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London – Key Centre for Islamic Finance

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Islamic finance has developed into a global phenomenon which is both highly dynamic and growing rapidly. The main defining feature of Islamic finance is that it offers financial products and services that are ethical and free of interest or usury (*Riba*) which is strictly prohibited in the Islamic tradition. According to KPMG, there are now around 270 Islamic financial institutions worldwide with assets estimated at over \$265 billion and financial investments over \$400 billion. The growth rate of the Islamic finance sector is estimated to be around 15% per annum. Assuming steady growth, the Arab Chamber of Commerce expects industry size to double by 2010.

While the main centres of Islamic finance are traditionally acknowledged to be in the Middle East and Gulf region such as Dubai and Bahrain, Asia and the Far East such as Malaysia, the clientele of Islamic Financial institutions are not confined to Muslim countries nor the providers confined to local institutions. Rather, the clientele are from globally diverse regions including Europe and the United States; there are also global institutions which are increasingly playing major roles in this industry. The Islamic Finance industry is attracting a growing interest from Western investment banks and governments.

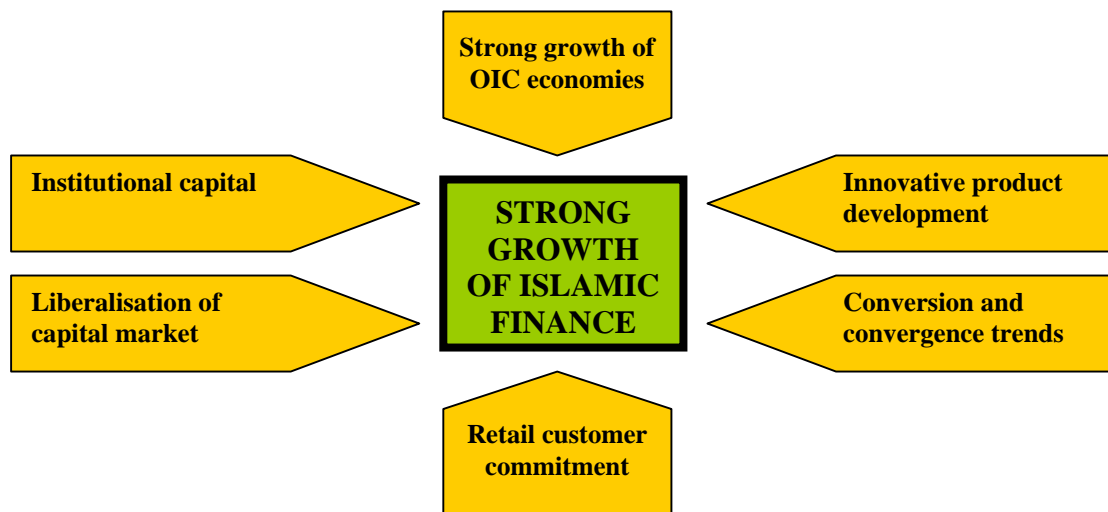


Fig1. Why Islamic finance is flourishing

The inaugural *Islamic Finance and Trade Conference* staged in London, June 2006 and hosted by the Muslim Council of Britain was attended by Secretaries of State, Finance and Trade Ministers, Islamic Scholars, senior managers of international banks and other banking professionals, as well as business leaders. This included the Chancellor of the Exchequer Gordon Brown, The Rt. Hon Jack Straw MP, the President of Islamic Development Bank (IDB) Dr Ahmad Mohamed Ali and the Chair of the Financial Services Authority (FSA) Sir Callum McCarthy. The conference highlighted the enterprise, expansion and innovation in the field of Islamic finance and the myriad of opportunities for trade with Muslim countries.

The Chancellor gave the keynote speech in which he proposed to make Britain the gateway to Islamic finance and trade. He highlighted the fact that today British banks are pioneering Islamic banking as London now has more banks supplying services under Islamic principles than any other Western financial centre. The UK Government recognises the expansion and relevance of the Islamic finance sector on the back of a number of factors including rising oil-related wealth in the Middle East (see Fig1 above).

