



Overview of Islamic Finance

June, 2007

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an Integreon company

- As an organization, Grail Research is committed to provide greater market insight to our clients.
- In this instance, we see a trend emerging in the financial services market that currently is large in size, growing rapidly, and has a few players but no real leader.
- While this overview is generic we'd be delighted to provide deeper or custom research support on this topic upon request.



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Islamic Finance

Overview

Islamic Finance is governed by the Shariah (Islamic Law), sourced from the Quran and the Sunnah

Introduction

- The Islamic law (Shariah) prohibits taking or giving interest (Riba) which is the most essential feature of Islamic banking
- The basic sources of Shariah principles are the 'Quran' and the 'Sunnah', which are followed by the consensus of the jurists and interpreters of Islamic law
- Profit sharing and fee-based financing approaches have developed in compliance with Shariah laws.
- These special modes of financing have emerged in retail, private and commercial banking for debt and capital markets, insurance, asset management, structured and project financing, derivatives, etc.

Shariah Prohibits

X

- Riba, which is taking or giving of interest

X

- Masir, which is involvement in speculative and gambling transactions

X

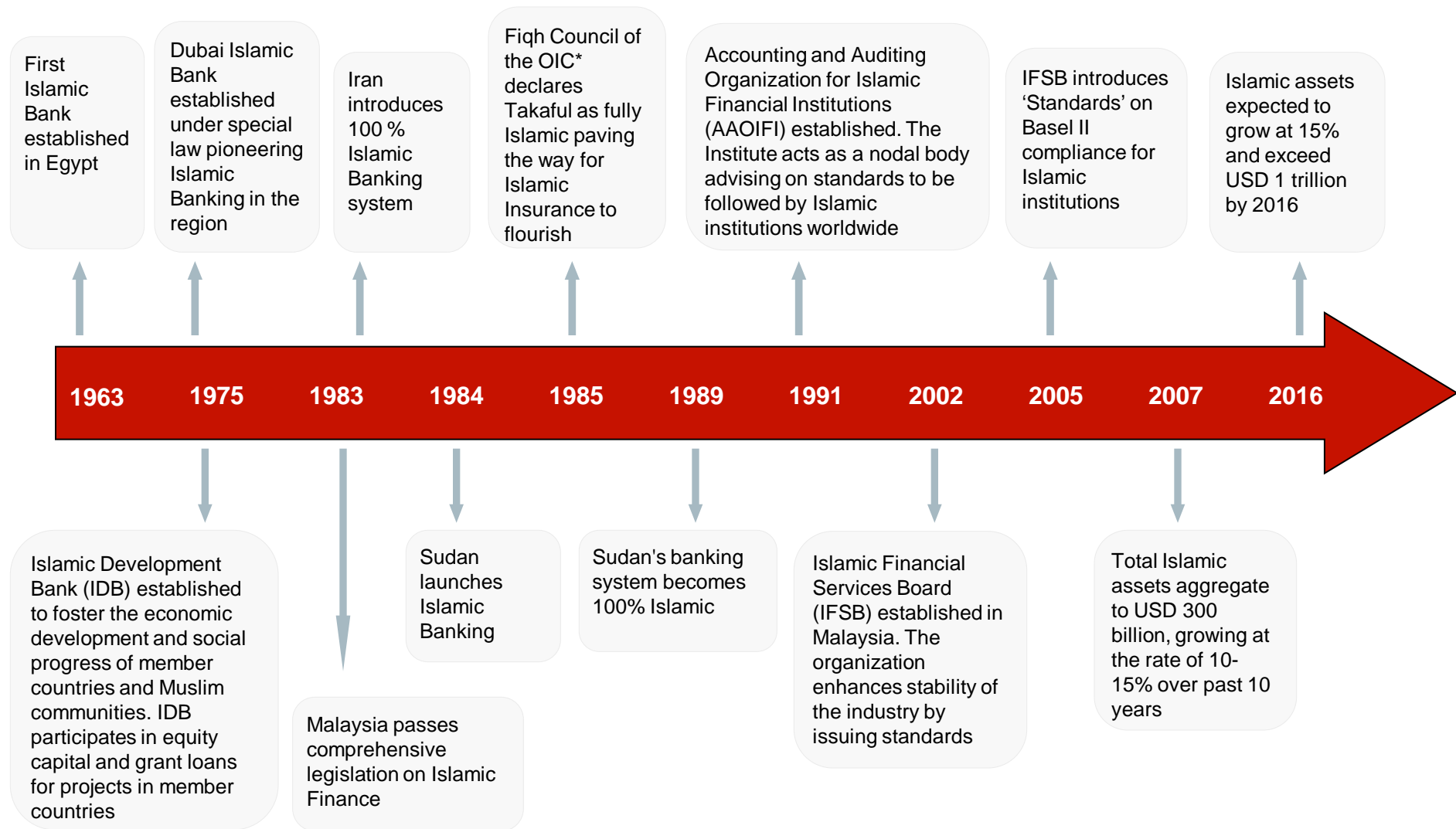
- Gharar, which is uncertainty about the terms of contract or the subject-matter, e.g. prohibits selling something which one does not own

