**“ If Islamic finance promoters find a way to market Shariah compliant products as SRIs, the industry can grow drastically ”**

## Review of 2016

On one hand, the year 2016 has been marked by decreased oil prices coupled by an unstable social and political environment in MENA countries and shriveled government spending in the Middle East. These factors have played a major role in dwindling the appetite of investors and in the compressed growth of Islamic finance products in the world as a whole and Luxembourg in particular. However, these slowing economic factors have not limited the recent extended support provided by the Luxembourg government to promote a network of cooperative Islamic finance relationships. In fact, an MoU was signed on the 10th March 2016 between the Abu Dhabi Global Market and Luxembourg for Finance on bilateral cooperation. One of the main objectives of such a memorandum is to facilitate any cross-border Islamic finance initiatives between the two countries.

On the other hand, given the events that Europe has gone through recently, a lesser investment appetite is being shown for Islamic finance products in general which can be related to the ideology

**Figure 1: Innovative Finance Ecosystem**

Islamic finance	Luxembourg school of finance	Fintech	Fund labeling
Largest domicile in the non-muslim world 2002: 1 <sup>st</sup> listing of a Sukuk on LuxSE 2014: 1 <sup>st</sup> Euro-denominated sovereign Sukuk ('AAA' rating)	Highest education and research in finance	Preferred hub for e-commerce and e-payment companies	LuxFLAG: recognized label for microfinance and environment funds

Source: [www.luxembourgforfinance.com](http://www.luxembourgforfinance.com)

of the name itself. In this case, one factor that might encourage the promotion of Islamic finance products globally and particularly in Luxembourg is to align and associate them to socially responsible investments (SRIs). SRIs are exponentially growing globally and they are naturally aligned with Islamic finance objectives and pillars.

## Preview of 2017

As Luxembourg's regulatory and investment vehicle framework is already flexible to house Shariah compliant structures, Luxembourg has a great potential to be a strategic place to develop these products in the future given the stable economic growth it has witnessed in the last few decades. In addition, the UK's exit from the EU through the June 2016 Brexit vote will open the doors for many non-EU companies based in the the UK to move to Luxembourg as it is a strong cross-border financing hub. In fact, as mentioned recently in a BBC radio interview by Nicolas Mackel, CEO of Luxembourg for Finance, Luxembourg has already received calls from a few large investment institutions serving the European market and domiciled in the UK that they are already looking at Luxembourg to host their operations.

In fact, Mackel gave the example of AMG, a leading global asset manager with approximately US\$700 billion in assets, which has chosen Luxembourg to set up its post-Brexit operations in the next year or so. Furthermore, 2017 can be a crucial year for the fund industry in Luxembourg in general and cross-border Islamic finance specifically.

## Conclusion

With continued political, economic and investment enthusiasm, Luxembourg is expected to witness a growth in its fund investment and banking industry. If Islamic finance promoters find a way to market Shariah compliant products as SRIs, the industry can grow drastically. SRIs are well perceived in Luxembourg and are experiencing fast growth as a subsector of conventional banking. So if a marketing emphasis of Islamic finance products can be drawn as a division of SRIs, a big market win will be waiting for the Islamic finance cross-border industry. ☺





# The state of Malaysia's Sukuk market: Resilience driving expectations



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Malaysia's Sukuk market has remained resilient despite generally less upbeat market sentiment. Notably, Sukuk issuance in the first 10 months of 2016 has already matched RAM Ratings's full-year projection for the local currency Sukuk market, ie RM100-120 billion (equivalent to US\$23-28 billion based on an exchange rate of US\$1 = RM4.3) which RAM had forecasted on the 23<sup>rd</sup> March 2016.

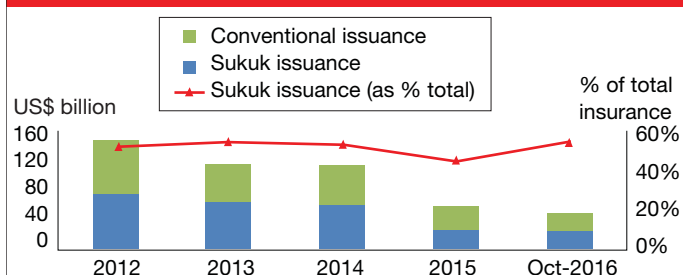
## Review of 2016

As at the end of October 2016, outstanding bonds amounted to RM1.2 trillion (US\$275 billion) with some 57% comprising Sukuk.

At the same time, Shariah compliant securities accounted for 55% of the market's total issuance of RM210.9 billion (US\$49 billion)-worth of government, quasi-government and corporate debt issues. Breaking this down further, corporate debt securities contributed 41%, followed by government (34%) and quasi-government (25%) Islamic debt securities.

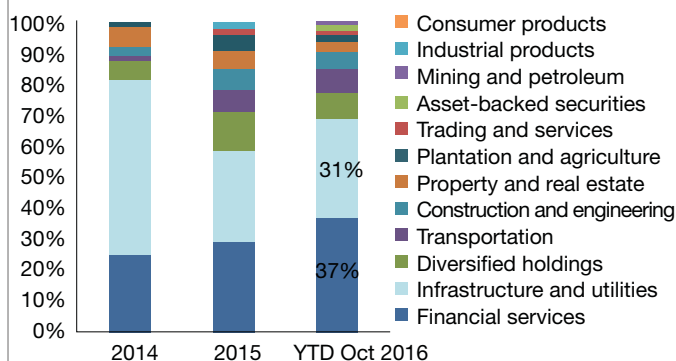
Backed by such strong support, especially from the corporate sector, Sukuk issuance summed up to RM115 billion (US\$26.7 billion) for the first 10 months of 2016. This already equals RAM's forecast of RM100-120 billion for the entire year.

**Chart 1: Malaysia's Sukuk issuance against total market issuance**



Source: Bond Pricing Agency Malaysia (BPAM) and RAM

**Chart 2: Malaysia's issuance of quasi-government and corporate Sukuk by sector**



Source: BPAM and RAM

# COUNTRY REPORT MALAYSIA

Based on RAM's analysis, the growth of a domestic Sukuk market is best measured by the issuance of quasi-government and corporate debt Sukuk.

To date, Sukuk issuances from these sectors have dominated the Malaysian bond market, with funding largely channeled toward Islamic financial institutions (37% of total quasi-government and corporate issuances) tapping the Sukuk market to meet their capital requirements as well as for infrastructure projects (31% of total quasi-government and corporate issuances).

In October 2016, US dollar-denominated Malaysian Sukuk were included in the EMBI Global Diversified Index. Together with the visibility provided by the incorporation of Malaysia's government investment issues (GII) into Barclay's Global Aggregate Index in March 2015, significant recognition has been attained among international investors. This is underlined by the 198% year-on-year surge in foreign holdings of GII to US\$7 billion as at the end of October 2016.

## Preview of 2017

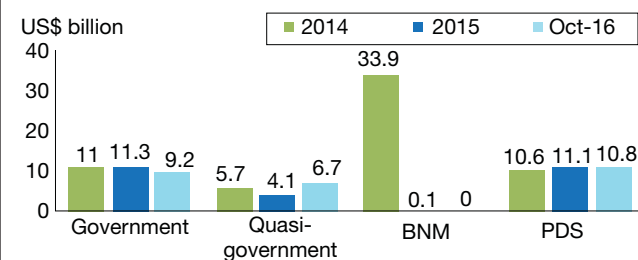
Malaysia's economic pump-priming through infrastructure-led projects has been a boon to the Sukuk market, and is likely to remain a key catalyst. Issuances from the quasi-government and corporate sectors are expected to continue playing a significant role in expanding the breadth and depth of the domestic Sukuk market.

## Conclusion

The performance of Malaysia's Sukuk market is anchored by its unique value proposition, underscored by an ecosystem that has been progressively developed into an international center for Islamic finance.

To fuel this growth, the regulators are promoting the linkage between Islamic finance and sustainable responsible investing. This augurs well for the domestic Sukuk market's thrust into its next phase of development and, ultimately, its sustainability as a competitive product amid the mainstream financial markets.<sup>(2)</sup>

**Chart 3: Malaysia's government, quasi-government and corporate Sukuk issuance**



Source: BPAM and RAM

**Table 1: Top 10 issuers in Malaysia's local currency Sukuk market (as at the end of September 2016)**

	Amount (RM million)	Amount (RM million)	Market share (%)
Government of Malaysia	33	8.25	33.2
Sunway Treasury Sukuk	11.3	2.83	11.3
Sarawak Hidro	5.54	1.39	5.6
Danainfra Nasional	4.5	1.13	4.5
Lembaga Pembiayaan Perumahan Sektor Awam	4	1	4
Lebuhraya DUKE Fasa 3	3.64	0.91	3.7
Perbadanan Tabung Pendidikan Tinggi Nasional	3.5	0.88	3.5
Pengurusan Air SPV	3.2	0.8	3.2
Prasarana Malaysia	3.05	0.76	3.1
Jambatan Kedua	2.6	0.65	2.6
<b>Top 10 issuers</b>	<b>74.33</b>	<b>18.6</b>	<b>74.7</b>
<b>Total Malaysian local currency market</b>	<b>99.53</b>	<b>24.88</b>	<b>100</b>

Source: BPAM





# The dawn of Islamic tourism: If there is a will, there is a way



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Tourism is the lifeline and the golden goose of the economy of the Maldives, the number one honeymoon destination in the world. Tourism is a sector that has shown progressive growth in the country and the largest contribution to the GDP of the country comes from this sector, proving that tourism is the most profitable sector in the country to be invested in.

However, although the Maldives is a 100% Muslim nation, the country is alien to the concept of Islamic tourism. With the rapid development of the Islamic finance industry in the country, the urge to test the practical applicability of Islamic tourism in the Maldives has grown. The year 2016 has proved that Islamic finance is here to stay and the country has novel developments that will hopefully realize in the next year which will lead to the sustainable development of Islamic finance in the country.

## Review of 2016

2016 can be summarized as a prosperous year for Islamic finance which brought joy to the patrons of the industry as new players joined the market and new products were introduced. 2016 can be viewed as the year that marked a new development in Islamic finance in the Maldives and in the region as President Abdulla Yameen Abdul Gayoom formed a 100% government-owned company named the Maldives Center for Islamic Finance with the primary objective of working toward developing the Maldives as the hub for Islamic finance in the South Asian region.

“The year 2017 will hopefully bring new players to the market and introduce new innovative products like crowdfunding mechanisms”

Simultaneously, Hazana Maldives was also incorporated to act as the SPV in the issuance of securities as there is no legal and regulatory framework in place for the creation and operation of SPVs. This development proves the commitment and political will of the government in the development of Islamic finance. For a country aspiring to develop a fully-fledged Islamic finance industry, this is indeed a huge achievement that will attract foreign institutions and investors to come and set up their business in the Maldives.

The year began with the news that Litus Automobiles, a private company offering Islamic hire purchase products to the public, and the Housing Development Corporation have introduced the option to choose a Shariah compliant solution for all of its existing customers who have conventional home purchase agreements. The Housing Development Corporation also announced that all of its future products for home purchasing will be Shariah compliant. The first investment project to generate sustainable income was the mosque cash Waqf fund initiated by the Ministry of Islamic Affairs



for the Darul Eman Project which became successful with the whole building completed this year and rented out, proving that Waqf can be sustained in an economically feasible manner in the country.