The Chancellor proceeded to deliver his three-point plan to make the UK the gateway to Islamic finance and trade. He pointed to regulatory and tax-regime reforms to support the development of Islamic products and Shari'ah compliant finance. He also announced proposals for expanding trade with emerging economies and boosting Islamic trade, as UK trade with Arab countries has grown over 60% in the past five years. In addition, facing up to the challenges of globalisation, he promised to work to break the deadlock at the World Trade Organisation so as to deliver fairer trading terms for less developed countries, of which several are Muslim states.

British Banks Lead in Islamic Financial Services

Many Western conventional banks have launched, or will soon launch, their own Islamic banking products. Last month saw one of Germany's biggest banks, Deutsche Bank, announce a joint venture with *Ithmaar Bank* of Bahrain and *Abraaj Capital* of Dubai to launch a \$2bn (£1bn) Shari'ah-compliant financial fund. London was chosen as the financial centre to advise on a \$1billion *sukuk* deal for the Dubai government. Other banks involved in Islamic finance structured transactions include *Citigroup*, *HSBC*, *Barclays Capital*, *BNP Paribas* and *Standard Chartered*. Investment banks in the City of London are hurriedly trying to acquire a portion of this market which is estimated to be worth £216 billion globally. Though these banks have been involved in international investment activity, the retail banking sector is now also providing Shari'ah compliant products.

Following the Finance Act of 2005 which included changes relating to the taxation of Islamic products, London has become the largest centre for Islamic finance outside the Muslim world. The UK banking industry is one of the most profitable in Europe with an average return on equity ranging from 15.4% to 23.5% as measured in the 5 years to 2004.

There are now 23 banks in the UK offering Islamic products. HSBC for example introduced Shari'ah compliant mortgages, pension and stockbroking services. Lloyds TSB offers an Islamic account. The first UK-based fully Shari'ah compliant bank – the *Islamic Bank of Britain* (IBB) was launched in 2004 and has introduced two 'halal' or permissible offerings unique in the UK of which the halal Home Finance Facility is offered in affiliation with *Bristol and West plc*. The products are fairer being based on risk and return sharing. The IBB currently operates seven branches throughout the UK.

In 2003, the government introduced a regulatory framework to support the creation of a domestic Islamic mortgage market through the abolition of double stamp duty for such mortgages. This market is now worth over £500m and is growing by almost 50% in the last year alone. The Treasury last year introduced measures to facilitate Islamic savings and borrowing and providing proper consumer protection for *Ijara* products. Earlier this year, for commercial mortgages and property deals, Parliament approved measures in the Finance Bill for diminishing *musharaka* and *wakala* contracts.

British professional law firms such as *Clifford Chance*, *Norton Rose*, *Denton Wilde Sapte* and *Allen & Overy* are also leading the way in the provision of Islamic business services.

Islamic Finance – Conference Proceedings

The Chairman of the FSA – Sir Callum McCarthy noted that as Islamic Finance spreads in both the retail and wholesale markets it becomes all the more important that a regulatory framework be created for it which is subject to the same degree of customer protection as is offered to those who use non-Islamic finance. As such it will be the use of principles and not detailed rules which will be applied i.e. adequate resources, sound corporate governance, reliable systems and controls, transparency and treating customers fairly. Innovatively, the FSA is applying a policy of interpretation of consumer protection legislation already in existence.

Dr Ahmed Mohammed Ali, President of the *Islamic Development Bank* (IDB), in Saudi Arabia, highlighted how the IDB is actively engaged in providing development aid for the Commonwealth of Independent State (CIS) countries and had adopted three policies - poverty alleviation, the promotion of trade and development of Islamic finance and to co-ordinate the efforts of central banks. Professor Umer Chapra, also of the IDB, demonstrated in his presentation how Islamic finance in essence fulfils the requirements of ethical and socially responsible investing.