X

- Investment in businesses dealing in alcohol, drugs, gambling, armaments, etc. which are considered unlawful or undesirable

Islamic Finance

Evolution of Institutional Framework



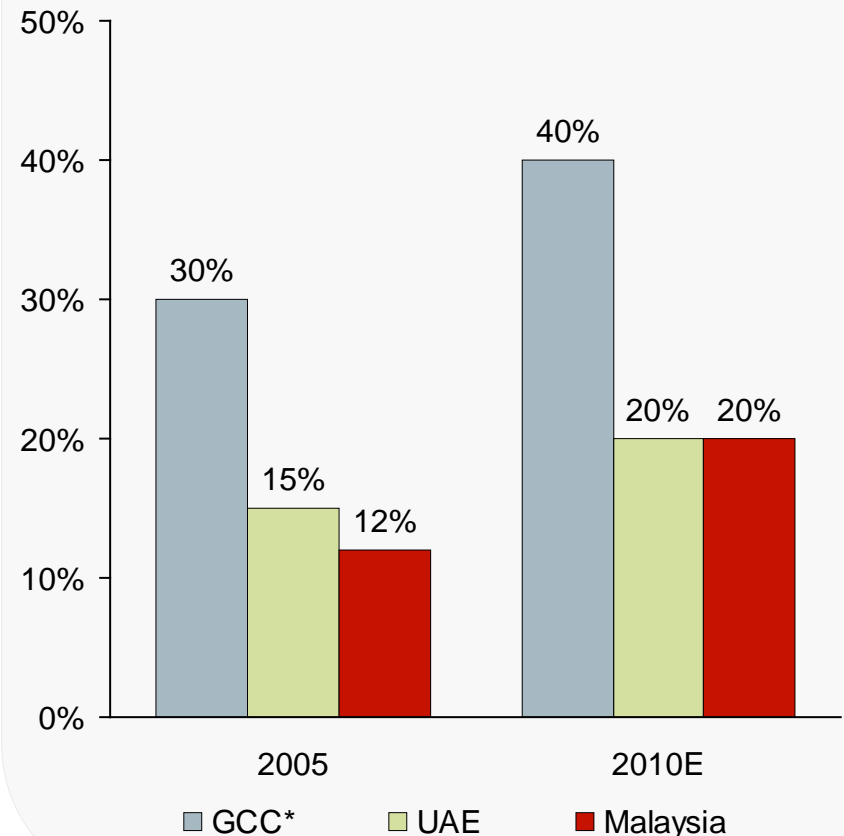
Note: * Organization of Islamic Conference

Source: AAOIFI, IFSB, IDB, Islamic Finance News, News Run

Market Description

- More than 300 Islamic Financial Institutions (IFIs) in approximately 50 countries
- Total assets and funds under management (AUM) exceeding USD 300 billion
- 10-15% growth over past 10 years
- Prevalent in all dimensions of financial services:
 - Debt and capital markets including mutual funds
 - Insurance
 - Asset Management
 - Structured and Project Financing
 - Derivates, etc.
- Market mainly concentrated in Islamic countries of the Middle East, North Africa and South-east Asia
- Gained popularity in Muslim-minority countries, e.g. US, UK and Germany