The government of the Maldives also issued Islamic treasury bills and for the first time the Musharakah Mutanaqisah structure was used. The Maldives Center for Islamic Finance also announced its intention to lay the foundation to develop an Islamic tourist resort to generate sustainable income to create a sovereign wealth fund. In the last quarter of the year, the Bank of Maldives opened a dedicated branch for Islamic banking services and proved once again the popularity of Islamic finance in the Maldives. They also announced the offering of Islamic home financing facilities and Islamic visa debit cards were introduced for the first time in the country.

The Islamic University of Maldives also signed an agreement with the International Center for Education in Islamic Finance (INCEIF) to design and offer Islamic finance programs in the Maldives, including Master's in Islamic Finance Practice programs. It was announced that these programs will be offered starting from January 2017. MoUs were also signed between the AlHuda Center of Islamic Banking and Economics, the Islamic University of Maldives and the Maldives Center for Islamic Finance to collaborate in the development of the Islamic finance sector in the Maldives especially in developing the required talent pool.

Ayady Takaful introduced Family Takaful to the Maldives for the first time in 2016. Initiatives were taken by the Ministry of Islamic Affairs to acquire recognition of the Halal certification process and the Halal logo of the Maldives from JAKIM in Malaysia and a team from JAKIM came to conduct an inspection and audit required for the process.

Maldives Islamic Bank, the only fully-fledged Islamic bank operating in the Maldives, celebrated its fifth year of operation in the market and expanded to other islands of the country including Hulhumale' and Thinadhoo. Maldives Islamic Bank also offered the first Education Financing scheme for students and signed an MoU with the Islamic University of Maldives to provide financial and technical support to develop Islamic finance education programs. The most significant event that happened at the end of 2016 was the announcement by the Housing Development Finance Corporation of its second Sukuk, the second corporate Sukuk of the country worth MVR200 million (US\$12.69 million). Inter-Islamic financial institution placements on Wakalah were also made between institutions to manage liquidity.

The Maldives Islamic Banking and Finance Industry Conference was held for the third time this year focusing on Islamic tourism. The Islamic finance players in the Maldives also received recognition and awards for their outstanding performance in Islamic finance during the first Annual Islamic Finance Forum of South Asia Awards ceremony held in Sri Lanka where for the first time in the South Asian region, the work of a woman to drive the Islamic finance industry in the region was recognized. This was indeed a remarkable development in the global Islamic finance industry to increase female participation. At the national level, the highest award conferred on women was also given this year to a recipient in recognition of her work in the Islamic finance industry – the first time a person has received an award to recognize work conducted to develop Islamic finance, proving that Islamic finance is a field that is recognized in the country. Overall, it can be said that 2016 was a year that has opened doors for Islamic tourism to link with Islamic finance in the Maldives.

## Preview of 2017

The year 2017 will definitely mark a new era for the development of Islamic tourism in the country linked with Islamic finance. The largest bank in the country, the Bank of Maldives, will start offering Islamic financing products that will help the population in other islands to use Islamic finance since accessibility is the most critical issue. Islamic microfinance schemes via Maldives Islamic Bank like 'Faseyha Madadhu' and other similar programs are expected to be successfully implemented.

The Islamic University of Maldives will start offering foundation, diploma and Bachelor-level courses in Islamic finance with assistance from INCEIF and hopefully this would resolve the problem of human resources shortages in the Islamic finance industry of the Maldives. This would be in addition to the Master's degree in Islamic finance practice of INCEIF offered by the Islamic University of Maldives. The year 2017 will hopefully bring new players to the market and introduce new innovative products like crowdfunding mechanisms.

## Conclusion

It is foreseen that the year 2017 will bring more optimistic growth to the Islamic finance architecture of the country. Islamic finance will flourish in the country and the success of Islamic tourism will be evident. Although the Maldives is a small island nation with a 100% Muslim population and with limited resources, it is proving to the world that if there is a will, there is a way and the dream to become the hub of Islamic finance in South Asia can be achieved soon. ☺

# Malta: An opportunity for SMEs



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**Malta is the southernmost country in Europe and it has always promoted itself as a gateway to Europe and North Africa. In 2010, it was stated that Malta could become the Bahrain equivalent in the Mediterranean.**

Malta has over the years done little in order to take this vision forward. However, in 2016, a new era started which could result in Islamic finance receiving a major boost in the coming years.

## Review of 2016

In 2016, Islamic finance activity in Malta continued to grow as more Islamic finance institutions have been using Malta, particularly due to the trust legislation that Malta has aligned with its advantageous tax environment.

An important step forward was the launch of the Shariah Equity Index by the Malta Stock Exchange, with eight Shariah compliant companies listed. In the same period, the Malta Stock Exchange also launched a program called 'Prospects' which encourages companies looking for finance to list on this program which have fewer reporting commitments and reduced costs.

**“ In Malta, there is excess liquidity which, if properly utilized, can enable one to raise capital ”**

## Preview of 2017

In November 2016, the Malta Stock Exchange launched its National Capital Markets Strategic plan with Islamic finance development one of the main pillars in the plan where the Malta Stock Exchange sees Islamic finance as a massive opportunity for Malta and for Shariah compliant companies.

In Malta, there is excess liquidity which, if properly utilized, can enable one to raise capital. Usually every call for capital is oversubscribed which gives a clear indication of the potential for Islamic finance.

With the Shariah index, the Malta Stock Exchange is giving Shariah compliant companies from around the globe an opportunity to access finance. This is particularly so for SMEs that are not in a position to list on larger stock exchanges due to fees and compliance costs. The Malta Stock Exchange through Prospects has also become accessible for microenterprises which may start using this list to gain experience and subsequently list on the main market.

The government of Malta is expected to concretely support the Malta Stock Exchange as this measure is also seen to boost even further the citizenship scheme promoted by Malta. This is in view of the fact that to date, Muslims cannot apply to this scheme due to its requirements. However, if the Maltese government finally launches its long-awaited sovereign Sukuk, this challenge would be addressed. In this sense, the government has left the market waiting for the last two years following its intention to look into Sukuk in 2014.



## Conclusion

The country is currently in a good economic moment although growth is seen mostly in the construction industry rather than in long-term sectors. However, this means that currently the government does not need cash although huge long-term infrastructure projects seem to be lacking in the country. Perhaps a forward-looking government may tap into the Sukuk opportunity to address certain national concerns. If the government of Malta launches such Sukuk, then the stock exchange would be in a better position to promote its Shariah listings and the Maltese government would have sent a strong message to the Islamic finance world.

Malta will hold the EU presidency in the first six months of 2017 which gives it the opportunity to lead the EU in addressing matters that are of interest to the Islamic finance world. There are two million Muslims in Europe who are not being allowed to properly practice their beliefs in spite of the rights given by the European Convention of Human Rights. Malta may lead in this and give Muslims as well as persons who believe in this method of financing a better future tied with opportunities that Europe may be open to if it puts Islamic finance on a level playing field as conventional finance.

Valletta 2018 is also an opportunity for Malta to promote its history and culture as Valletta will be the cultural capital city of Europe. If one analyzes the history of Malta, one will find strong links to the Arab and Muslim world. It is claimed that throughout the ages Malta had a number of Islamic finance transactions and the foundation of one of its mid-tier banks finds its origins in transactions similar to Takaful. Perhaps Malta will use Valletta 2018 as an opportunity to promote itself better in encouraging Islamic finance in the country. ☺



# The implementation process of Islamic finance in Morocco: Comprehensive but slow



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Since the final vote of Law n° 103-12 related to credit institutions in November 2014, Moroccans were expecting the first Islamic banks to begin their activities in 2015. However, the implementation process took longer than expected.

## Review of 2016

### The Islamic banking license applicants

In November 2015, all investors wishing to launch fully-fledged Islamic banks submitted their license applications. According to the legal framework, Bank Al-Maghrib, the central bank of Morocco, had to give an answer by the end of March 2016. Instead, the central bank asked conventional banks wishing to launch Islamic windows to submit their license applications before the end of April 2016.

The central bank received 11 license applications as follows:

- Seven applications for fully-fledged Islamic bank status

“Any delay could disturb the players and the market and negatively affect the whole process”

All the five local conventional banks wishing to launch fully-fledged Islamic banks have foreign partners as follows:

- 1) Attijariwafa Bank's partner is the IDB.
- 2) BMCE Bank of Africa's partner is Al Baraka Banking Group.
- 3) Groupe Banques Populaires's partner is Guidance Financial Group.
- 4) CIH's partner is Qatar International Islamic Bank.
- 5) Crédit Agricole Maroc's partner is the IDB Group's Islamic Corporation for the Development of the Private Sector.

The two other applicants are Islamic banks from the GCC: Barwa Bank and Emirates Islamic.

- *Three applications for Islamic windows*

Three applicants were interested in the window model and are all subsidiaries of French conventional banks, namely, Société Générale Maroc, Crédit du Maroc (Crédit Agricole) and BMCI (BNP Paribas).

- *One application for a specialized Islamic consumer finance company*

Renault Maroc submitted a license application for an Islamic consumer finance company through its subsidiary specializing in car financing (RCI Finance).

## The Islamic banking licensing process

According to the law, the central bank was supposed to revert to the applicants by the end of March but because of a delay as mentioned previously where the central bank instead asked banks to submit their license applications before the end of April 2016, the general manager and the head of the Banking Supervision Department held a press conference on the 30<sup>th</sup> June to give an overview of the progress of the implementation process. The main issues addressed are as follows:

- *The Shariah governance framework*

The Central Shariah Board for Participative Finance (part of the Higher Council of Ulama) has already been created and its members appointed (nine scholars, a coordinator and three external experts). Moreover, a follow-up committee has also been created for better collaboration between the Central Shariah Board and the central bank.

- *The regulatory framework*

The central bank has prepared three circulars and submitted them to the Central Shariah Board for approval as follows:

- 1) A circular related to Islamic finance products
- 2) A circular related to investment accounts, and

**“The law did not define exactly the Takaful models that are authorized. Nevertheless, it required that the Takaful surplus needs to be distributed exclusively to participants”**

- 3) A circular related to Islamic windows.

The central bank also prepared two circulars that do not need the approval of the Higher Council of Ulama as follows:

- 1) A circular on the Shariah compliance function in participative banks, and
- 2) A circular on license application.

Seven other circulars are currently being drafted relating to prudential rules and accounting.

- *The tax framework*

The Ministry of Finance in 2016 introduced many amendments related to Islamic financial products to ensure the tax neutrality

with conventional banking products. Nevertheless, the central bank declared that many other tax issues need to be addressed.

- *The challenges*

During the press conference, the central bank also listed a number of challenges and issues that need to be addressed as follows:

- 1) The Takaful legal framework needs to be voted on.
- 2) The tax framework needs to be completed.
- 3) An Islamic interbank market needs to be implemented.
- 4) Shariah compliant liquidity management instruments need to be developed.

In October 2016, a request for the assistance of the central bank in drafting the regulatory framework was issued.

According to the central bank, the licenses will be granted before the end of 2016.

## The Takaful legal framework

On the 2<sup>nd</sup> August, the House of Councilors adopted Law n°59-13, modifying and completing Law n° 17-99 relating to the insurance code and introducing, for the first time, provisions concerning Takaful.

- *The legal framework*

The Takaful legal framework in Morocco is part of the insurance code that defines all the requirements for insurance operators. The legal framework introduced several amendments and provisions related to the Takaful sector.

