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## Islamic Finance: the reality post 2009

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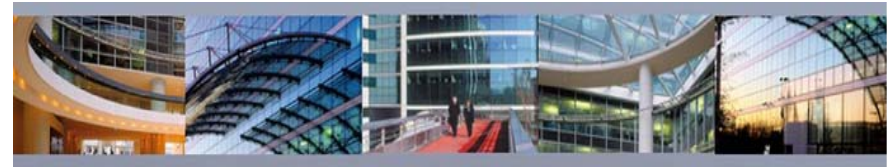
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## Section 1

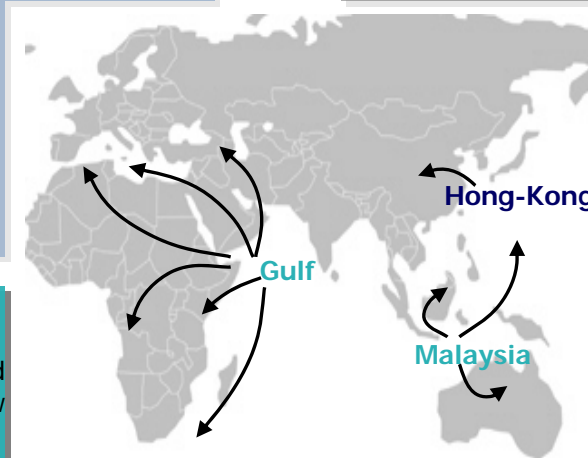
### Islamic Finance Overview and the crisis



## Islamic Market Development

### Figures

- **1.6 billion** Muslims worldwide (nearly **25%** of the world population)
- A **15% to 20% increase** forecast for the next years (McKinsey study)
- Total Islamic funds between **\$500bn to one trillion** dollars.
- Market is composed of approximately **500 Islamic institutions** and conventional banks with Islamic windows
- The total Islamic **potential is estimated at \$4 trillion** – current penetration at just **17.5%** with more than **80%** remaining to be captured



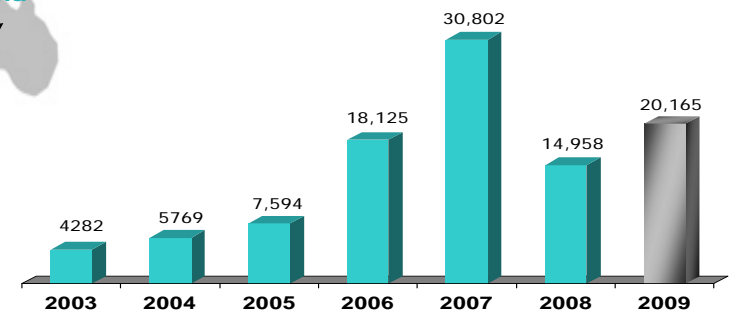
### Products

- Product offer still limited despite important innovation in the last 5 years
- Genuinely more oriented to financing and trade, the Islamic banking market has seen a tremendous expansion on the Capital Market side with the development of Sukuk and Islamic hedging products
- There is still room for more sophistication despite a cautious approach by the Scholars
- Risk management, securitization and money market instruments are fields where there are a lack of products.
- Innovation is mostly driven by Islamic windows of conventional banks

### Players

- Historically present in the Middle East and South East Asia, Islamic Finance is now **expanding in Europe, Africa, Japan...**
- Majority of the banks are **start-ups** based in the GCC and Malaysia. There are few banks in the place that are the historical players (Al Rajhi, Kuwait Finance House, Dubai Islamic Bank...) with strong equity and expertise.
- The Middle Eastern governments have established their own highly capitalised Islamic banks in order to capture a part of the anticipated regional infrastructure projects which are expected to exceed several trillion dollars in the next decade (Allnma – Saudi Arabia: Noor Islamic – Dubai: Al Hilal – Abu Dhabi: Masraf Al Rayan – Qatar)

Debt - Islamic Bonds (MIn US\$)



Source: Bloomberg

## Challenging times

### Protected from the first effects

- All the credit structured products are not acceptable to Islamic banks
- Consequently, no Islamic institutions were impacted by the first shocks of the crisis
- Combined with record high oil prices, Islamic banking was in very good health until Lehman Brothers collapse

