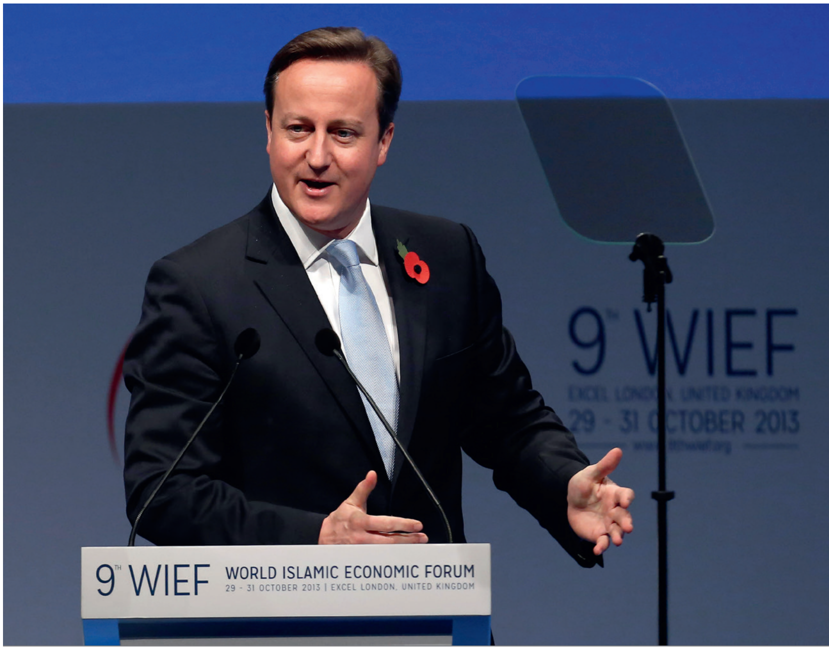
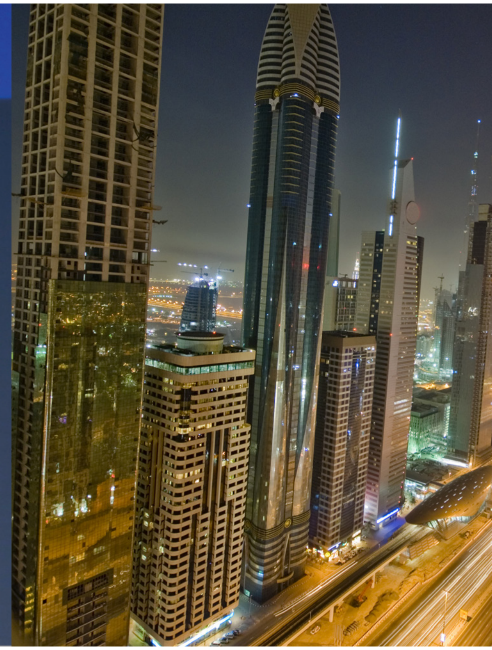




Year of the sukuk

From Indonesia to Turkey and the United Kingdom, Shari'ah-compliant finance is entering the mainstream, as Muslim investors seek to structure their financing needs according to religious principles, and conventional banks and asset managers look to attract this fast-growing pool of capital.

After years of discussion and debate, global financial centers are beginning to take greater interest in Islamic finance as they compete for a slice of this growing market. At the same time, Shari'ah-compliant financial instruments have grown in popularity, as Muslim investors—many in countries with high levels of liquidity—have responded.

As a result, the Islamic finance industry's total global assets are expected to amount to an estimated US$2.1 trillion by the end of 2014, according to research from Kuwait Finance House (KFH).

The spread of "sukuk" (the Islamic equivalent of bonds) beyond their traditional strongholds in the Middle East and Malaysia now includes the penetration of Shari'ah structures in parts of the Muslim world that have had minimal exposure to this asset class. This fact has caught the eye of mainstream global financial hubs. As Middle Eastern and Asian corporates look to deploy Islamic financing mechanisms in their global transactions, Western financial centers are beginning to realize their importance.