The Takaful sector is under the supervision of the Central Shariah Board for Participative Finance.

- *The main provisions of the legal framework*

The law introduced the following amendments for the Takaful industry:

- 1) The Shariah compliance of Takaful operators and operations is under the supervision of the Higher Council of Ulama which supervises the whole Islamic financial sector in Morocco including banking, Takaful and the capital markets.
- 2) The law did not define exactly the Takaful models that are authorized. Nevertheless, it required that the Takaful surplus needs to be distributed exclusively to participants.
- 3) In case of a Takaful deficit, the operator has to provide the funds with a free financing in order to cover all the claims.
- 4) Conventional insurance companies are not authorized to offer Takaful products. Takaful windows are not allowed.

## Preview of 2017

The licenses will be granted to Islamic banks by the end of December 2016. The main challenge that will be facing the industry as a whole is the regulatory framework that needs to be achieved before the final launch of the Islamic banking activity.

For the Takaful sector, the financial authorities will start the preparation of the regulatory framework as well as the licensing process.

## Conclusion

The involvement of the financial authorities in the implementation process of Islamic finance in Morocco has given more credibility to the industry. Nevertheless, any delay could disturb the players and the market and negatively affect the whole process. ☹️

# Opportunities ripe for picking for courageous Islamic finance players



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**Over the years, the New Zealand economy has changed from being one of the most regulated in the OECD to one of the least regulated. The government aims to lift the long-term performance of the economy through: building a stronger economy; investment in world-class infrastructure; better public services; and by building a safer New Zealand.**

The global sentiments are very positive toward New Zealand. It continues to be a popular overseas visitor destination and tourism is an important source of export income. Inward immigration is at record levels. The World Bank's 'Doing Business 2017: Equal Opportunities for All' report ranked New Zealand as the easiest country in the world to do business, bumping Singapore off the top spot. Researchers at the Legatum Institute think tank put New Zealand at the top of the world's best places to live, because of its "unrivaled ability to turn its wealth into prosperity" – a broader measure than just money.

The economic omens for New Zealand this year and the immediate future are looking positive. The top independent world economic brains in the OECD and the IMF expect New Zealand to continue to outstrip most developed countries in the next couple of years.

## Review of 2016

Momentum across the New Zealand economy is strong. The latest GDP figures which rose to 3.6% are not only historically strong and above trend, but right in the top echelons of growth performance across the developed world.

Business sentiment is strong (and rising). Job advertisements across the board has risen for seven consecutive months. Skill shortages are becoming more widespread. The construction sector remains a key contributor.

Population growth should remain at 2% or thereabouts for some time yet. Tourists continue to flood in as new airlines arrive and new routes are developed.

A strengthening labor market, net wealth gains, historically low interest rates and the competitive retail environment are all supporting consumption growth both at an overall level and more recently on a per capita basis.

From an Islamic finance perspective, Awqaf NZ commissioned a Sukuk Waqf study in partnership with the International Shari'ah Research Academy for Islamic Finance of Malaysia. A Shariah compliant retirement savings fund called Amanah Ethical launched a couple of years ago is gaining momentum in the New Zealand marketplace.

## Preview of 2017

The underlying economic performance story is expected to continue for New Zealand in the next 12 months. Projected annual GDP growth forecasts range between 3½% and 4% for the next 12 months or so.

Domestic demand is leading this growth charge. Private consumption is forecasted to grow at approximately 3.5% through 2017, with growth roughly stable at 1.5% in per capita terms.

Residential investment growth is likely to moderate at close to 12%; other fixed asset investments are forecasted to lift, with total investment forecasted to grow 4.5% in 2017 after a 2.7% growth in 2016. Final domestic demand is expected to expand at a 3.6% pace in both 2016 and 2017.

The growth from net exports is forecasted to remain roughly flat over the next few years.

Pressures are evident in construction, largely due to a lack of skilled staff to meet the bow wave of work coming over the next few years. This will lead to firms investing in capital (capital deepening), education and training in the next 12 months and more.

A strong New Zealand dollar scenario will continue given that the New Zealand economy continues to look strong on many relative measures.

The tourism sector is expected to continue to grow with the number of arrivals expected to increase over the next 12 months or so.

High migration inflows are creating tension and pressure on housing and infrastructure, and currently look to be dampening wage growth. The current immigration policy framework may warrant a review given there are continued skill shortages despite high migration levels.

Awqaf NZ will keep developing its Sukuk Waqf initiative and has planned a number of workshops with both Waqf sector stakeholders and the Islamic finance and Shariah experts across key global markets.

Challenges remain for the dairy sector due to low dairy prices, falling land values and tight cash-flows due to losses. A positive cash flow for the typical dairy farmer will not be restored until 2017/18 (breakeven beckons this season), but with dairy prices up the outlook is improving.

With the general election looming in 2017, there will be election goodies on offer.

## Conclusion

Conventional factors are pointing toward stronger New Zealand inflation being around the corner, with above-trend growth, elevated construction cost inflation, a falling unemployment rate, a positive output gap and increased difficulty finding labor.

The global scene remains the key source of risk that could alter the solid domestic picture. However, the New Zealand economy is in a better place structurally than it has been in the past, and has the ability to face any challenges with its fiscal and monetary policy.

A notable absentee from all this good news is the lack of participation of the Islamic finance sector in the New Zealand economy. With significant focus, an ideal platform for infrastructure development and foreign direct investment within this growing and steady economy, the opportunities are ripe for the picking for courageous industry players. (2)

# Islamic finance industry in Nigeria growing despite recession



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**Nigeria, with a population size of about 200 million partly divided along the religious line between Muslims and Christians, is in its fifth year of Islamic finance which was introduced in 2011 with the issuance of a fully-fledged banking license. The market has grown considerably from a relatively unknown market to being one of the potential hubs of Islamic finance in Africa. The Nigerian Islamic finance market comprises most of the segments including banking, Takaful, fund management, the capital market, Sukuk and education, all of which were achieved within the last five years. Several factors account for the growth, mostly due to the large Muslim population, market size, regulatory support as well as increased awareness. The last financial year 2016 has been tremendous and is discussed in the following.**

## Review of 2016

As mentioned earlier, the year has been tremendous in terms of positive achievements recorded in most sectors of the Islamic finance Industry. These achievements that cut across banking, Takaful, regulatory and Sukuk markets have contributed significantly in making the whole industry stable and raised the confidence of a large number of the citizenry which have hitherto been skeptical about the Islamic banking and finance industry.

In the banking subsector, 2016 witnessed the upgrade of Jaiz Bank, the only fully-fledged bank, from a regional bank to that of a national bank. This is a remarkable achievement as it will widen the presence of the bank to all nooks and crannies of the country. It also portrays the viability of this type of banking as a suitable alternative to conventional banking in the country.

The sector also saw the emergence of an Islamic interbank product developed between the three players (Jaiz and two window operators) to take care of their liquidity needs. In addition to that, the total asset size of the Islamic banking sector in the country has reached NGN40 billion (about US\$125.35 million) while deposits reached about NGN65 billion (US\$203.69 million). Other developments during the year include the emergence of a group called Taj; a group of investors looking to set up a second fully-fledged non-interest banking institution.

The banking regulator; the Central Bank of Nigeria (CBN), has also done a lot in strengthening the Islamic banking (non-interest banking) subsector. To enhance Shariah compliance in products offered by banks, a stakeholders meeting was organized by the apex bank between members of the Financial Regulation Advisory Council of Experts (FRACE – the Shariah Board of the CBN) and Shariah board members of the three major players otherwise known as the Advisory Committee of Experts. Furthermore, the central bank granted Sukuk a liquidity status where the bank can consider Sukuk when calculating the liquidity ratio.

The Takaful subsector of the Islamic finance industry has recorded massive development as the regulator, the National Insurance Commission has issued licenses to two fully-fledged Takaful operators, the first time in the country. They are Noor Takaful based in Lagos, the commercial hub of the country and Jaiz Takaful based

in Abuja. Although these operators are yet to roll out their products, but it is a significant milestone toward the development of the industry in Nigeria.

One very important event in 2016 was the progress made by the Debt Management Office, a body responsible for the issuance of government bonds and Sukuk. The body issued draft guidelines for the issuance of sovereign Sukuk and this has raised hope of the possibility of the federal government issuing Sukuk to raise capital for infrastructure.

Despite the decline in the economy due to falling oil prices and the dwindling exchange rate of the naira against foreign currencies, the Islamic finance industry recorded marginal growth when compared to its conventional counterpart that recorded some decline. Both sides of the balance sheet of non-interest banks in the country showed some element of growth when compared with the previous year.

**“The decaying infrastructure and the needs of the current government as well as dwindling oil revenues made it necessary for the government to look for funds through the capital market”**

## Preview of 2017

Despite the fact that the country is currently in economic recession as declared by the federal government at the end of the second quarter of 2016 which affected and slowed down businesses nationwide, the Islamic financial industry will likely witness steady growth especially if the CBN grants a license to the Taj group. This will enhance competition thereby promoting growth.

The decaying infrastructure and the needs of the current government as well as dwindling oil revenues made it necessary for the government to look for funds through the capital market. One such means is through raising capital by way of sovereign Sukuk. It is expected that this will be made possible by the end of the first quarter of 2017. Non-interest banks are likely to issue Sukuk in collaboration with Lotus Capital and Nigerian Mortgage Refinancing. The Sukuk may likely use the Ijarah assets of the bank as a way of raising liquidity and promoting the Sukuk market.

## Conclusion

It is worth noting that despite the recession, Nigerians are becoming more and more interested in the Islamic finance industry. There is a rise in the number of Nigerians seeking Islamic finance certificates. There was also an increase in the number of accounts opened daily by non-interest banks in the country. All these suggest that the market will reach its peak in the next few years and Nigeria will soon compete for a leading position in the global Islamic finance industry. ☺



# Offshore jurisdictions to remain popular domiciles for Islamic finance



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**Offshore centers have continued to be popular domiciles for the structuring of Islamic finance transactions in 2016. We have noticed a continued trend in the use of Cayman Islands (as well as the Dubai International Financial Center (DIFC)) SPVs, in particular for the issuance of Tier 1 capital Sukuk by GCC banks and to raise Shariah compliant financing in the aviation space. Uncertainty in the global economy and recent movements in the international markets may, however, impact upon the recent momentum of the strong growth of Islamic finance and how Islamic finance transactions may be structured over the next year and beyond.**

## Review of 2016

During 2016, we continued to witness a number of banks in the GCC raising Tier 1 capital by way of Sukuk issuances in order to satisfy the stringent requirements of the Basel III banking regulations. In 2015, the vehicles used for such issuances were most commonly incorporated in either the Cayman Islands or the DIFC, and this trend continued in 2016.

Over the year, we have seen a number of such issuances emanating out of Kuwait. Kuwait's first Tier 1 capital Sukuk issuance occurred in May 2016 with Boubyan Bank's issue of US\$250 million-worth of Tier 1 capital certificates. Following on its heels was the issuance of a

US\$200 million perpetual additional Tier 1 Sukuk facility by Kuwait's Ahli United Bank in October 2016. Both issuances were dual listed on NASDAQ Dubai and the Irish Stock Exchange. Boubyan Bank utilized a DIFC SPV as its issuing vehicle and Ahli United Bank's Sukuk issuer was a Cayman Islands exempted company. Both issuing vehicles were (as is typically the case) set up as 'orphan' entities with their shares held in charitable trust by a licensed trust company and their management independent from the obligor. A third Kuwaiti bank, Warba Bank, recently announced its own proposed Tier 1 capital issuance, and we can reasonably expect similar announcements out of Kuwait and neighboring countries into 2017, utilizing similar Cayman Islands and DIFC structures.