The CEO of the Government's department of *UK Trade and Investment* (UKTI) - Mr Andrew Cahn noted that as the UKTI is dedicated to trade development and inward investment, the Treasury has levelled the playing field for Islamic finance against conventional finance. Given globalisation and the widening and deepening of all markets, London has taken the step of embracing Islamic banking before other Western financial centres. He promoted the diversity of business practice, turning away from economic nationalisation and towards striving to make the UK the partner of choice for high growth countries and emerging markets – many of which are Muslim. He commented on how various banks such as HSBC and Deutsche Bank are meeting the demands of Islamic finance but there remains a need for yet more innovative products and hence the potential for increasing business.

Mr Iqbal Khan, CEO of *HSBC Amanah*, considered the conversion of conventional institutions in the GCC to modes of Islamic finance giving the examples of the *National Bank of Sharjah* and *Bank Al Jazeera*. He noted that these conversions have reached the tipping point in key markets such as Saudi Arabia, the UAE, Bahrain and Kuwait. In addition to conversion there is the trend of convergence which is being driven by factors such as CSR principles, ethical investment, community banking and affinity marketing. As such the Islamic finance industry is becoming institutionalised and standards bodies such as the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) in Bahrain and the Islamic Financial Services Board (IFSB) in Malaysia are overseeing the growth and regulation of the market. In addition, there are various research bodies and think tanks that are contributing to the industry.

With increasing cross border lines of credit and investment and a shifting from debt-based to equity-based instruments, there is also a paradigm shift for regulators as EU legislation takes hold to further regulate the industry and help to ensure that Islamic finance achieves competitive pricing as well as providing the OECD world with a gateway to lucrative OIC markets and joint venture opportunities (see Fig 2 below).

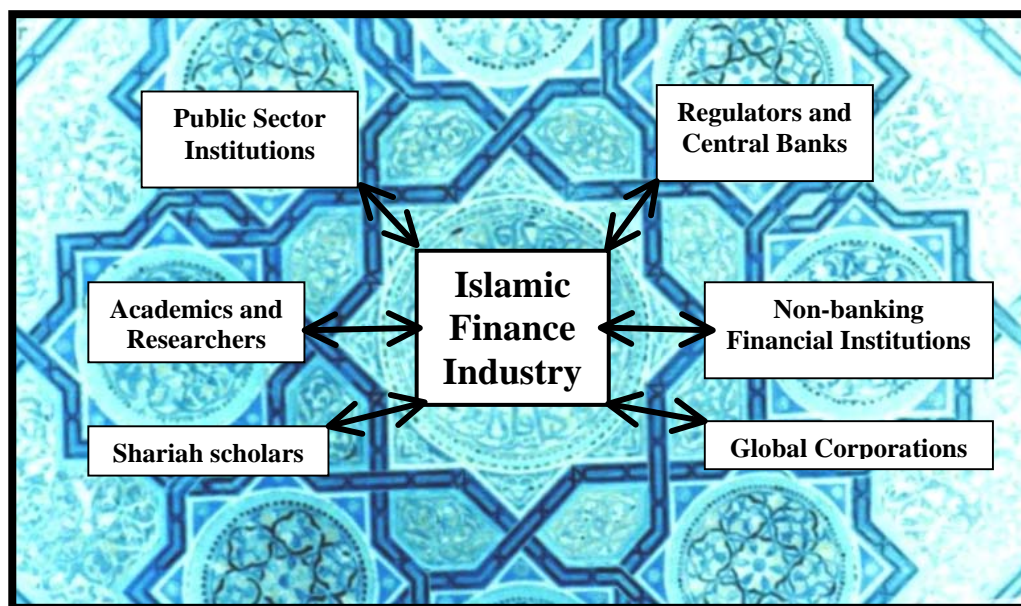


Fig2. Partnering for growth and institutionalising the industry

Shariah Compliant AIM Listings

Following the listing of the Shari'ah compliant banks - IBB and the European Islamic and Investment Bank (EIIB), *Tejoori* (TJI) is the first independent and ethical Shari'ah compliant investment company that listed on AIM in April 2006 via a private placing. *Tejoori*'s objective is to capture the significant pools of capital from outside the region for investment due to the major opportunities and growth potential that exists with the region of investment; which initially will cover the GCC, Middle East and Asia. Investment opportunities are expected to include sectors such as investment services, oil & gas, real estate, aviation, agriculture, telecommunications and petrochemicals. The investment policy is flexible in that *Tejoori* could invest in start-up ventures, mature businesses or companies whose shares are publicly traded. Following the principles of Shari'ah, *Tejoori* will donate 2.5% of its net profits on an annual basis to charities for distribution to social causes.