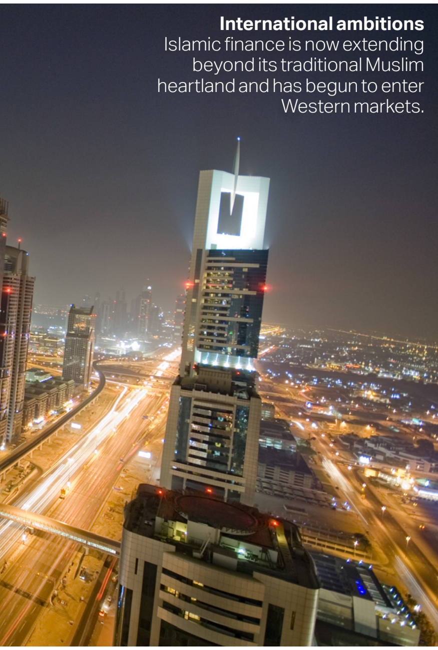
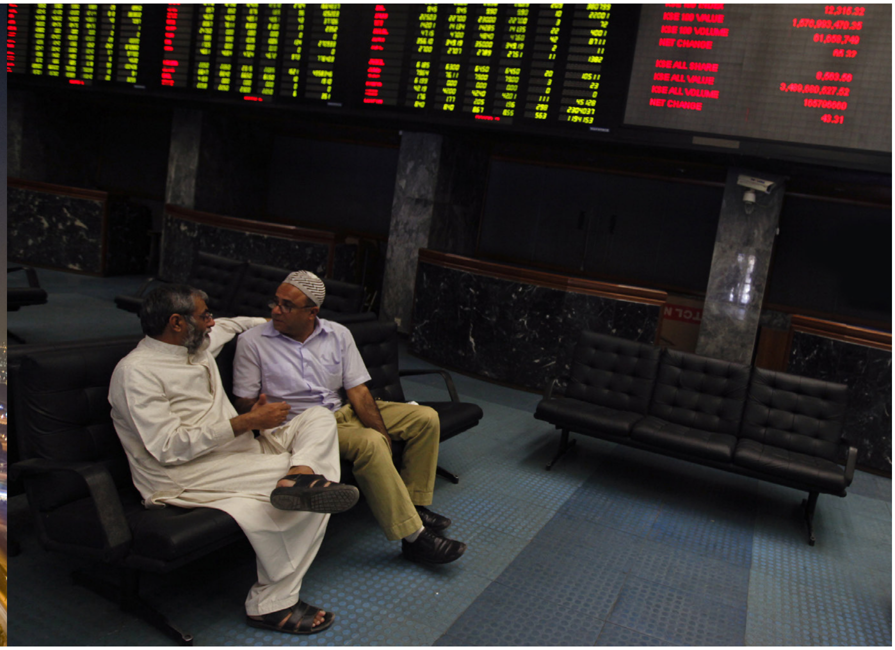
Indonesia, Malaysia and Turkey

The largest markets for Islamic finance are in the Middle East and Malaysia. Saudi Arabia alone holds 18 percent of global Islamic banking assets, followed by Malaysia (13 percent), the United Arab Emirates (7 percent), Kuwait (6 percent) and Qatar (4 percent), notes KFH.

However, the rise of two of the largest Muslim nations with only a limited track record in Islamic finance to date may prove a significant driver of expansion beyond its heartland.

Indonesia, the world's most populous Muslim country with 250 million inhabitants, is frequently cited as one of the biggest potential growth markets for Islamic finance. Though physically close to the world's most established Islamic finance center, Malaysia, the country still has catching up to do.