Another area experiencing growth in the utilization of Islamic compliant SPV structures is the aviation sector. In 2015, Emirates issued close to US\$1 billion in Sukuk to finance the acquisition of four A380 aircraft, and Garuda Indonesia had its inaugural international Sukuk issuance of US\$500 million. Both of these transactions utilized a Cayman Islands entity as the issuing vehicle. Now in 2016, it was reported by Reuters that Etihad plans to issue a debut US dollar-denominated benchmark Sukuk and, if it follows recent issuances in the industry, it will also implement a similar SPV structure.

In addition to Sukuk, Cayman Islands companies have been widely used by airlines and aircraft lessors for the structuring of both Shariah compliant financings and equity investments to finance the acquisition of aircraft. In September 2016, International Airfinance Corporation (IAFC) reported that it had delivered three A330 Airbus aircraft to Saudi Arabian Airlines; this is out of a total 50 aircraft expected to be delivered to Saudia by the ALIF Fund. IAFC manages

the ALIF Fund, a Shariah compliant aircraft leasing investment entity established with Airbus and the IDB as seed investors. The fund is incorporated as a Cayman Islands segregated portfolio company, the structure of which provides great flexibility by facilitating (through the use of different segregated portfolios) the financing of aircraft by various Shariah compliant means, including Ijarah financings and Sukuk.

### Preview of 2017

Many have been surprised over recent events in the US, firstly by Republican Donald Trump's victory as the president-elect of the US and, secondly by the rallying in the US stock markets just one day following the election. The US bond markets have been affected as well with yields on 10-year US Treasury rising sharply. According to Market Intelligence Center, this is largely a reaction to 'Trump Trade', Trump's proposed protectionist trade plan and aggressive economic stimulus plan touted during his election campaign, which is anticipated to add supply to the Treasury bond market. Furthermore, the president-elect's promises to cut taxes and increase spending are expected to lead to higher inflation in the US and a stronger US dollar.

**“ There will always be some appetite for investments into riskier emerging market assets, and jurisdictions such as the Cayman Islands and Jersey are well placed for the structuring of such investments through Shariah compliant investment funds ”**

Some analysts fear that these circumstances could result in reduced investments into emerging markets as investors are lured to the US and its offering of safer assets and greater returns. These fears have already materialized to some degree in certain Asian emerging markets, with Asian currencies falling in recent weeks.

So how might Trump's new administration affect the offshore centers and the growth of Islamic finance? In terms of Islamic bonds, the Sukuk market does not necessarily follow the trends of the conventional bond markets. Higher yields in the US and a stronger US dollar may make it more challenging (and costly) to issue Sukuk (particularly US dollar-denominated Sukuk) to global investors, but there are many benefits to Islamic finance that will continue to make Sukuk investments very attractive.

As Sukuk are asset-based, many investors perceive it to be a safer investment than a conventional unsecured bond and one that is based on underlying assets and business practices that may be more ethical in nature. Islamic finance is generally seen to promote financial stability, as it is based on real assets and risk-sharing principles of Shariah. We witnessed this following the economic crisis of 2008 with Islamic banks faring much better than their conventional counterparts.

Notwithstanding any implications arising from the US markets, Islamic financial institutions will continue to seek Shariah compliant solutions for their customers and their own internal capital requirements and will do so using entities formed in jurisdictions such as the Cayman Islands, the British Virgin Islands, the DIFC, Labuan and Jersey. As mentioned previously, we should expect the continued use of such jurisdictions for Sukuk offerings in the Tier 1 capital space and to raise Islamic compliant financing for airlines and aircraft lessors. The trend of sovereign Sukuk issuance is also likely to continue as governments seek to fulfil their strategic policy goals for the development of Islamic finance; many of these issuances will likely be carried out through SPV structures. Furthermore, there will always be some appetite for investments into riskier emerging market assets, and jurisdictions such as the Cayman Islands and Jersey are well placed for the structuring of such investments through Shariah compliant investment funds.

One of the challenges moving forward will be to raise awareness of, and educate global investors on, the benefits of Islamic finance.

### Conclusion

Notwithstanding the uncertainty in the market, there remains much liquidity as well as interest in Islamic finance, thus Shariah compliant structures will continue to remain attractive particularly to global investors seeking to diversify their portfolios. Offshore jurisdictions (such as the Cayman Islands), which offer a tax-neutral, low-cost environment and have enacted legislation to simplify structuring for Islamic financing transactions, will continue to remain popular domiciles for vehicles used in Islamic finance.☺

## IFN ONLINE DIRECTORY

Over 6,955 individual companies directly involved in the Islamic finance industry

# Mixed prospects for Oman's Islamic finance industry going into 2017



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In Oman, as in all the GCC countries, it is impossible to sever the link between the sustained depressed level of global crude oil prices and the prospects for Islamic finance growth in its banking sector. Islamic finance was launched in Oman at the end of 2012 when oil still stood at over US\$100 per barrel. But everything changed just as Islamic finance was getting established in the country; by the middle of 2014, crude dipped to much less than its peak value, and stayed there. This is of the greatest importance since the sustained success of Islamic finance in the country is dependent upon the participation of the government, if only as a provider of liquidity for the sector, now pre-occupied with plugging its annual budget deficit and supporting the value of the national currency.

**“ 2017 looks set to be at least as difficult as this year economically, if not more so ”**

## Review of 2016

The government's principal participation in Islamic finance in Oman – through the issuance of sovereign Sukuk – has been disappointing, especially after the great success of its debut in October 2015; there has been just one further issuance since then, in June 2016, once more well received. With a combined issuance value of OMR500 million (US\$1.29 billion) to date, it has at least set an initial pricing benchmark that the private sector can follow for commercial Sukuk.

At the same time, Oman has, during the course of 2016, achieved a sound infrastructure for its Islamic finance sector to develop and progress. The Capital Market Authority's regulations for Sukuk went live early in the year with innovative flexible provisions aimed at simplifying solicitation procedures and reducing the launch time for issuance. Oman Sovereign Sukuk is the state's vehicle for any further issuances. And the Shariah Index of the Muscat Securities Market, the country's bourse, now boasts 15 listings, bolstering the claims of Sukuk to recognition as a separate distinctive asset class as well as delivering a much-needed liquidity tool.

Also, the Islamic banking sector in the Sultanate continues the progress made in the course of the past two years. To the end of the third quarter (Q3), the sector leader, Bank Muscat (Meethaq), posted a respectable 30% increase in income, with rival Bank Dhofar (Maisarah) seeing a OMR2.13 million (US\$5.51 million) profit over the same time period. Overall, the eight participating banks in the sector generated a 53% increase in financing commitments up to the end of July, continuing an established trend from 2016.

Set against that, Alizz Islamic Bank, one of the two dedicated Islamic banks, continued its battle to achieve profit and realized a OMR3.42 million (US\$8.85 million) loss, again to the end of Q3. In the same vein, bank credit (conventional and Islamic combined) jumped 11% year-on-year for the first three quarters; this is attributable,



according to some sources, not to customer confidence but rather to borrowers locking in to current interest rates in anticipation of the central bank taking these higher where it needs to do so to defend the Omani rial's US dollar peg.

Separately, the two Omani Shariah compliant insurers, Al Madina Takaful and Takaful Oman, saw continuing profitability to the end of Q3.

## Preview of 2017

The coming year is slated to be a tough one for Oman economically, with a growing government deficit, a continued strength in the US dollar and no appreciable rise in the price of crude. Looking to cover the funding gap, the central bank has already indicated that the greater part of its borrowing requirement (60%-plus of the total) will be met from the international bond markets. That does assume no further significant reduction in Oman's credit rating.

Where it draws on domestic sources, Sukuk will be simply one of the options along with government development bonds, treasury bills and others. Assuming that Islamic debt liquidity is not going to be as high on the government's list of priorities as it once was, this may impact on the sector in time.

Islamic finance has proven itself as an accepted and successful option for project financing in the private sector and as an alternative to conventional retail lending, and in both respects it carries potential for sustained growth into 2017.

## Conclusion

Islamic finance in Oman has coped well with a difficult year in 2016, meeting the challenge set by its introduction in late 2012, which was to make a significant contribution to the development of the country's economy. 2017 looks set to be at least as difficult as this year economically, if not more so. The sector continues, along with its conventional counterpart, to suffer from a significant problem of oversupply and it is reasonable to expect that some mergers or acquisitions will be seen among the eight bank participants, where the two front-runners are doing well but the rest are striving to achieve profitability.☺



# Islamic finance of Pakistan: A journey of continuous success



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**Islamic finance has shown amazing growth over the past two decades. Strong demand for this segment has resulted in global financial assets surging. Growth in the Islamic banking sector continues to surpass that of conventional banks in several areas of banking and finance, supported by strong retail demand and positive legislation for the industry by the regulators.**

Pakistan, with a large Muslim population, remains at the forefront in developing and promoting Islamic finance and is one of the active and effective players in the global Islamic finance industry. It is one of the world's diversified countries in terms of its culture, landscape and climate. The nation has important strategic endowments and great potential for growth. Located in the heart of Asia, Pakistan is a gateway to the energy-rich central Asian states, financially liquid Gulf states and economically advanced Asian region.

The Islamic finance industry has grown rapidly in Pakistan in the last few years. Pakistan has been moving toward developing an economic system based on Islamic principles. In the last one and a half decades, Pakistan has shifted to a dual Islamic/conventional financial system which encourages businesses along with the global economy. Simultaneously, it has also progressed toward making a fully Islamic financial system by creating market demand.

The Islamic finance industry of Pakistan has diversified segments consisting of Islamic banks, microfinance banks, Islamic mutual

funds, Modaraba entities, Takaful companies and Islamic REITs. Commercial and microfinance banks operate under the State Bank of Pakistan (SBP) while the rest of the entities in the sector are supervised by the Securities and Exchange Commission of Pakistan (SECP).

## Review of 2016

The Islamic banking industry has a large share within the Islamic finance industry and witnessed good growth during 2016. The market share of Islamic banking stood at around 14%. The Islamic banking industry continued its double-digit growth reflected by the year-on-year growth of its assets which is higher than the growth of the overall banking industry. Islamic banks are growing fast and have already expanded significantly in the consumer finance sector, capturing half of the market share in car leasing and mortgage finance.

The SBP has played an instrumental role in providing an enabling environment for growth of the Islamic banking industry and its promotion at the grass roots level. Recently, the SBP has introduced a comprehensive legal, regulatory and Shariah compliance framework for the Islamic banking industry. As a facilitator, the SBP is not only actively engaged in capacity-building of the industry through various promotional and training programs but also in collaboration with the industry including issuing a five-year strategic plan for the Islamic banking industry which provides a direction and roadmap for the industry to sustain its growth momentum.