Islamic Banking Assets as a Proportion of Total



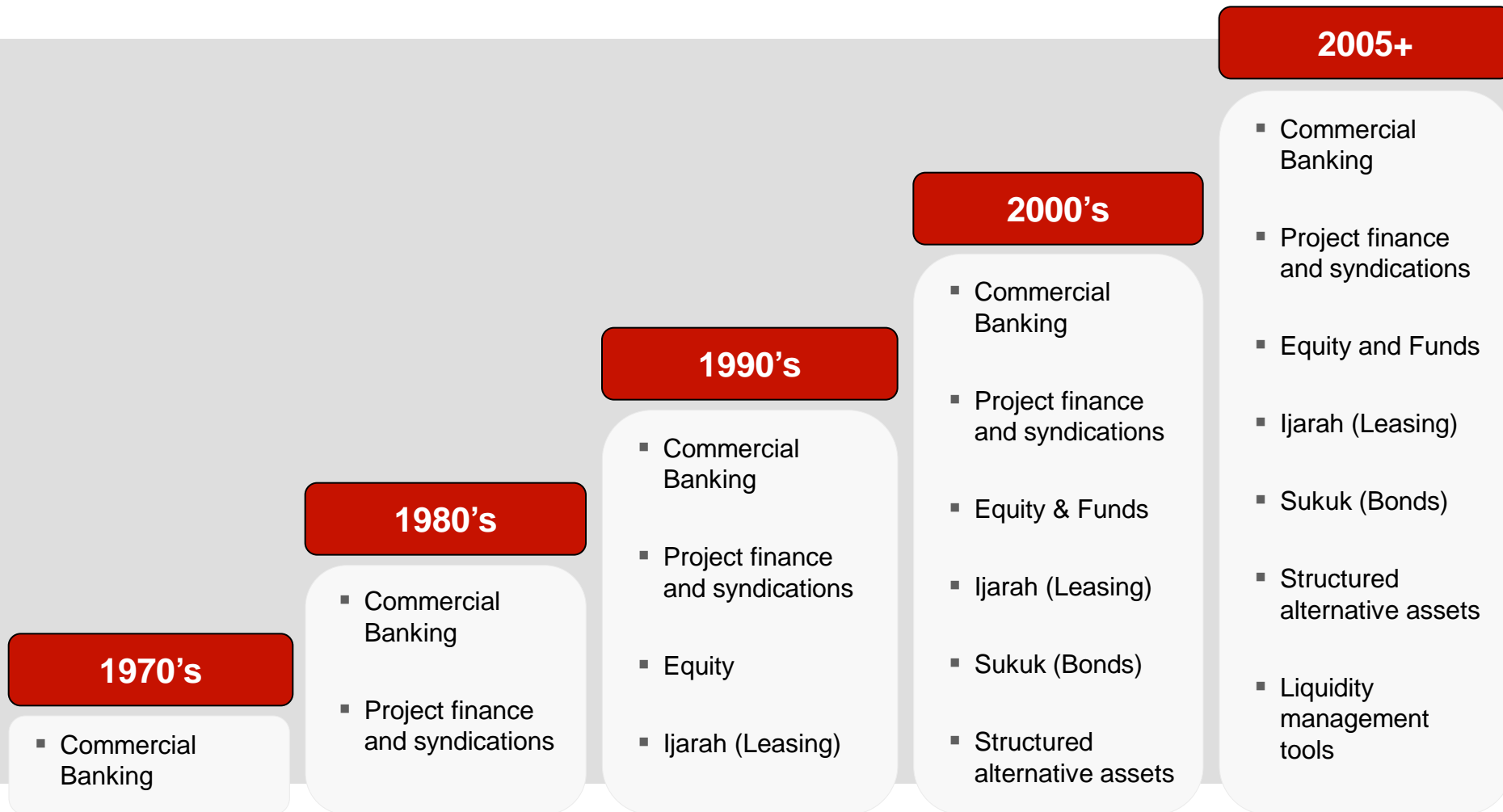
Note: *GCC countries include Saudi Arabia, Qatar, Kuwait, Bahrain, and Oman

Source: S&P – IF Outlook 2006, Freshfields Bruckhaus Deringer – IF Basic Principles and Structures, HSBC Amanah – IF Relevance & Growth, IBS Journal

Islamic Finance

Facts & Figures – Evolution (2/3)

Over the years the complexity of the products has increased



Islamic Finance

Facts & Figures – Current Positioning (3/3)

GCC, UAE, Malaysia and Indonesia are the high potential markets for Islamic Finance

Middle East and North Africa

- 204 million Muslims GCC countries, UAE, Iran, Egypt (13% of total Muslim population)
- GCC (excluding Oman): 17 commercial banks offering Islamic banking. Islamic AUM USD 100 billion
- Oman: The government has discouraged Islamic banking
- UAE: 15% (USD 37 billion) of banking assets under Islamic laws. Expected to grow to 20% by the end of 2010
- Iran: 100% banking is as per Islamic laws, USD 35 billion
- Egypt: Prominent Egyptian Islamic investment companies collapsed in the late 1980s and the concept is not encouraged by the government

South East Asia

- 16 million Muslims in Malaysia and 195 million Muslims in Indonesia (13% of total Muslim population)
- Malaysia: AUM USD 31 billion. The Islamic money market in Malaysia channels funds ranging from USD 8 – 12 billion monthly. Issued 60% of the world's total Sukuks in 2006
- Indonesia: Only 1.2% of total banking assets under Islamic Finance