### Correlation to oil and economic growth

- Islamic banking is strongly correlated to economic activity and oil prices
- The GCC economy has known a slowdown of its economy as oil prices tumbled and world demand decreased
- Real Estate prices collapsed in some regions putting financial institutions under pressure
- Dubai has been supported by Abu Dhabi through a financing but put the GCC credit market under huge stress
- Islamic financing has stopped between October 08 and April 09 with liquidity also drying up in the conventional market

### First defaults

- Few institutions defaulted (Private Equity firm Investment Dar) which brought back the market to reality
- Islamic market experienced the first Sukuk defaults which become interesting case studies over the recourse of the underlying assets of the sukuk
- However, it must be said that many Islamic banks managed the crisis well thanks to a strong retail basis

### Algozaibi/Saad Issue

- In spring 2009, Saad's group went into default bringing with it the Algozaibi Group due to a multi billion fraud of Saad's Group owner
- Financial institutions (including Islamic ones) were closely working with those two groups, some for decades
- The estimated claims are around USD 10 billions
- This fraud seriously challenged the credibility of the region and the amount of losses born by each bank is yet to be known

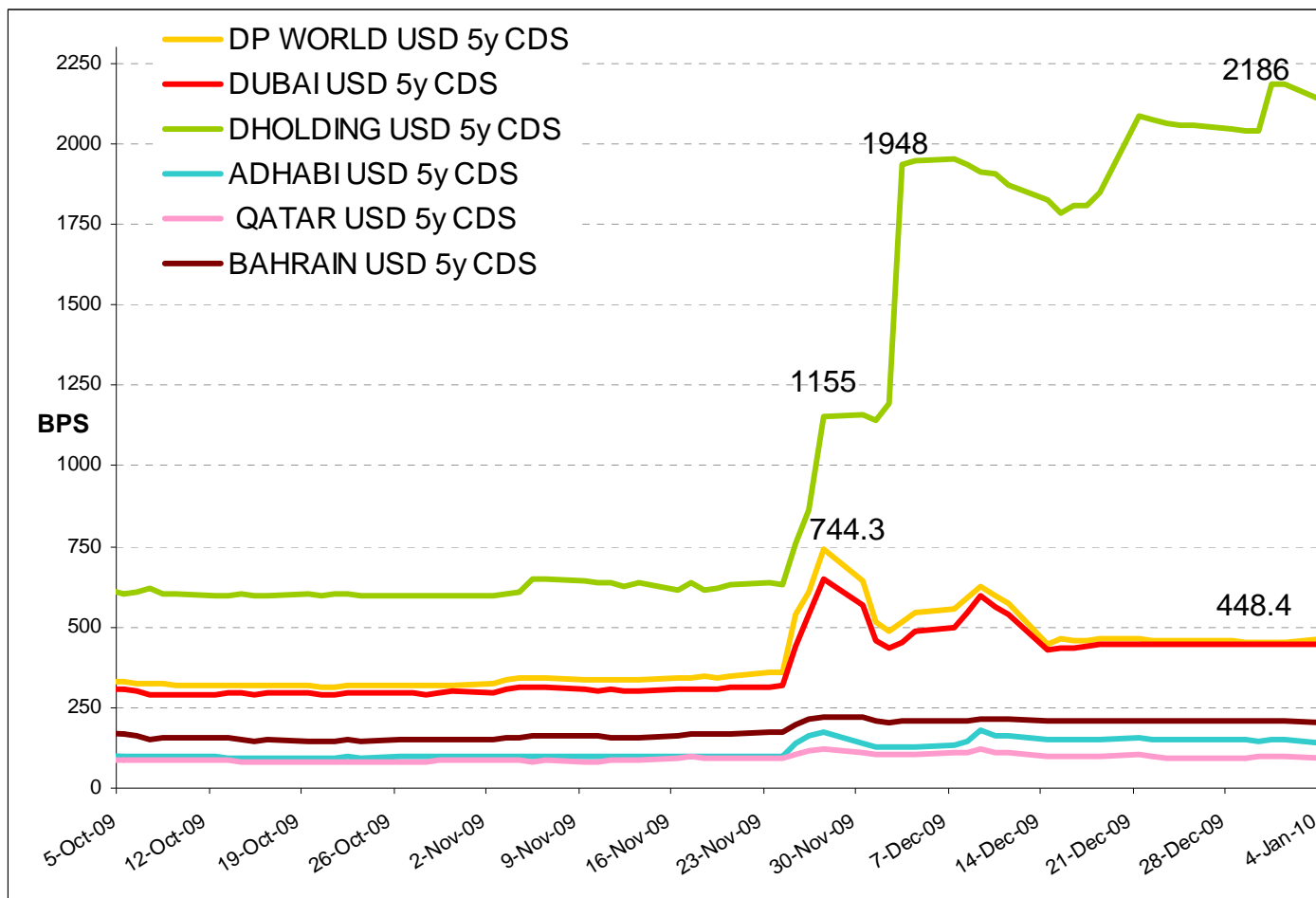
### Dubai World

- Restructuring of Dubai World liabilities
- Possible standstill may be requested on the financings of Dubai World and Nakheel
- Abu Dhabi provided US\$ 10bn new funding to Dubai, some of which Dubai World used to avert a default at Nakheel

# The Bailout of Dubai – return of cautious optimism

- 25 November 2009 – announcement of the restructuring of Dubai World liabilities, and request of a possible standstill on the financings of Dubai World and Nakheel
- What Dubai World turmoil reveals
  - Lack of bankruptcy rules
  - Fragile investor confidence
  - Inability and over reliance on advisors to convey true story
  - Abu Dhabi support; conditional, not unconditional as believed by investors
  - Role of Shariah board in the restructuring debt
  - Dubai Inc. was large scale borrower on the credit markets and the banks were guilty of financing, did they know what they were doing?
  - Small exposure, but significant impact on GCC and emerging markets.
- **What should be the real impact on the market:**
  - The Investor appetite for the region should be tested soon with the first sukuk/bond issuance but it should remain unchanged giving the fact that the UAE is only one of the actor in the GCC sukuk market which represented only 4% of the global sukuk issuance in 2009. Moreover, the Nakheel issue is a credit issue and is decoupled from any Shariah compliant issues
  - The sukuk structures are not at issue, but rather the underlying credit. However sukuk structures will now be tested in the courts to determine the restructuring/liquidation process