The SECP has also played a vital role in the promotion of Islamic finance within the country. The authority is a regulator of the Islamic capital market responsible for the regulation and supervision of

Modarabas, Islamic mutual funds, Takaful, Islamic REITs and other Islamic non-bank financial institutions as well as the issuance of Shariah compliant instruments such as Sukuk. The Islamic Finance Department (IFD) which established in 2015 has made excellent progress under the supervision of Bilal Rasul. The IFD was established for the first time at the SECP in order to provide a coordinated and holistic approach for governing and promoting Shariah compliant companies and Sukuk. Under the visionary leadership of Zafar Hijazi, the chairman of the SECP, the IFD has embarked on a mission to eliminate Riba from the financial market. Zafar has a keen interest in Islamic finance and is very enthusiastic in promoting it within Pakistan. The IFD has taken various remarkable initiatives under his supervision for the growth of Islamic finance and some of the key initiatives are as follows:

- The adoption of Shariah standards of AAOIFI.
- The launch of the All-Share Islamic Index.
- The definition of a Shariah compliant company has been added into the proposed Companies Law 2016.
- The institution of many reforms for the Takaful industry for its further development and growth.
- The provision of a 2% tax rebate by the government for Shariah compliant listed companies and taxation neutrality for Sukuk issuance on the recommendation of the SECP.

During the year, the Center of Islamic Excellence-IBA arranged an international conference on Islamic finance which was well received. Islamic Finance news of Malaysia also did a roadshow in Lahore, Pakistan in September which also proved to be a successful event. Regarding Sukuk issuance, a consortium of 16 banks arranged a PKR100 billion (US\$947.76 million) Sukuk facility for the Neelum-Jhelum Hydropower Project. This was the country's biggest-ever fund mobilization for a public sector entity. Recently, the government also issued a US\$1 billion Sukuk facility in the international market which was oversubscribed by 2.5 times. The Pakistani Sukuk market has witnessed growth over the years with both sovereign and corporate entities as issuers. Islamic REITs were also launched during this period with the first iREIT of Pakistan and Southeast Asia.

## Preview of 2017

As the two apex regulators of Pakistan's financial industry, the SECP and SBP are closely collaborating with each other on various forums

for the development of Islamic finance. The SBP has introduced a comprehensive legal, regulatory and Shariah compliance framework for the Islamic banking industry. Due to a downward revision of the initial paid-up capital requirement for the establishment of Islamic banking subsidiaries, a few other conventional banks are also planning to establish an Islamic bank as its subsidiary.

The IFD of the SECP has also done a remarkable job to develop Islamic finance. Being a capital market regulator, the SECP oversees several sectors of Islamic finance such as Modarabas, Islamic mutual funds, Takaful companies, Islamic REITs, Sukuk and the Islamic capital and debt markets. The IFD is entrusted with a mandate to develop the aforementioned sectors and is actively engaged. The department is focusing on a comprehensive Shariah governance and compliance framework, new products for different players of Islamic finance, enhancing outreach through microfinancing and microTakaful and the inclusion of financially excluded segments through product innovation and effective distributive channels.

## Conclusion

The Islamic banking industry in Pakistan, just like other jurisdictions elsewhere, faces some key challenges including the limited availability of trained employees and a lack of understanding and awareness within the public. Despite its impressive growth, there is still a huge untapped market for the Islamic finance industry. Given its strong fundamentals and increasing public acceptability, the further growth prospects of Islamic finance in Pakistan are very promising.

So far, the Islamic finance industry has not penetrated deep enough to serve the financial needs of SMEs, agriculture, microfinance and low-cost housing. Pakistan's massive infrastructure needs, especially those under the China-Pakistan Economic Corridor, represent lucrative Islamic finance public-private partnership opportunities in the high potential sectors of energy and construction.

Islamic finance is taking root in Pakistan with support from the government, the SBP and the SECP. Besides the growth in Islamic finance assets, sustained progress is being made on a long-term basis in regulations, the legal framework and capacity-building of market players. The Islamic finance industry is has a very bright future indeed in Pakistan. (F)



# Qatar: 2016, a year of change



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**2016 was certainly a memorable and strategically important year for Qatar. The Qatari economy has had to go through a paradigm shift and embrace diversification in a manner and pace that were never imagined. The era of dependency on natural resources looks to be a thing of the past and the move into a more expanded and integrated private sector has been a key priority.**

Many entities (in both the public and private sectors) have gone through the difficult task of restructuring their business operations in line of with the changes and downturn in the Qatari market. Unfortunately, the banking sector has not been exempt from the effects of this slowdown and some financial institutions have had to make difficult decisions over the past year.

Nevertheless, the banking sector has maintained a strong performance overall. Overall net profit for the banking sector increased by 1.4% for the last year, which was the result of higher net interest/profit income by QAR4.3 billion (US\$1.18 billion) and higher net fee and commission income by QAR962 million (US\$263.93 million). However, share prices of the listed banks have had a turbulent year.

Islamic banks (both listed and non-listed) fell within that trend and, despite experiencing a rollercoaster year, maintained a strong performance.

## Review of 2016

This year has seen a number of important transactions completed by the Islamic banks in Qatar, from the listing of the Qatar First Bank to the issuance of Sukuk instruments.

## Listing of QFB

The listing of Qatar First Bank (QFB) on the Qatar Stock Exchange marked a major step in the right direction for the Qatari market and has set a precedent for what is yet to come in Qatar. The listing of QFB took place on the 27<sup>th</sup> April 2016, marking the bank as the 44<sup>th</sup> listed company on the Qatar Stock Exchange. However, the greater importance and significance of this listing is that it is the first-ever listing of a company registered in the Qatar Financial Center (QFC) and it is anticipated that more QFC-registered companies will follow in QFB's footsteps. This brings together the Qatar Central Bank and QFC regimes in a way that is only going to benefit the local economy.

QFB was established on the 4<sup>th</sup> September 2008. The bank's authorized share capital of QAR2.5 billion (US\$685.9 million) and paid-up capital of QAR2 billion (US\$548.72 million) divided into 200 million shares have all been listed and are now publicly traded on the Qatar Stock Exchange. The listing share price was QAR15 (US\$4.12) per share and the share price has now settled at QAR13.85 (US\$3.8) with the bank's market capitalization now reaching QAR2.7 billion (US\$740.77 million).

## Transactions

Qatar Islamic Bank announced on the 1<sup>st</sup> September that it raised QAR2 billion in a Basel III compliant additional Tier 1 perpetual Sukuk to enhance its capital adequacy ratios and to support its future business growth.

Additionally, Qatar International Islamic Bank (QIIB) announced in August 2016 that it raised QAR1 billion (US\$274.36 million) through a local Sukuk issuance. In its announcement, QIIB reported that this was its first issue with capital-boosting tools in compliance with Basel III and that the Sukuk facility was issued within the first tranche of its capital boost as part of QIIB's interim and strategic plans.

Elsewhere, Qatar National Bank (QNB) Group completed two bond issuances during the course of the year. The first was a QAR10 billion (US\$2.74 billion) in additional Tier 1 perpetual capital notes by way of private placement, to strengthen the group's capital adequacy ratios and to support future growth across the QNB Group in accordance with group's strategy. The second was a US\$1 billion tranche under its euro medium-term note program in the international capital markets.

Additionally, QNB Group also completed the acquisition of a 99.81% stake in Finansbank in Turkey to extend its international presence and will be able to increasingly benefit from the rapid development of trade and strengthening of economic ties between Turkey and the Middle East in general, as well as between Qatar and Turkey in particular.

QInvest recently announced the acquisition of ERGO Portfoy, one of the largest and fastest-growing asset management companies in Turkey. Following the completion of this acquisition, QInvest Asset Management will have assets under management close to US\$1 billion.

**“ The banking sector has maintained a strong performance overall ”**

## Preview of 2017

2017 will be an important year in Qatar as the state continues to expedite its transition from a hydrocarbon-based economy to a more balanced business environment. Initiatives like the establishment of three new economic zones under the supervision of Manateq are key in this diversification strategy.

The government of the State of Qatar announced that a number of listings will take place during the course of 2017, which will be closely monitored by investors and entities looking to list. In particular, it is expected that the first two exchange-traded funds (ETFs) will be listed soon, including a Shariah compliant ETF managed by Al Rayan Investments (a subsidiary of Masraf Al Rayan).

The recent global political developments (particularly Brexit and the election of a new administration in the US) will undoubtedly have an impact on the Islamic banking and finance sector globally and in Qatar. Players within this sector will monitor what the appetite will be for Shariah compliant investments and instruments in Europe, the UK and the US in light of these events.

## Conclusion

In summary, the path of transformation of the Qatari market is on course and Islamic banks form an integral part of this journey. It is hoped that the banks will continue to grow during these tough times and assist in the diversification of the local economy.<sup>(2)</sup>



# Islamic finance in Russia: What lies ahead?



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**Russia historically does not have a visible Islamic finance industry, despite the fact that it has a significant (up to 10%) Muslim population constituting a majority in nine Russian regions.**

However, over the years there were attempts to either conduct particular Islamic finance transactions, or establish retail practices. To a certain extent, these attempts have been successful, although the establishment of fully-fledged, comprehensive Islamic finance retail solutions is a matter for the coming years.

## Review of 2016

While many processes such as Russia-wide conferences and discussions on necessary legislative changes continued, there were few distinctive and promising developments.

The major development was the active role played by a working group on the development of Islamic finance at the level of the Central Bank of Russia. The group held several meetings and the role of the Central Bank of Russia in supporting Islamic finance development in Russia became much more visible.

Another important development is the opening of the Center of Partnership Banking by one of the largest banking groups in Tatarstan. Previously, a few smaller Russian banks were opening retail Islamic banking divisions, but it is the first time that a significant regional player has proceeded to establish a fully-fledged Islamic banking division.

Regarding legislative developments to facilitate Islamic finance, there were not that many and the necessary amendments to Russian legislation to facilitate Islamic finance are still being discussed.

However, there is an indication that bigger banking groups are also tapping into Islamic banking in Russia. In particular, it was announced that Sberbank hired an experienced top manager of Islamic finance to develop this line of business. It is expected that by the end of 2016 Sberbank will execute at least one domestic Russian Islamic finance transaction.

As mentioned in the preview of 2016 last year, cooperation with business associations has boosted the development of Islamic finance products among local entrepreneurs. In particular, the Association of Muslim Entrepreneurs of Russia supported the Center of Partnership Banking and actively promoted Islamic banking services among its members.

In line with these developments, a new translation of AAOIFI Shariah standards from Arabic into Russian has started.

## Preview of 2017

Among anticipated major events of 2017 are the annual Halal Expo and KazanSummit, which are the major Russian platforms for discussion of Islamic finance prospects and developments.

Over the years, the forward-looking stance has remained pretty much the same. Businesses are demonstrating growing interest toward the development of Islamic finance, as are regulatory authorities. However, the further development of Islamic finance in Russia will very much depend on the role of the government, the central bank and parliament. Although Islamic finance is growing and developing, but in order to enter a new level, legislative changes are required.

## Conclusion

It appears that the organic growth of the Islamic finance industry in Russia is close to its limits existing under the current regulatory environment. It is hard to predict whether the government will take an active role and introduce the necessary legislative changes, similar to the UK model, or keep the current course of observing and analyzing. The year 2017 may provide an answer. (2)

# The Kingdom of Saudi Arabia: A year in transition



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**The Saudi Arabian economy, while strong and stable relative to other countries in the region, has entered a period of transition, largely due to lower oil prices and the ongoing war in Yemen. The IMF had forecasted a GDP growth of 1.2% versus 3.5% in 2015. In early 2016, the country's leadership adopted a national transformation plan, 'Vision 2030', the aim of which was to modernize and diversify the economy. In particular, Vision 2030 focuses on increasing employment, particularly in the private sector.**

A number of new regulations were passed in 2016 to further bolster the economy ahead of proposed privatizations and public-private partnerships (PPPs). There will also likely be continued investment by the private sector in the retail, power, renewables, transport, education and healthcare sectors.

