REDmoney *Research*

# GAINING GLOBAL TRACTION

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# Contents

# Executive summary

Islamic financing continues to hold considerable potential, with market size estimated to reach USD1.6tn by 2012 from approximately USD1tn at the end of 2009. Islamic banks (74% of Islamic financing industry) have attracted widespread attention since the onset of the financial crisis, especially due to their limited exposure to subprime and toxic structured products. Amid the financial turmoil in late-2008 that crippled many large Western institutions, Islamic banks have continued to grow both in prominence and size (33% CAGR over 2006-08 in asset base). They have not, however, been immune to the effects of the crisis and the subsequent economic downturn, which saw a decline in energy prices and the slump in the real estate market. The impact of the downturn was more pronounced on Islamic banks in the Middle East due to their concentration in real estate as compared with their counterparts in the Asian region. Although the Islamic banks in the Gulf Cooperation Council (GCC) have fared better than the conventional banks due to low mark-to-market write-downs on structured products, the Islamic banks in the UAE and Qatar have much higher exposure to the real estate sector than their conventional banking compatriots. Therefore, these Islamic banks are more exposed to a second wave of write-downs, which should mainly originate from real estate assets.

Growth prospects for Islamic banking continue to be attractive, especially in the retail banking arena as the bulk of the Muslim population continues to avoid conventional banks as they do not operate in compliance with their beliefs. Zawya's survey during 2009 indicated that half of the Muslim population (c. 800m) worldwide is willing to use Islamic financing services if they are given the right value proposition. This would require the Islamic bankers to focus on product innovation. From a geographical perspective, as existing markets for Islamic finance mature, Islamic banks with aggressive growth strategies would have to expand into unexplored geographies. There have been positive indications on this front, with China and France already making headway in changing their regulatory structure to accommodate Islamic financing in their banking systems. Interest is also increasing from non-Islamic investors who wish to gain exposure to diverse, but high-quality assets.

On the capital markets side, the Sukuk market, a key constituent of the Islamic financing industry, is gaining traction and Sukuk issuances in the first seven months of 2010 alone have almost touched fullyear 2009 levels. In addition, this is accompanied by a strong pipeline as issuers in the Islamic nations as well as the Western world seek to tap into this growing market. Tight lending norms during the crisis turned out to be a positive for the Sukuk market, as borrowers realized the need to diversify their funding beyond bank loans.

On the other hand, the industry does face barriers to growth. The secondary market in Sukuk is poorly developed in the Middle East and the lack of standardization in Shariah interpretation and documentation pose challenges. In addition, establishment of an Islamic yield curve also remains a priority. Further, there is ambiguity surrounding the default rights of asset-backed and asset-based Sukuk. A lot depends on the final verdict from the jurisdictional legal authorities. The term asset-based Sukuk could be quite misleading as the assets are irrelevant to the Sukuk's performance and these are identical to unsecured bonds. Further, with approximately one-fifth of all Sukuk outstanding due to mature in 2012, the market will find it challenging to pass through that phase without major setbacks depending on the refinancing conditions. Challenges will be particularly acute for companies in sectors such as real estate, which are dealing in a tough operating environment.

Currently, market watchers are paying keen attention to the prospects of improvement in the GCC's real estate market. Although Dubai is only a part of the GCC, the collapse of its real estate market has overshadowed growth in the Islamic financing market and has raised concerns about concentration risk. We looked at three large real estate players in the GCC and find evidence that the credit metrics of the players concentrated in the UAE such as Emaar (no outstanding Sukuk) and Aldar (Sukuk USD2.5bn maturing in 2012) have seen greater deterioration than Saudi player DAAR, the largest real estate developer in Saudi Arabia (Sukuk USD1bn maturing in 2012).

# Islamic financing

### 1. Overview – Market size over USD1tn

Assets of the global Islamic financing industry were estimated at USD951bn as of 2008, having grown at 31.6% (CAGR) over the past two years. S&P estimates the current size of the industry to be over USD1tn (May 2010).