"Indonesia has a lot of potential, but there are some constraints related to the legal regulatory framework, such as tax treatment and uncertainty about the creation of special purpose vehicles

International ambitions
Islamic finance is now extending beyond its traditional Muslim heartland and has begun to enter Western markets.

needed to implement sukuk, particularly in structures involving the sale and leaseback of property," says Shibeer Ahmed, a White & Case partner in the UAE. "The Indonesian Financial Services Authority (Otoritas Jasa Keuangan) is looking to develop clearer rules and regulations for the issuance of corporate sukuk in Indonesia, but more work needs to be done to promote corporate sukuk issuances in the country."

Turkey's government also wants to increase the participation of Islamic banking (known as participation banking) in the near future.

"Turkey introduced Islamic banking legislation relating to profit-and-loss and Islamic Banks (or Special Finance Houses as they are known in Turkey) as far back as 1983," says Mushtak Parker, editor of *Islamic Banker* magazine.

"But only after Turkey's financial crisis of 2001 and amendments under the Banking Act 2011 (when the above institutions were renamed Participation Banks) has there been real momentum behind it.

"In the past few years, participation banking has really taken off, especially retail banking, trade finance and financing SMEs. It accounts for about 6 percent of the total banking sector but the aim is to increase this to 15 percent over the next few years.

"Turkish institutions are traditionally very active in the international Syndicated Murabaha market and, over the past three years, have resorted to the sukuk market to raise medium-term funds from the international market. This follows the debut international sovereign sukuk by Turkey two years ago, which has since been followed by another such issuance. All four Participation Banks have issued sukuk in the past two years. The government is also issuing sukuk for domestic liquidity purposes to enable banks to manage their liquidity and reserve capital lodged with the Central Bank."

Big moves in the UK

While the expansion of Islamic finance into some countries may have been predictable, some moves are more surprising. For example, in October 2013, UK Prime Minister David Cameron informed a meeting of the World Islamic Economic Forum that he wanted London to "stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance anywhere in the world."

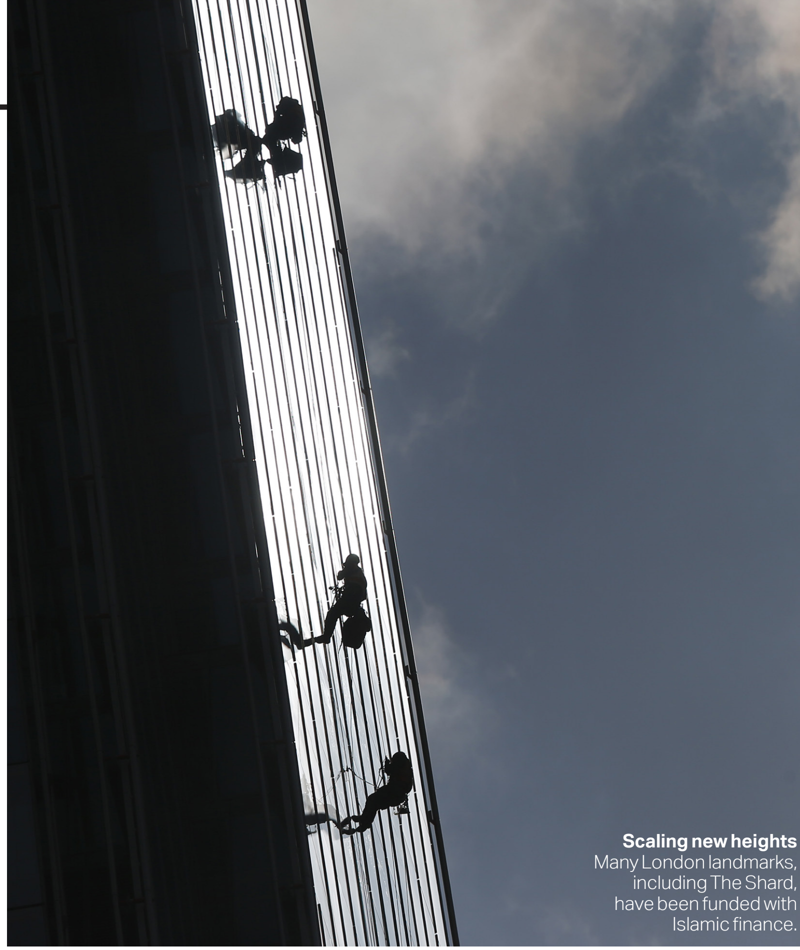
According to Cameron, Islamic finance is growing 50 percent faster than traditional banking and, with global Islamic