International confidence in Saudi Arabia was recently demonstrated when it raised US\$17.5 billion in its debut sovereign bond resulting in the largest-ever emerging market bond. Saudi Arabia has also announced it intends to launch an IPO of a small portion of its crown jewel, Saudi Aramco, which is expected to generate significant international interest.

The financial services sector in Saudi Arabia is undergoing a period of bold transformation. The Capital Market Authority (CMA), which regulates the financial services and asset management industries in Saudi Arabia, has long sought to encourage asset managers and investment banks to grow assets under management by tapping retail markets and international investors. The CMA also wants to encourage managers to develop products which can be accessed by the Saudi public in order to encourage individuals to invest their income in the Saudi domestic market.

## Review of 2016

As such, throughout 2016, the CMA has released numerous regulations covering the establishment of new corporate vehicles, the IPO process and foreign investment in Saudi Arabia and has promised a complete revamp of existing financial services regulations. Two regulations in particular are pivotal for asset managers looking to raise Saudi Arabia-targeted funds: the amended investment fund regulations (the New Funds Regulations) and the real estate investment-traded funds instructions (the REIT Regulations).

After a consultation period, the New Funds Regulations were released in May 2016 and became effective on the 6<sup>th</sup> November 2016. The New Funds Regulations govern the formation, offering and operations of all private and public investment funds in Saudi Arabia, except publicly offered real estate funds, which are governed by the REIT Regulations. The issuance of the New Funds Regulations was long expected as the CMA had publicly acknowledged for years that new regulations were in progress.

In August 2016, the CMA released the draft REIT Regulations, which provide for certain public real estate funds to be listed on the Saudi Arabian Stock Exchange (Tadawul) as real estate investment-traded funds (REITFs). These REIT Regulations

were initially subject to a consultation period, which ended in late August. To date, the only listed funds in Saudi Arabia are exchange-traded funds. Riyadh Capital listed the first REIT in November 2016. Two additional REITs are expected in December.

Both new regulations provide opportunities to investment banks, private equity firms and asset managers to expand their product offerings and access additional investor bases.

A new Saudi Arabian Companies law also came into effect on the 2<sup>nd</sup> May 2016. The new Companies Law was widely welcomed. For the first time, for example, it permitted the possibility of single shareholder limited liability companies. It also allowed for joint stock companies to be formed with two rather than a minimum of five shareholders.

Further, the amount of reserve capital required was reduced from 50% of the stated capital to 30%. There were also important changes regarding potential shareholder and director liability as well as reducing shareholder liability with regards to a corporate entity not having sufficient capital.

The Competition Law also resulted in examples of its enforcement. In one example, various soft drink companies were fined SAR5 million (US\$1.33 million) for alleged price fixing. Parties are now more actively monitoring activities to ensure such are in compliance with the Competition Law.

The CMA has also approved the Rules for Qualified Foreign Financial Institutions Investment in Listed Shares and has amended the same to ease the ability of foreign parties to participate in listed shares in Saudi Arabia.

## Preview of 2017

We expect the various privatization and PPP initiatives will be implemented in early 2017. A number of such initiatives are being pursued in the healthcare, education, transportation, housing and energy industries. We expect that many of these projects will seek Shariah compliant leveraging including Sukuk. Further various parties are forming Shariah compliant funds to provide equity to such projects.

There will likely be a further focus on the employment of Saudi Arabian nationals with initiatives that already include new regulations and test projects to provide part-time work for Saudi Arabian nationals including females. Certain sectors are further 'Saudizing' in addition to mobile phone shops; other retail sectors are expected to move to 100% 'Saudization' in 2017. Further certain job titles are being reserved for Saudi Arabian nationals including all human resources jobs.

2016 was a record year in terms of venture capital investments in Saudi Arabia, and it appears the government is taking further steps to further encourage venture capital and SME investments in 2017.

## Conclusion

Over the last few years, the CMA and the Saudi Arabian General Investment Authority have been focused on issuing new regulations and new products to help spur the domestic market and foreign investment into Saudi Arabia. We further expect the Saudi Arabian government to work more closely with the private sector to participate in the development or financing of hospitals, schools, housing and the generation of power. ☺



## Singapore staying focused amid economic uncertainty



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Singapore has long been recognized as one of the key financial hubs in the global economy. In September 2016, PwC's Cities of Opportunities Index ranked Singapore at number 2 ahead of Paris and Amsterdam. The results exhibit Singapore's growing business clout, driven in part by an expanding financial and insurance industry, which makes up about 13% of the economy, according to PwC's 'Cities of Opportunities 7' report dated the 7<sup>th</sup> September 2016.

However, 2016 has proven to be a challenging year for Singapore's economy. As the global economy remains in the doldrums and its key trading partners faced with economic woes, Singapore's economy contracted by 4.1% in the third quarter on a seasonally adjusted annualized basis, from the previous three months, recording the biggest slump since 2012. Analysts have forecasted a mere 0.3% growth, as reported by AsiaOne, for 2016.

The downturn in the oil and gas and commodity industries has resulted in several companies cutting jobs and defaulting on debt obligations. August 2016 saw the first-ever default in a local currency Sukuk facility by a subsidiary of Swiber Holdings, followed by several bond defaults by other oil and gas players in the industry. This has raised concerns on the financial sector's exposure to the oil and gas sector, with the expectation that market conditions are expected to continue in 2017.

“ It is key for financial institutions offering Islamic finance to sustain the public's level of awareness and interest in Islamic finance ”

### Review of 2016

Not surprisingly, Islamic finance activities in Singapore are not spared from the woes plaguing the global economy. In November 2015, DBS Group had announced its intention to wind down the Islamic Bank of Asia (IBA), citing the inability to meet economies of scale as the reason for its decision.

While the winding-down of the IBA may be viewed as a setback to Singapore's aspirations to become an Islamic finance hub in the ASEAN region, 2016 was the year where Islamic finance was still able to make headlines and garner interest from the public in Singapore. Notable news include:

1. The RB Capital transaction: April 2016 saw a one-of-a-kind Islamic financing deal worth SG\$260 million (US\$182.16 million) involving Maybank Singapore and RB Capital. The deal involved structuring Shariah compliant financing using Holiday Inn Express Singapore Clarke Quay as the underlying security and is one of the biggest Islamic deals in Singapore. This landmark deal showcases the ability to structure a Shariah compliant financing facility using hospitality assets as underlying assets in a secular country.

2. Sabana REIT refinancing: In August 2016, Sabana REIT, the first and currently the only Shariah compliant REIT listed in Singapore, takes up Islamic financing facilities amounting to SG\$181 million (US\$126.81 million) involving banks like Maybank Singapore, HSBC and UOB. The facilities included a 3.5-year term commodity Murabahah facility of up to SG\$90 million (US\$63.05 million) that was used to refinance existing financings.

3. Awareness in Islamic finance: Maybank Singapore was invited by Singapore Polytechnic to give a presentation to its students in August 2016. Among the topics presented included a brief history in Islamic finance and developments in the global Islamic industry which provided insights into the world of Islamic finance for students of finance.

4. The Swiber Sukuk default: Swiber Capital, a subsidiary of Swiber Holdings became the first company to default on a local currency Sukuk facility in Singapore. On the 2<sup>nd</sup> August, it was announced that Swiber Capital was unable to service the profit payment amounting to US\$4.88 million under its US\$150 million Sukuk facility issued in 2013, as reported by The Straits Times.

## Preview of 2017

With economic growth in 2017 expected to remain flat, the key is to create and sustain awareness of Islamic finance in Singapore while at the same time identifying the pockets of opportunities with the aim to grow further once economic conditions have improved by addressing the following areas:

1. Islamic wealth management: With Singapore poised to be one of the world's key wealth management centers coupled with its Islamic finance regulations already in place, the development of Islamic wealth management in the country would help to further increase the fund flows between the Middle East and Singapore. It is timely that Islamic wealth management capabilities are developed in order to further attract the increasing number of wealthy Muslim investors looking to invest without the need to compromise on their religious beliefs.

2. Increase in product offerings: Financial institutions need to identify the current gaps in the Singaporean market where Islamic finance is not present. Products including Islamic credit cards, home financing and Takaful are only some of the areas which can be explored and developed further. For example, total assets for Singapore's insurance industry are estimated to stand at approximately US\$163.8 billion as at the end of March 2016, up 4% compared to a year ago, according to the January to June 2016 results from Life Insurance Association Singapore. This coupled with the increase in Islamic financing assets can potentially present an opportunity to reintroduce Takaful into the Singaporean market.

3. Increased awareness in Islam and Islamic finance among Malay Muslims: according to the Department of Statistics of Singapore, Malays make up 13.4% of Singapore's population at the end of June 2016. Discussions with key players in Singapore's Halal industry such as MY Outlets have indicated that there is an increased awareness of the Halal concept among Malay Muslims with further enquiries into Islamic financing and how Islamic finance in Singapore can grow to serve the Malay Muslim community. Collaborations between Islamic financial institutions and key Malay Muslim organizations in Singapore are one of the ways to penetrate and increase the participation of Malay Muslims to grow Islamic finance in Singapore.

## Conclusion

With the challenges faced in 2016 expected to continue well into 2017, it is key for financial institutions offering Islamic finance to sustain the public's level of awareness and interest in Islamic finance and to identify the gaps which could be converted into opportunities once the economy recovers.

It is important there is continuous engagement between Islamic financial institutions, regulators, the academic community and members of the public for secular nations such as Singapore to ensure the awareness and relevance of Islamic finance amid the current economic uncertainty. ☺



# Adaptation, innovation and evolution crucial to South Africa's Islamic finance industry



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South Africa's economy remains under pressure and recent indicators do not provide much hope for an economic acceleration anytime soon. The economy is also threatened by political turmoil. The recently withdrawn fraud charges against the finance minister suggest a level of political interference which has created uncertainty in investor's minds.

In late October, the government delivered its Medium-Term Budget Policy Statement and announced that it will opt for a more restrictive fiscal policy against the backdrop of slower economic growth. The threat of a ratings downgrade to junk status looms which could create a very difficult and bumpy 2017.

## Review of 2016

As with all emerging markets, South Africa faced significant challenges from weaker commodity prices, lower Chinese demand and the possibility of rising US interest rates. These difficult headwinds were further compounded by domestic factors including policy uncertainty, infrastructure gaps and a severe drought that gripped the country. The forecast for real GDP growth is 0.8% in 2016, down from 1.3% in 2015 and the lowest rate of growth since 2009.

**“With the local economy under pressure, the South African Islamic finance industry has to adapt, innovate and evolve to continue on its growth trajectory”**

In spite of these challenges, the Islamic finance industry continued to show growth. The banking sector was boosted by the introduction of Shariah banking services by Standard Bank. Innovation and product development within Islamic finance is assisting in attracting new customers to the Islamic banking industry.

Asset managers continued their recent growth trends; however, the returns for most asset managers were under pressure given the volatility in the markets. With only one Takaful operator in the market, the growth of Takaful has been sluggish over the year. The demand for General and Family Takaful remains strong but increased competition or greater partnerships with the Islamic banks is needed to propel this market. The market is watching this space closely and the success of the Takaful offering will result in acceleration from other financial institutions to develop products like life covers, pension funds, medical aid and the like.