**Figure 1: Asset classification - 2008**

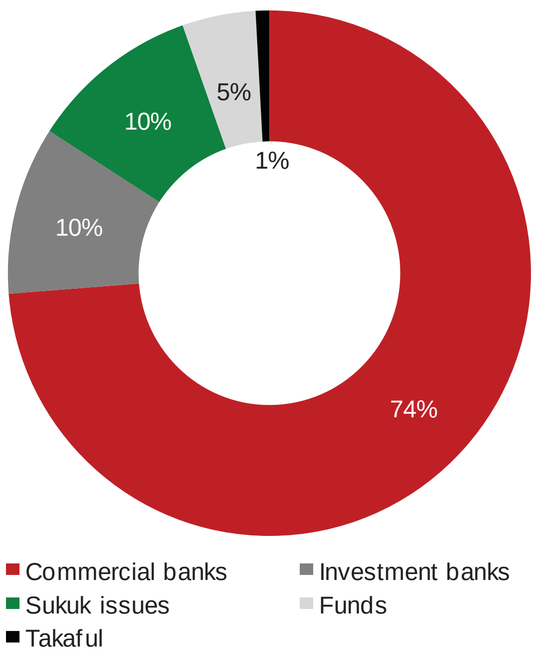
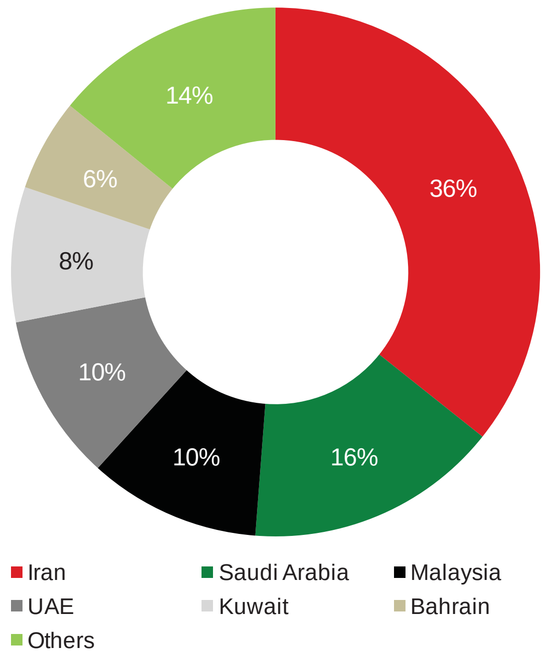



**Figure 2: Geographical split - 2008 ***




*Note: Excludes Sukuk and Investment Banks

Source: IFSL

The Islamic financing industry is dominated by commercial banks, followed by investment banks, Sukuk issues, funds, and Takafuls (Figure 1). [10]

Geographically, the Islamic financing market is concentrated in the Middle East and Malaysia (Figure 2). The top five countries (Iran, Saudi Arabia, Malaysia, Kuwait, and the UAE) together comprise c. 80% of the market, with the GCC being the largest Islamic banking market in the world (c. 43% excluding the Sultanate of Oman), followed by Iran (35.7%). The UK, in eighth place, is the leading Western market and Europe's premier center for Islamic banking, with USD19bn in reported assets (c. 2.4% of the total), largely accounted for by HSBC Amanah. Assets in other Western countries are currently small, but a number of countries, particularly France, are looking to develop a presence in Islamic financing [10]. Further, Islamic financing has made significant development in Asian countries such as Bangladesh, Pakistan, and Indonesia, as well as in North African countries such as Sudan and Egypt. [10]

### 2. Growth in Islamic financing – Outpacing traditional banking in emerging economies

Islamic financing assets at the end of 2008 increased to USD951bn (+25% YoY) with commercial banks driving growth. Sharia-compliant assets at Islamic commercial banks grew by 29% YoY to USD822bn at the end of 2008, followed by Sukuk issues (+18%) and investment banks (+16%) (Figure 3). (10) During 2009, 28 new banks offering Sharia-compliant finance entered the market. However, the rate at which new players enter the market has slowed from previous years (51 banks in 2008 and 78 banks in 2007). At the end of 2009, there were over 430 Islamic banks and financial

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