# CDS prices – Oct. 09 to Jan 2010



### Historical markets are going towards maturity



- The size of the Islamic assets is growing despite the crisis
- The issuance of Islamic debt is outpacing the conventional one in GCC and Malaysia
- An increasing oil price will support the liquidity of the sector
- Even if the product range has not the depth of the conventional market, innovation is still on
- **Islamic Finance is a mainstream in Gulf and Malaysia**

### Interest in Islamic banking is strong in new markets



- The Asian Sukuk market has led the sector into recovery with few issuances mainly governmental local currency and some sovereign international sukuk in Singapore, Indonesia, Malaysia and Pakistan
- New markets (Thailand, South Korea, Indonesia, +200Mln Muslims) are opening
- Interest from Europe is becoming firmer (UK, France, Luxembourg, Switzerland, Germany)
- Sovereign and Corporates are more and more considering Islamic Banking as a potential financing format

### Islamic finance is close to the critical size



- Despite being a “small” one trillion industry, Islamic banking has a strong enough retail activity to be sustainable
- The creation of a mega Islamic institution and the long term presence of international institutions is bringing credibility to the industry
- Islamic finance is still dependant of two markets (Malaysia and Gulf) but its global expansion will bring it to a critical size that would avoid it to rely on a limited number of countries



### Big ambition of Asian countries and Strong political commitment

- Islamic Finance is a mainstream in Malaysia which is the leading Islamic Financial centre, but other countries are keen on competing for that position
- **Hong-Kong** is working on becoming a leader in Islamic Finance; an Islamic platform is under development with a focus on the Islamic Capital Market
- Singapore is focusing in the area of Islamic wealth management
- Indonesia issued its first global sovereign sukuk; the first international sale of dollar sukuk drew orders for \$4.7bn, 7 times the \$650 mln of securities on offer. Indonesia plans to sell \$315 mln of Islamic bonds to retail investors in February 2010
- Brunei's total sukuk issue tops \$2 bln as of December 2009

### Regulatory support for Islamic Finance

- South Korea: a bill to facilitate tax neutrality for the issuance of sukuk is in progress
- **Hong-Kong**: finalizing the tax laws to facilitate the introduction of Islamic Finance.
- Thailand: is considering issuing a sovereign sukuk. The first sukuk is expected in Q110 according to regulators who are finalising a new trust law for capital market transaction
- Singapore: in May 2009, the Monetary Authority of Singapore issued new Islamic Finance regulations to boost the Islamic Finance Industry. Singapore also introduced its reverse enquiry sukuk.

