

# Islamic Financial Services Board: The Development of the Islamic Financial Services Industry in the Middle East

December 2007 (Frankfurt)

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# Historical Background

- Need for liquidity and good liquidity management
- Different periods between maturities of assets and deposits – resulting in either surplus of non-performing cash or a shortage of cash to fund investments
- Lack of:
  - active interbank and secondary market (mostly primary market trading)
  - acceptable Shariah compliant instruments
  - acceptable regulatory conditions
  - limited available agency credit ratings/transparency
  - unsophisticated market
  - limited information flow

# Shariah Requirements

- Shariah compliance
  - General prohibitions and assumptions
  - **RIBA** : “interest or usury”
  - **JAHALA** : “uncertainty and/or lack of full transparency/disclosure”
  - **GHARAR** : “deception/hazard/undue risk”

- Underlying Asset/Transaction
  - Existence and tangible
  - Not only the asset has to be acceptable but the proposed contractual structure has to be acceptable as well
- Maysir and Maslaha: general interest, necessity
- URF: custom
- Certification: Fatwa (different schools of interpretation)

# Key Contractual Structures used

## 1. Murabaha

Cost-plus financing. The transaction usually involves one party making a purchase of an asset (at the request of another). The first party then sells the asset back to the other on a deferred sale basis with a markup. The markup is determined before the purchase takes place and cannot be modified during the life of the contract.

# Key Contractual Structures

## 2. Ijara

Leasing arrangements that are comparable to conventional operating and finance leases. The financier rents an asset to its client for agreed payments throughout a specific period of time but the client does not, in the absence of agreed option arrangements, have the option of owning the asset.

## Key Contractual Structures

### 3. Istisna

This operates like a commissioned manufacture. The financier is responsible for manufacturing assets, usually through a parallel contract with another entity. It then sells them to a client at a profit in exchange for taking on the risk of manufacturing the assets.

## Key Contractual Structures

### 4. Mudaraba

This is similar to an equity arrangement and is also similar to a conventional limited partnership whereby one party contributes capital to a business and the other party provides expertise/management. A profit-sharing ratio is agreed upon prior to undertaking the project.

## Key Contractual Structures

### 5. Musharaka

This is similar to an equity arrangement and can be compared to a joint venture in that two parties provide capital towards the financing of a project. Profits are shared based on a prearranged ratio but losses are distributed in proportion to equity participation.

## Other structures

- **Arboun**
- **Salaam**
- **Sukuk**
  - derivatives
  - hedging

# General Overview

## ■ Middle East

- An estimated \$6 – 7 billion of Shariah compliant new structured products have been issued to date
- At least 50% of all new project financing in the Middle East features some element of Islamic funding
- As the petro-economies in the Middle East continue to flourish and as both regional and international investors demand product structures which comply with Islamic Shariah law, Islamic finance is expected to surpass its current 20% annual growth rate
- Global demand for Islamic finance is likely to surge to \$4 trillion from the current \$400 billion to satisfy investor appetite for new banking products and services
- The sukuk is the fastest growing market and saw a 75% increase in figures from last year
- \$30 billion of sukuks are expected to be issued by the beginning of 2008. These will include Sovereign, Institutional/ Treasury and the fast developing Corporate sukuk market.

# Syria

- The school of thought followed in Syria is predominantly the Hanafi school
- Cham Islamic Bank, the first bank in Syria to operate on the basis of Shariah, launched in August 2007
- Stock exchange to open in Damascus and begin operations in 2008
- Arab Finance House have indicated an intention to open up a Sharia-compliant bank in Syria by the end of 2007 with capital of \$100 million. A major shareholder in the new Syrian bank will be Qatar Islamic Bank, which also owns 70 percent of Arab Finance House

# Bahrain

- Bahrain follows the Maliki school of thought on Islamic jurisprudence, which is considered to be moderately liberal
- Bahrain is recognised as, historically, having had the pre eminent financial services centre in the Middle East and is noted as a pioneer in Islamic banking and finance
- Bahrain is the host country for AAOIFI
- Bahrain based Liquidity Management Centre acted as arranger in a \$130 million sukuk issue arranged for Berber Cement Company
- Last year, Deutsche Bank announced a joint venture with Ithmaar Bank of Bahrain and Abraaj Capital of Dubai to launch a \$2 billion Shariah compliant financial fund

## Qatar

- The Hanbali school is also the predominant school in Qatar. It is also generally said to be the most conservative
- Islamic finance is now a regulated activity within the Qatar financial services centre
- The landmark Qatargas II LNG project contained significant Islamic finance participation
- HSBC Bank acted as lead manager on a US\$300 million *sukuk* on behalf of Qatar Real Estate Investment Company. It was the first rated *sukuk* to be issued by a Qatari corporate
- Doha Bank in Qatar is planning a \$1 billion *sukuk* to finance renewable energy

# Saudi Arabia

- Saudi Arabia follows the Hanbali school of thought
- Al-Tala'a International Transportation Company in Saudi Arabia is to issue a \$63 million sukuk
- The Rabigh Petrochemical project included one of the largest long-term Islamic project financings in the Middle East
- HSBC Saudi Arabia entered into the Islamic finance market by arranging a SR3bn (\$800m) debt sukuk issue for Saudi Arabia Basic Industries Corporation (SABIC) – the first public sukuk launched in the Saudi market under the new Capital Market Law.
- Saudi International Petrochemical Company recently tapped SR2 billion (\$533 million) worth of ijara facilities from five regional banks to support its new project developments
- Saudi Arabian Mining Company (Maaden) and Saudi Basic Industries Corporation (Sabic) announced plans to raise \$2,000 million in what would be the world's largest Shariah compliant project finance transaction

# UAE

- Dubai and Abu Dhabi follow the Maliki school of thought on Islamic jurisprudence.
- Dubai is fast becoming a recognised global centre for the Islamic finance industry, with a proliferation of investment banks, advisors and other professionals together with the regulation of the industry by such bodies as the DFSA and the DIFC
- In November 2006, Abu Dhabi Islamic Bank established the first Islamic securities (sukuk) programme in the UAE, with an aggregate size of US\$5 billion
- The Shuweihat transaction in Abu Dhabi broke significant ground in incorporating Islamic finance tranches in significant projects

# Pakistan

- Pakistan follows the Hanafi school of thought on Islamic jurisprudence. This is generally considered to be the most liberal school of thought, although from a financier's perspective this may not be the case
- Pakistan successfully launched a Shariah compliant treasury bond to lift the country's growing Islamic banking sector
- The market share of Islamic banks in Pakistan has now reached over 2% of the total banking industry

# Kuwait

- Kuwait has adopted the Maliki school of Islamic jurisprudence
- HSBC have been in discussions with Kuwait Finance House, seen as a key player in the growth of Islamic finance in Kuwait, in relation to building co-operative ties between them
- KIPCO Asset Management Company has announced the launch of a specialized Sharia compliant market fund in Kuwait called the Al Jazi Money Market Fund
- Kuwait has been making great progress in strengthening its local shariah compliant institutions, including gradually moving toward a new regulatory framework for sukuk in light of growing demand

## Other Significant Markets

- **Turkey**
- **Egypt**
- **Iran**
- **Sudan**
- **Lebanon**
- **Jordan**

## Conclusion

- **Fast developing market and significant scope for innovation**
- **Interaction with global capital markets is and will continue to be significant**
- **Bear in mind the different schools of thought**
- **A continuing demand for good corporate governance and transparency and encouragement from bodies such as the IFSB and AAOIFI**

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