Tejoori has made its first equity investment of \$22m from its own cash resources by entering into a Musharaka agreement for a 6 month period with a private company *Omnivat* to develop several real estate projects across Dubai. *Tejoori* now has a direct equity stake in land deals and total projects in excess of \$135m. *Tejoori* is currently capitalised at £109m and expects the investment to contribute positively to its net asset value.

IHG Securities a Dubai based corporate consultancy firm which brought *Tejoori* to market believes that most of the instruments made available by traditional financial institutions will be made available in a Shari'ah compliant form in the near future and that the Islamic finance sector should continue to grow at double digit rates for the next 10 years, whereas the majority of the financial industry is experiencing less exciting growth potential. *IHG Securities* will be involved in the listing of other companies and estimate that various banks/firms will bring approximately \$5 billion (£2.7 billion) worth of cumulative market capitalisation from the Middle East to the London Stock Exchange by July 2007. They expect that the majority of the stock listings on AIM will be in the sectors of real estate and Shari'ah compliant investments.

Principal Requirements of Islamic Finance Investment

The Islamic Financial system encourages profit on an ethical investment platform and provides an alternative paradigm for financial services whereby capitalism is provided with a moral compass. It is similar to and broader than the concept of socially responsible investing (SRI). With SRI, investors seek to align their personal values and financial goals by choosing to invest in companies and organisations displaying values comparable to their own. In Islamic Finance, the basic principles are as follows:-

- **Prohibition of interest.** Interest is considered usury (*Riba*) and therefore businesses that derive a significant portion of their income from interest are considered prohibited. This includes banks, credit card, financing operations and margin trading – where money is loaned from a broker to whom interest is then paid. Due to the prevalence of interest in the modern economy, it is difficult to find businesses that derive no portion of their income from interest; so some Islamic scholars have set a level of 33.3% as the maximum threshold. An investment in such a business would then require the investor to account for the interest based portion of the income by giving it away to a public charity.
- **Prohibition of speculative behaviour.** Uncertainty, risk or speculation (known as *Gharar*) is also prohibited. Neither party to the transaction should be exploited by its operation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Therefore, derivatives such as options and futures are considered as un-Islamic by most Islamic scholars and so are forward foreign exchange transactions because rates are determined by interest differentials.

The above 2 points may be translated into 4 basic principles: -

- **Risk sharing** – each participant in a transaction should share the profit and loss of a transaction.
- **Materiality** – the transaction should have a ‘material finality’ in that it is directly or indirectly linked to a real economic transaction.
- **No exploitation** – the concern here is for social equity - a financial transaction should not lead to the exploitation of any party to the transaction.
- **No financing of sinful (*haram*) activities** as defined by the principles of Islam include business activities such as alcoholic beverages, pork and pork products, tobacco, pornography and gambling. Prohibited also are companies that harm the natural environment, endangered species and animal welfare and manufacture or trade warfare equipment.

Other requirements in Islamic Finance are:-

- **Sanctity of contracts.** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.
- **Debt/Equity restrictions.** Companies whose debt to equity ratio is above 33% are prohibited.

Glossary of Terms Used

ijara: An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer.

musharaka: Profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner.

Shari’ah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Shariah compliant product meets the requirements of Islamic law. A Shari’ah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Shari’ah compliant products.

sukuk: Similar characteristics to that of a conventional bond with the difference being that they are asset backed, a sukuk represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the sukuk.

Wakala: Wakala is an agency contract, which usually includes in its terms a fee for the expertise of the agent.

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