With South Africa's need for funding, speculation has been rife around the issuance of a second Sukuk. The South African government issued its debut US\$500 million Sukuk in 2014. The Sukuk facility



was four times oversubscribed, highlighting the appetite for this product. It was expected that a second issuance would happen in 2016 but development is ongoing and it would seem that this Sukuk would be issued sooner rather than later.

With regards to corporate Sukuk, there are a number of initiatives underway and we can expect to see a corporate Sukuk issuance in the near future.

## Preview of 2017

In December, South Africa faces a sovereign credit rating review and the country will either just manage to scrape through or face a downgrade to junk status. The effect of a downgrade will be felt for some time and would adversely affect growth.

The Islamic finance industry, with low penetration rates, has room to grow; however, there will be some significant challenges.

The volatile currency is forcing investors to look for more stable investment options. We see an increasing number of customers moving into the international property market, and with business confidence down, property finance deals are increasingly coming under pressure in terms of volumes and profit margins.

Over the course of 2016, we have seen new car sales figures plummet. It is expected that this trend will continue and will have an impact on the banking and Takaful markets.

## Conclusion

With the local economy under pressure, the South African Islamic finance industry has to adapt, innovate and evolve to continue on its growth trajectory. The market is looking for alternatives but there is a need for education and awareness to highlight the value that Islamic finance provides. One of the major opportunities remains the expansion into the rest of sub-Saharan Africa where the market is crying out for affordable, interest-free banking.<sup>(9)</sup>

# Islamic finance development in Tunisia



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**Over the past four years, the Tunisian economy has faced significant challenges which have increased pressure on Tunisia's public finances and led to the country revising higher current account and fiscal deficits, indicating a significant deterioration in the debt burden over the past year.**

In the same way, these challenges will continue to influence Tunisian banks' financial performance despite the recent banking regulation enhancement and the development of the Islamic financial landscape in Tunisia.

The Tunisian banking system consists of 23 full-service banks, of which five banks are specialized (three Islamic banks, one SME finance bank and one microfinance bank).

The three Islamic banks are:

- Zitouna Bank, which obtained a license in May 2010
- Al Baraka Bank, which was transformed from a non-resident bank to an onshore bank in January 2014, and
- Wifack International Bank, which was transformed from a leasing company to an onshore bank and which was granted a banking license in November 2015 and authorized to transform its activity to Islamic banking.

There are also six Islamic mutual funds: ATID Fund (March 2009), Al Kaouther Fund (March 2010), FCPR MAX-Jasmin (2012), Theemar Investment Fund (February 2013), UGFS Islamic Fund and CEA Islamic Fund (December 2014).

Furthermore, four Takaful institutions were recently created: Zitouna Takaful (2011), El Amana Takaful, Al Takafulia Insurance (June 2013) and Tunis Re which created a dedicated unit, Tunis ReTakaful to meet the needs of the domestic market. In addition, there is also BEST RE (L) (April 1985) which is considered as an offshore reinsurance company (with headquarters based in Tunis) and as the world's re-Takaful pioneer.

Another component of the Islamic financial landscape is Best Lease (1999) which is the only operator on the market of Islamic leasing in Tunisia.

## Review of 2016

Zitouna Bank's initiatives continued in 2016 after its successful TND40 million (US\$17.41 million) local issuance in December 2015 of participative bonds for seven years (a hybrid facility with a fixed part of its yield of 6% and a variable part of up to 2%). Indeed, Zitouna Bank recently developed the activities of an Islamic microfinance fund, Zitouna Tamkeen, in partnership with the IDB.

Moreover, the Tunisian Solidarity Bank recently adopted the Islamic banking option in conformity with the new banking law to regularize the funding for projects supported by the IDB's grant of US\$50 million.

In 2016, Tunisia and the IDB signed an agreement to fund the gas turbine power plant in Mornaguia with a budget of US\$200 million in addition to a US\$27.7 million funding for the Sfax Integrated Agricultural Development Project.

Furthermore, Tunisia and the International Islamic Trade Finance Corporation, a member of the IDB Group, signed a US\$310 million agreement to support the energy sector.

Following certain major changes related to tax provisions (Finance Act 2014: the exemption of profit margin from value-added tax and the avoidance of double taxation on the transfer of properties) and those related to certain legal provisions (Sukuk law, Islamic funds and Takaful), the New Banking Law approved in 2016 introduces a number of changes to the functioning and supervision of the banking sector in order to reorganize it through the formal legal recognition of Islamic banking activities.

This banking law defines Islamic finance transactions (Murabahah, Ijarah, Mudarabah, Musharakah, Istisnah, Salam, Wadiah Istithmar) and also allows all banks to carry out Islamic finance transactions, subject to approval from the central bank (including for Islamic windows).

## Preview of 2017

Although Islamic finance transactions are expressed in the law, and subject to the same law, the central bank is expected to elaborate more on this in early 2017 with a circular which will define these transactions and provide their regime.

Even though the law is placing Islamic finance transactions under the supervision of the central bank, it is also expected in 2017 that Shariah compliance will be well defined in the subsequent regulations (for example, the limits between the roles of the Shariah board, the board of directors and the central bank and the recognition of international regulations).

## Conclusion

The following is a list of what should and perhaps what needs to happen for the Islamic finance industry to develop regarding the legal and regulatory framework:

- Tax and accounting aspects
- Convergence between Tunisian law and Islamic principles and even additional laws
- Conditions to accept the approval to perform Islamic banking activities
- New regulations with reference to the new banking law that will fit alongside with other laws
- New Islamic finance transactions not regulated by the banking law to be allowed in Tunisia, and
- SPV/trustee regulations and law to develop the Sukuk market and project finance.☺

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## Evaluations on Turkey's current economic and financial situation



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**Turkey is among the world's developing countries and the IMF defines its economy as an 'emerging market' economy. The country is one of the world's leading producers of agricultural products, textiles, motor vehicles, ships and other transportation equipment, construction materials and consumer electronics. Besides that, the banking sector plays an active role in the Turkish finance sector. There are six participation banks, 34 deposit banks and 13 development and investment banks in the country and 21 of these banks are foreign capitalized.**

The private sector has a significant place in Turkey, therefore the privatization process has been expedited in recent years. Turkey also has a geopolitical advantage since it is located in the middle of the rich oil-producing area and the consumer markets in Europe. Additionally, as well as its strategic geopolitical position, being at the crossroads of Europe, Asia and the Middle East makes it a prime gateway. Turkey provides a big opportunity to investors through its geographical location, tax advantages, financial incentives and its extensive internal market.

### Review of 2016

Turkey has a massive role in the Islamic finance world by virtue of the fact that it has issued a massive amount of Sukuk in recent years. Islamic finance has a remarkable place in Turkey therefore it is continuously developing and expanding in the country. The government emphasizes the importance of Islamic finance at every turn. In fact, new Islamic participation banks were established in

2016 and in the same year, Turkey actualized many reforms in the economic field. These reforms have been implemented in financial markets as well as in sectors such as agriculture, social security, energy and communication. By means of these reforms, Turkey receives many investments from Europe, the Middle East and North Africa in the field of energy, banking and the services sector. According to data from the general Directorate of Budget and Fiscal Control, Turkey will reach a 5% growth rate in 2017 and 2018.

Turkey struggled with challenging political issues after it experienced a failed coup attempt on the 15<sup>th</sup> July. The economic stability of Turkey was damaged by the event and as a result, credit rating agencies decreased Turkey's credit note due to the failed attempted coup and its expected effects. However, contrary to expectations, Turkey managed to shake off the negative effects of the attempted coup. And despite these problems, Turkey remains attractive to foreign investors. The failed coup seems to have strengthened Turkey's economy rather than weakening it.

Following these developments, credit note agencies increased Turkey's credit rating due to the efficient reforms. Usually, an attempted coup would have negative effects on any country. However, Turkey sorted out these problems in a very short time, proving that it has a solid and developing economy and political structure.

### Preview of 2017 and conclusion

The Turkish government aims to improve more economical and financial reforms in the Islamic finance sector. Even though new participation banks have been established in 2016, the Turkish government should pave the way for investors to increase the number of Islamic banks since it has not reached a sufficient number. The government should support and encourage the banking sector and make necessary amendments to current regulations. (F)

# UAE: Slow and steady it goes



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**The year 2016 was a year of slow and steady progress for Islamic finance in the UAE. Although total banking assets under Islamic banks increased, the pace of growth reduced in an otherwise challenging operating environment. Growth in the Takaful sector also remained subdued. On a positive note, policy support for a standardized Shariah board at the Central Bank of the UAE, the launch of the Sukuk index and plans to launch a Shariah compliant trade bank all support Dubai's aspiration of becoming the global capital for Islamic finance. On the flip side, there was a lack of momentum in Sukuk issuance.**

## Review of 2016

The drop in oil prices has seen a significant slowdown in the UAE's economy and has reduced growth opportunity for Islamic banks, much in sync with their conventional counterparts. Also, the current trend in the real estate sector has stifled growth although investment related to Dubai Expo 2020 is creating opportunities. Based on data from the central bank, Islamic banking assets reached AED493 billion (US\$134.19 billion) as at the third quarter of 2016 compared with AED446 billion (US\$121.39 billion) in the previous year, reflecting a growth of 10.4% over the year versus 2% for conventional banking assets. The asset quality of Islamic banks has largely remained strong; however, given their higher exposure to real estate, there is a heightened concern for the future outlook on non-performing loans. That said, the creation of sufficient capital buffers in the previous years should alleviate any material decline in credit quality of the Islamic banks.

Working toward its ambition to become the global capital of the Islamic economy, the Dubai government announced plans to launch the world's first Shariah compliant trade finance-focused bank in the UAE soon. The bank is to be called the Emirates Trade Bank and will support endeavors to double the UAE's estimated US\$1.4 trillion trade flows in 2014 by 2020.

The Islamic insurance industry had seen good growth over the last few years in the UAE as organizations such as the Dubai Health Authority introduced comprehensive medical insurance schemes

and the population continued to grow. However, premium growth slowed in 2016 as a sharp drop in hydrocarbon prices hit economic growth across all sectors and reduced the pace of employment and immigrant population growth. Despite tariff increases, only half of the listed Takaful companies in the UAE reported profits in the year 2015. The losses in the remaining Takaful companies, mainly from the motor insurance segment, were in fact so large that the overall Takaful market in the UAE recorded a total loss of over US\$40 million in 2015. Looking at the interim results so far, it appears that the year 2016 will also be a loss-making year for the Takaful sector.

In terms of debt capital markets, despite a budget deficit of over 3% of GDP in the UAE, Sukuk issuance did not materialize as anticipated. In fact, as a percentage of the total figure, Sukuk issuance fell in 2016 compared with 2015 as sovereign and government-related entities needing to raise money in a hurry chose the path of conventional bonds, particularly as they endeavored to tap the abundant cheap liquidity from Japanese and European investors. The Abu Dhabi government also did a US\$5 billion deal in the conventional bond form. During the year, Sukuk investors received multiple offerings from the likes of Sharjah, Bahrain and Oman sovereigns as well as corporates. Banks were also active with Tier 1 issuances from Boubayan, Barwa and others.

A welcome development for investors in the secondary market for Sukuk was the launch of the NASDAQ Dubai Idea Rating Global Sukuk Index during the year. The index measures the performance of the global investable Sukuk universe with issuances in multiple currencies.