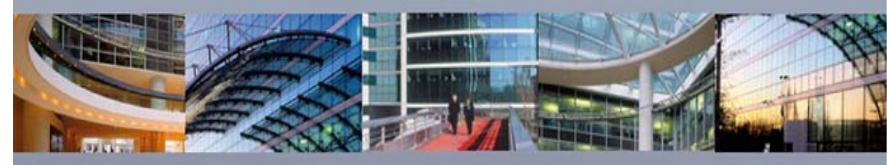
### Further Challenges

- Deal with regulatory hurdles: Tax and accounting treatment issues still need to be sorted out
- Competition from major Islamic financial centers including Malaysia and GCC countries
- Promote Asia's commitment in the new field of Islamic Finance
- Increasing awareness of Islamic Finance principles

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## Section 2

# Sukuk Market Overview and Challenges



- Latest Sukuk Development in 2009: The first months of 2009 have seen more or less the same number of sukuk coming to the market as during the same period in 2008.
  - Saudi Arabia took the lead as the country host to the largest sukuk issuance. Saudi Electric Co. issued that sukuk, for a total amount of Saudi Arabian riyal (SAR) 7.0 billion (\$1.8 billion). Saudi Electric Co. will reportedly use the proceeds of issuance for general corporate purposes.
  - Central Bank of Bahrain (NR/A/A) has launched a \$750 million 5-year Sukuk on 9-Jun-2009, jointly managed by Calyon. The response was overwhelming with over \$4 billion on book.
  - The Republic of Indonesia recently issued a 5 year \$650 million issuance that was well received in the market. This new Indonesia Sukuk has tightened by more than 200 bps over UST since its issuance.
  - The Monetary Authority of Singapore launched \$200 million Islamic bond program in Jan-09 which will offer Singapore dollar denominated Sukuk bond on reverse-enquiry basis in order to promote the development of Islamic banking industry in the city.
  - In August 2009, Malaysia-based Petroliaam National Bhd. Petronas, also issued a large sukuk, for a total amount of \$1.5 billion.
  - The International Finance Corporation (IFC) just launched a \$100 million non-amortizing Sukuk with a five years maturity. IFC is the first non-Islamic financial institution to issue a sukuk in the GCC region. This issuance is a landmark transaction which will help develop the Sukuk market. The IFC plans to return to the market with new issuances every 12 months to 18 months. The sukuk is the IFC's second Islamic bond. It issued a \$132m three-year bond denominated in Malaysian ringgit in 2004.
  - GE launched a Sukuk into the GCC and SEA in mid December. The underlying assets were aircraft assets that supported an Ijarah structure. The deal was closed at USD\$500m for a 5 year deal and was well received in the market. This was the first major western corporate to target GCC and SEA investors.

Regardless of growing demand fuelled by banks, corporations and governments in the GCC region, there is a shortage of supply. As a result the recent sukuk issues have all been significantly oversubscribed. Considering the current market conditions and the strong market appetite, it's definitely the best time to raise funds successfully in the region. The medium-term outlook for the sukuk market is positive given the strong pipeline and efforts to resolve some issues related to the sukuk market development.