> **"The UK sovereign sukuk will…help the UK to establish itself as a global capital for Islamic finance, alongside Dubai and Kuala Lumpur"**
>
> Shibeer Ahmed, partner, White & Case, Abu Dhabi

investments set to grow, he intends a large part of that new investment to be made in Britain. The UK's prospective foray into the sovereign sukuk market, which would be the first by a non-Muslim country, is likely to take the form of a £200 million issuance.

Part of the aim is to add further ballast to the City of London's reputation as a global financial center, by gaining the confidence of investors who prefer to structure their transactions Islamically.

This process is not a top-down marketing effort, despite the evident push from senior officials in government. In the past few years, a growing number of Western-based financial institutions have become accustomed to Islamic financial instruments. London, where Middle Eastern investors have acquired large chunks of real estate using Islamic debt, is at the heart of this burst of activity. Some of the most iconic of London's recent real estate landmarks, such as The Shard skyscraper, the athletes' village for the 2012 Olympic Games and Battersea Power Station, have been funded with Islamic finance.



Scaling new heights
Many London landmarks, including The Shard, have been funded with Islamic finance.

What's more, major corporates have developed a fondness for sukuk and view it as a strategically significant source of financing. US giant GE Capital has also issued Islamic paper in recent years, while the London Stock Exchange has listed US$38 billion worth of sukuk issuance from 53 separate issuers.

The UK authorities have had to prepare the legal groundwork to get this far, addressing critical issues such as the tax treatment of Islamic finance.

"The British government has, for the past ten years, tried to create a level playing field for Islamic finance, so that, for example, anyone who wants to get a mortgage can get a Shari'ah-compliant mortgage without incurring any additional taxes or duties, compared with a conventional mortgage," explains Ahmed.

To capture a bigger piece of the pie, non-Muslim financial centers will have to prove they have the capabilities to issue sukuk successfully.

"Attracting Middle Eastern capital to invest in UK infrastructure projects, which is easy to do Islamically as they have underlying assets, is something that is driving the process," says Nigel Denison, head of wealth management at the Shari'ah-compliant UK-based lender, Bank of London and The Middle East (BLME).

Sukuk provides access to a different and broader investor base that sits alongside the existing conventional one: "This brings an incremental benefit by opening up another source of liquidity," says White & Case's Ahmed.

The proposed UK sovereign sukuk highlights the potentially catalytic impact such an issuance may have on the wider market: "The UK sovereign sukuk will encourage corporates to consider it as an alternative source of funding," says Ahmed. "It will also help the UK to establish itself as a global capital for Islamic finance, alongside Dubai and Kuala Lumpur."

In fact, a number of Western financial centers are already bidding for more Islamic business. Dublin has positioned itself as a destination to list sukuk, while Luxembourg became the first European country to list sukuk back in 2002.

A wider range of financings

The expansion of Islamic instruments beyond the comfort zones of the Arabian Gulf States and Malaysia will likely be the big story in the industry for the next few years, amid surging demand for these debt securities.

Sukuk demand in the Gulf and southeast Asia is exceeding supply, despite the relentless rise in Islamic paper issuance. According to figures from the Zawya Sukuk Monitor, Gulf Cooperation Council sukuk issuance rose to US$25.4 billion in 2013, up from US$23.7 billion the year before.