## Preview of 2017

Looking ahead, Islamic finance is expected to have a stronger growth trajectory next year driven by improving oil prices, asset-financing needs of the upcoming infrastructure projects and potential funding needs arising from merger and acquisition activities in the banking sector.

Opportunities for growth in Islamic finance are also likely to gather momentum from the natural connection between the principles of Shariah finance and some of the 17 sustainable development goals of the United Nations that aim to reduce income inequalities, invest in clean water and sanitation, improve infrastructure and quality education.

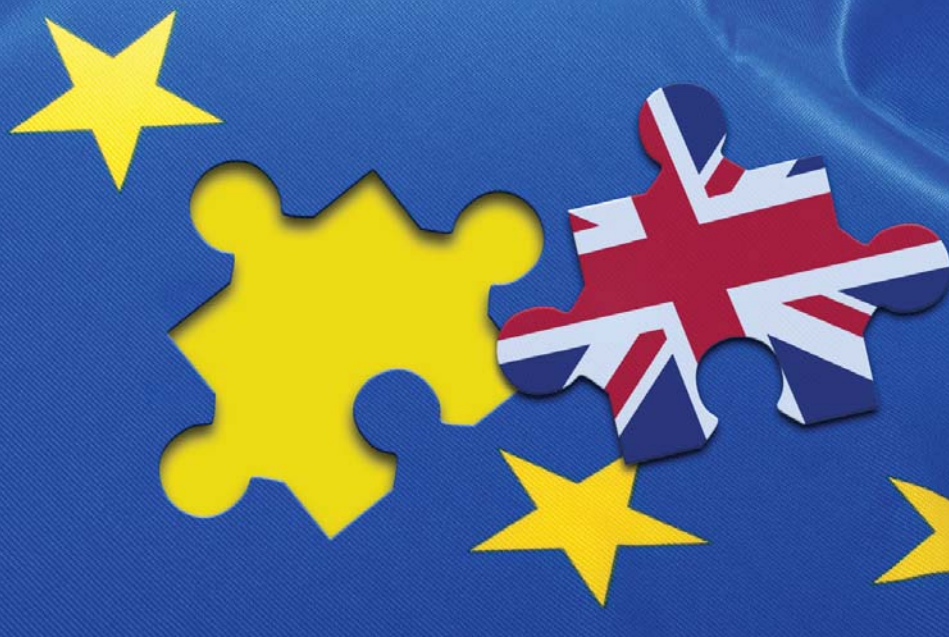
While Sukuk issuance in 2017 is likely to be higher than in 2016, much will depend on monetary and fiscal policy developments and volatility in the developed markets particularly in the US. Construction activity in the UAE is likely to be high as it makes progress on one of the GCC's largest projects – the Al Maktoum International Airport, budgeted at over US\$30 billion in total. The Dubai government has already mandated banks to arrange circa US\$3 billion in financing over the coming quarters –in both the conventional as well as the Islamic finance format (aka Sukuk).

The UAE market will also likely benefit from the financing needs to fund another large project – the Al Gharbia Chemical industrial city in Abu Dhabi. In addition, the likes of Etihad Airways are also likely to tap the market soon.

## Conclusion

The year 2016 marked another year of slow and steady growth for the Islamic finance industry in the UAE, although low oil prices created some headwinds. Looking ahead, government efforts to position Dubai as the global capital for Islamic finance is likely to bear fruit and the industry can look forward to another solid year ahead. ☺





# Islamic finance in the UK: The impact of Brexit



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Islamic finance has developed rapidly in the UK over the past decade and the UK government has been very supportive toward its development and promotion. The UK hosted the first stand-alone Islamic financial institution in the EU and has the highest value of Shariah compliant assets of any non-Muslim country. The UK has a strong and proud tradition of openness and flexibility which provides a strong foundation for growth when combined with London's position as a leading international financial center and the UK's significant Muslim population (just under 5% of the UK population according to the 2011 Census). As a result of its standing, London has long been perceived as the western hub for Islamic finance.

## Review of 2016

The UK's vote to leave the EU in 2016 and new banking regulations, such as the implementation of the Bank Recovery and Resolution Directive (Directive 2014/59/EU), affected the way in which Islamic finance transactions were structured in the UK in 2016. More generally, the geopolitical and economic circumstances (including the fall in the oil price) presented both a challenge and an opportunity for Islamic finance as Middle Eastern oil-exporting countries (who have been a key driver of the global Islamic finance industry, and who are also likely to have been the most affected by the decline in the oil price) re-assessed their balance sheets, and equally searched for alternative sources of finance, including Islamic finance, to maintain their ambitious capital-spending programs.

Against this backdrop, Islamic finance continued to play a significant role in the infrastructure, real estate and retail banking sectors in the UK. The UK is currently the number one foreign investment

destination in Europe with net inflows of US\$72 billion and around US\$185 billion in foreign property investment alone. The fall in UK real estate values and the low pound to US dollar exchange rate following Brexit have presented buying opportunities for those looking to invest in the mid to longer term and dissuaded more cautious buyers. This is particularly attractive for Middle Eastern investors with a US dollar-denominated currency.

## Preview of 2017

The UK Trade & Investment Department continues to develop initiatives to increase new opportunities in the Islamic finance sector, and this is set to continue in 2017. Sovereign wealth funds from Islamic countries are also expected to remain active in the UK in 2017.

The mandate of the Islamic Finance Task Force is to facilitate Islamic financial business, including investment in UK infrastructure by Islamic sovereign wealth funds. 2017 may see a surge in Sukuk issuance by Middle Eastern sovereigns (including those listed on the London Stock Exchange) to support their ambitious capital-spending programs in a low oil price environment.

## Conclusion

The UK government believes that the growth of Islamic finance in the UK is beneficial to all UK citizens and that Islamic finance should be available to everybody. On the retail side, all consumers gain from a wider choice of retail financial services, in particular those consumers whose religious beliefs prevent them from accessing conventional finance. On the wholesale side, the entire country benefits from the UK financial services industry's success as the leading western center for Islamic finance. The UK's prominent position in the Islamic finance market looks set to be maintained (and potentially enhanced) by Brexit. Many of the fundamentals to doing business in the UK have not changed, and the UK government is showing a willingness to expand its horizons to attract the investment that the UK needs. ☺

# Real estate continues to be the focus of Islamic finance in the US



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**With the results of the 2016 US presidential election behind us, there is at least one certainty—who the president of the US will be in 2017. Beyond that fact, not much else is certain. The new administration's policies are yet to be prioritized and publicized, and as such, it is unclear what the impact of the new administration will be on the US economy or if there will be any impact altogether from the transfer of executive power. The uncertain political climate adds to what is an already murky mix of economic indicators. Quarterly GDP growth, employment and wage growth, corporate sales and profits, financing activity and a multitude of other signals providing insight into the direction of the US economy have been vacillating of late, causing confusion as to whether the US economy will get a kick-start and continue along a more robust growth trajectory or stall out and reverse course.**

Although the future direction of the US economy has become less clear, the consensus seems to be that the country is on solid footing for the time being. Indicators of economic strength, such as GDP growth, employment levels, consumer confidence, manufacturing activity and trade activity have all shown resiliency over the course of the year. In short, no major 'red flags' have gone up yet signaling any sort of distress in the US economy, and as such, the country remains an investment safe haven relative to other global markets, with investment capital continuing to pour into the country. Foreign investors seeking Islamic finance products in the US continued to show the greatest interest in private real estate investments in 2016, with relatively marginal activity on US originated Sukuk issuances or other sectors of Islamic finance. US real estate valuations have been bolstered by strong fundamentals and a high level of interest from a multitude of capital sources in 2016. Apart from the fact that US real estate fits well with requirements of Islamic financial products, the current strength and stability of the asset class make it the center of focus for Islamic financial transactions in the US.

## Review of 2016

With 2015 having been an exceptional year for investment activity in the US real estate sector, it is no surprise that investment volume in 2016 has declined from the prior year. It is important to keep this decline in perspective, however. 2015 marked the sixth straight year of increasing investment activity in US real estate reaching nearly US\$550 billion-worth of transaction activity by some estimates. To surpass or even meet 2015's total investment volume would have been difficult. Final investment sales figures for 2016 will not be published until well into 2017; however, all indications are that the 2016 total volume will be down slightly from the prior year.

In spite of the decline in transaction volume, property valuations have remained stable. In fact, some sources suggest that weighted average cap rates have actually continued to decline over the course of 2016, tightening by as much as 35bps from the third quarter of 2015 to the third quarter of 2016. Fundamentals for the sector also remained strong in 2016 as growth in property level net operating income continued to outpace price inflation in the wider economy. Operating income growth from individual properties in 2016 was not as strong as 2015, but again, it is important to keep in perspective that 2015 was a record year for US real estate with some property

classes such as apartments and hotels reportedly seeing as much as a 6-8% average growth in operating income across the sector.

Encouraged by the healthy level of investment activity and growing income trends in the sector, foreign investors continued to play a major role in US real estate transactions in 2016. Over the past few years, foreign investors have been net buyers of US real estate even in periods when domestic institutions, REITs and private domestic investors have been net sellers. In 2016, however, foreign capital sources faced stiffer competition for US properties. While REITs remained net sellers, domestic institutional investors and private buyers joined foreign investors as net buyers in the marketplace. In spite of peak pricing, these capital sources made a grab for US real estate in 2016 as they had few choices for yield-generating assets in what has become a virtually negative yielding fixed income environment around the globe.

## Preview of 2017

As mentioned previously, 'red flags' have yet to be identified that would signal a retreat in the strong fundamentals that underpin peak valuations of US real estate at present. If occupancy levels remain at or even decline slightly from their current levels and rents continue to grow or even stabilize without significant decline, property valuations are unlikely to deteriorate in the near term. Supply and demand dynamics are also favorable as we look forward to 2017. The pace of new construction has been muted in the current cycle relative to previous cycles, allowing for steady absorption of new products and limited backlog. Even with the robust availability of capital from both domestic and foreign sources in the form of both debt and equity, new construction remains in check. The current balance of strong fundamentals, plentiful liquidity and a favorable supply/demand dynamic portends another healthy year for US commercial real estate valuations and investment activity in 2017.

The wild card affecting valuations and transaction activity, however, will be the pace at which interest rates begin to rise. Credit markets have seemed to price in an increase in US interest rates before the end of the year. The rise in interest rates is imminent, but the pace of that rise is unknown. Nonetheless, the yield generation potential of US real estate appears to be comparatively attractive even in a rising interest rate environment. Average cap rates are still somewhere between 350-400bps higher than 10-year US government treasuries. That spread will need to contract by at least another 100bps before inflation alone begins to threaten the relative attractiveness of US real estate among yield-oriented investors.

## Conclusion

As we transition from 2016 to 2017, it seems that the collective consciousness of investors in US real estate has also begun to transition from a sentiment of pure optimism to one of cautious optimism. The positive trajectory of the US real estate market has been slow and steady and sustained over several years following the Great Recession. While there are no apparent signals that the recovery should or will reverse course over the next 12 months, the mere fact that the recovery has sustained for this long naturally gives rise to caution. Caution, however, is distinct from pessimism and in fact, it is often caution that allows for continued growth in cycles that would otherwise come to a crashing halt when optimism remains unchecked. Real estate has been the backbone of Islamic financial activity thus far in the US and should continue to provide a strong foundation for Islamic investments in the US for the foreseeable future. ☺

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