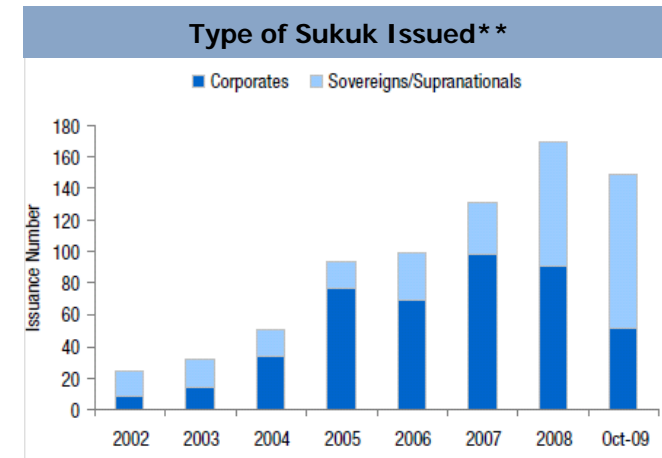
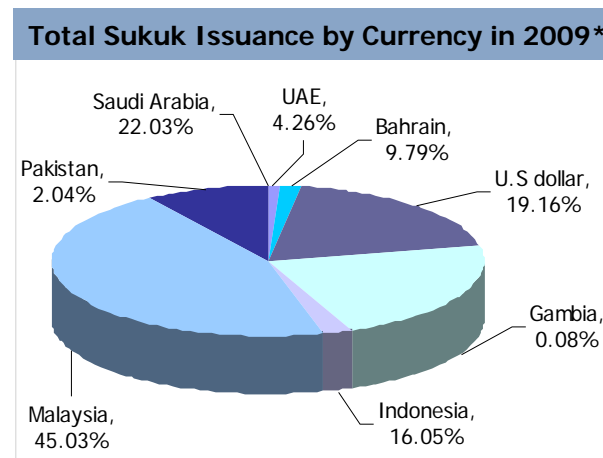
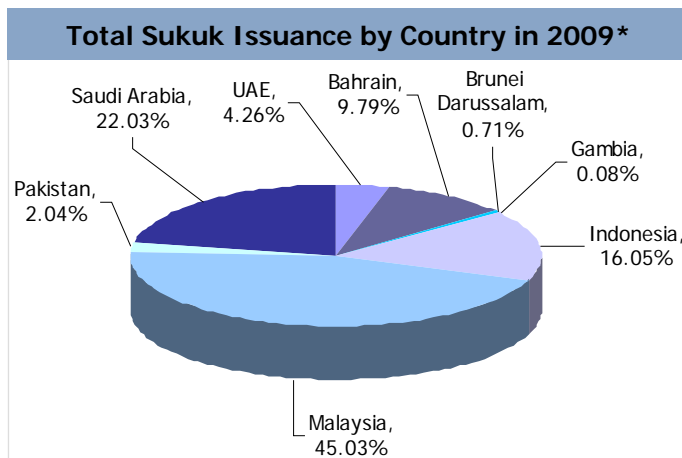
### Secondary markets:

- The secondary credit markets have reflected the continued positive sentiment in other markets, and spreads continue to tighten. The positive momentum has continued today the release of GDP numbers showing the return of the US economy to growth.

So far this year, MENA issuance is all about the GCC

- **2009 a clear turnaround for the Sukuk market:** global Sukuk issuance surged by over 40% in the first ten months of 2009 compared to the same period in 2008, according to Moody's.
- Government and Government-related issuers have dominated sukuk issuance and helped the creation of a stronger sukuk market, driving more corporate sukuk issuances that can be more transparently priced.

Comparison Sukuk Volume					
2009		2008		2007	
Size (USD in mln)	# of deals	Size (USD in mln)	# of deals	Size (USD in mln)	# of deals
20,165	203	14,958	232	30,802	252



\* Source: Standard & Poor's \*\* Moody's

- Despite enormous success, the sukuk market is not as deep or liquid as a regular bond market. Regardless of growing demand fuelled by banks, corporations and governments in the GCC region, there is a shortage of supply. As a result, the recent sukuk issues have all been significantly oversubscribed.

Additionally, the sukuk market is still stagnant: holders keep their bonds to maturity and there is relatively little secondary market trading.

- Asia can take advantage of the current market conditions and the strong market appetite to raise funds successfully in the region.
- The Gulf market opened up with a US\$3 bn bond issue from both Abu Dhabi and Qatar, and was followed quickly by an issue from the Central Bank of Bahrain that were all massively oversubscribed as well as the sukuk from the Islamic Development Bank.

### Sukuk, a promising instrument

- Islamic investors and investors in general are looking for rated fixed income assets following the up and downs of the stock market
- There is a growing appetite for Islamic securities
- Sukuk expands the investor base
- Better liquidity and increasing market size thanks to new legislative developments and the launch of sukuk funds
- In June 2009, establishment of the Tadawul sukuk platform in Saudi Arabia: a market for trading and pricing of sukuk which should create an active and regulated secondary market

# Post Crisis Recovery

- **Higher regulatory Standard**
  - ✓ Less real estate and stock market
- **Better accounting standard**
- **Clearing up B/S**
- **Government support, e.g. Qatar and QIA stakes, how long can this go on**
- **Role of Shariah; both the scholars and the principles they espouse**
  - ✓ Do we need a new Shariah mechanism
- **Investors should be aware of the Risk factors relating to investments/issuers**
- **Transparency**
- **Due Diligence**
- **End of name lending as we know it?**
- **Pricing should reflect risk and not implied risk**

**Universal values for all banks and corporates not just Islamic**

# Contact

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