But if conventional lenders and corporates are to capture the full potential of this asset class, they will need to become more comfortable with it. This means overcoming a number of barriers. For example, many businesses have chosen not to go for sukuk because of the perception of added cost and time, and the need for available tangible assets that can be used as part of the underlying sukuk structure.

"If you're a Western corporate, you may be accustomed to plain vanilla corporate bond issues where you know what's involved, how long it will take and, if the issuance is asset-backed, what assets are needed to underpin the structure," says Ahmed.

When GE Capital launched a US$500 million sukuk in 2009, hopes were raised that there would be a string of other companies tapping the market.

"That there hasn't been is a disappointment because there has generally been strong demand for all sukuk transactions in dollars," says BLME's Denison.

Different attitudes to risk and contractual relationships also have to be considered.

"At the end of the day, you need tangible assets to underpin Islamic financings. This means ensuring availability of appropriate assets (which, from a Shari'ah compliance perspective are widely defined and can include, for example, minutes of airtime for telecoms companies and concession rights in concession-based infrastructure projects), the ability to use those assets and whether the use of such assets will trigger any regulatory or tax consequences," says Ahmed.

As demand for sukuk increases and investors and issuers alike grow more comfortable with this paper, these structures will find use in a wider range of financings.

Sukuk is already being deployed in large infrastructure financings. In April 2013, Sadara Chemical Company in Saudi Arabia (a joint venture between state oil company Saudi Aramco and Dow Chemical Company in the United States) closed its sukuk issue in Saudi riyals worth US$2 billion. This was part of a broader financing package for the US$20 billion project to build a world-scale, fully integrated chemicals complex in Jubail Industrial City.

"This was the first time that a limited recourse project sukuk has been used for a greenfield project, in that it was put in place before the project assets were developed. Project finance sukuk has previously only been deployed in the refinancing of existing debt and usually after the physical completion of the relevant project assets," says Ahmed.

What is Shari'ah-compliant finance?

Islamic banking is based on compliance with Islamic law, or Shari'ah, and a focus on fairness for all parties. For example, Shari'ah prohibits the lending of money at interest or solely for fees, which means Islamic rules on transactions are quite specific about what can and cannot be done. Shari'ah also precludes investing in businesses that offer any goods or services considered haraam (contrary to Islamic principles), e.g., alcohol, pork, gambling, etc.

While traditional banking is based on risk-trading, with the onus put on the borrower to take on the burden of the risk, Islamic banking is based on both parties sharing the risk, through profit sharing, joint ventures, leasing and other vehicles. An Islamic residential mortgage financing, for example, might involve the bank buying the property and selling it to the buyer at a profit, rather than lending money at interest.

Ultimately, Islamic banking seeks to engage in ethical investing and "moral purchasing"—where income distribution is more balanced and no individual bank is able to exert too much influence on an economy.

New market potential

Another significant driver behind the proposed UK sovereign sukuk is the need to develop a nascent market maker, including in the secondary trading of sukuk.

"This is much needed, and issuances by the Treasury, another government agency or even a municipality could give momentum to that," says *Islamic Banker*'s Parker. "Sukuk has got fantastic potential in the UK and it's not only government agencies that could issue the paper, but also local authorities and corporates looking to raise funds for various purposes."

In Parker's view, pushing Islamic transactions through Western financial institutions would serve another purpose in broadening the market reach of Shari'ah-compliant finance.

"The Islamic finance industry is still introverted and hasn't developed beyond its immediate ambit of influence. London as an issuance domicile could radically transform that," he argues.

As the global Islamic market develops, in more and more cases when there is a choice of structuring a transaction Islamically or conventionally, the Shari'ah-compliant option will be chosen, subject, of course, to competitive pricing.

Around the globe, a growing number of companies and financial institutions want to be part of this story. The ability to gain exposure to this relatively new and exciting asset class will doubtless prove a compelling proposition.

"The Islamic finance industry is still introverted and hasn't developed beyond its immediate ambit of influence"

Mushtak Parker, editor, *Islamic Banker*