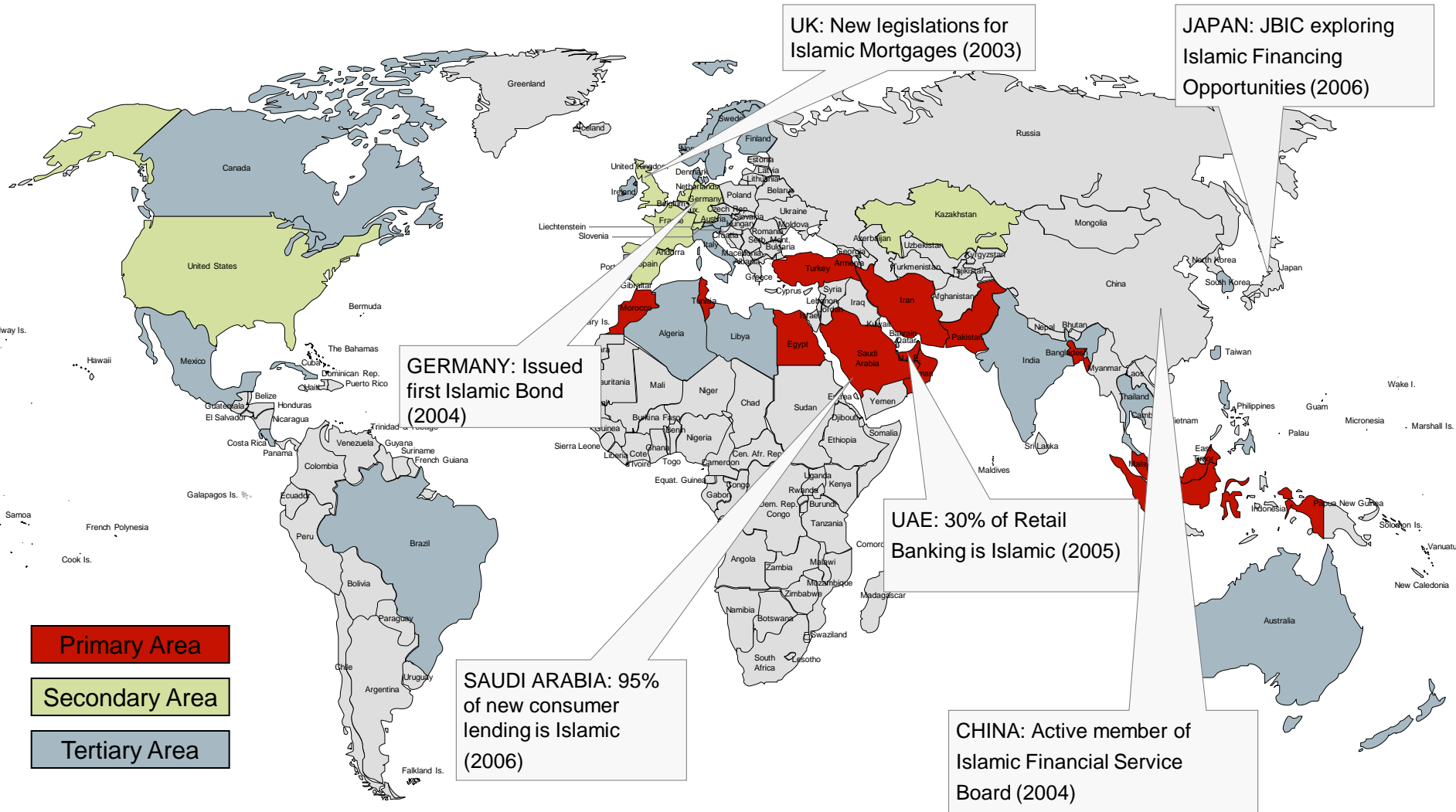
Others

- 439 million Muslims in India, Pakistan, and Bangladesh (28% of the total Muslim population)
- 16 million Muslims in UK, US, Germany and France
- India: Only a few Non-Banking Financial Institutions operate on the Islamic system
- Pakistan: 11 banks offering Islamic products. AUM USD 3 billion at the end of 2006. Expected to increase from 3% to 12% by the end of 2012
- Bangladesh: 10% of the total deposits under Islamic banking system
- UK, US no estimates available for Islamic Finance AUM

Islamic Finance

Global Coverage

Islamic Finance has a strong footprint in the Middle East and South-east Asia



Source: HSBC Amanah – IF Relevance & Growth, Kuwait Finance House – Asian Economic Outlook & Prospects for IF

Islamic Finance

Muslim Population (Millions)

There are approximately 1.6 billion Muslims worldwide (24% of total world's population)

Muslim Population by Country

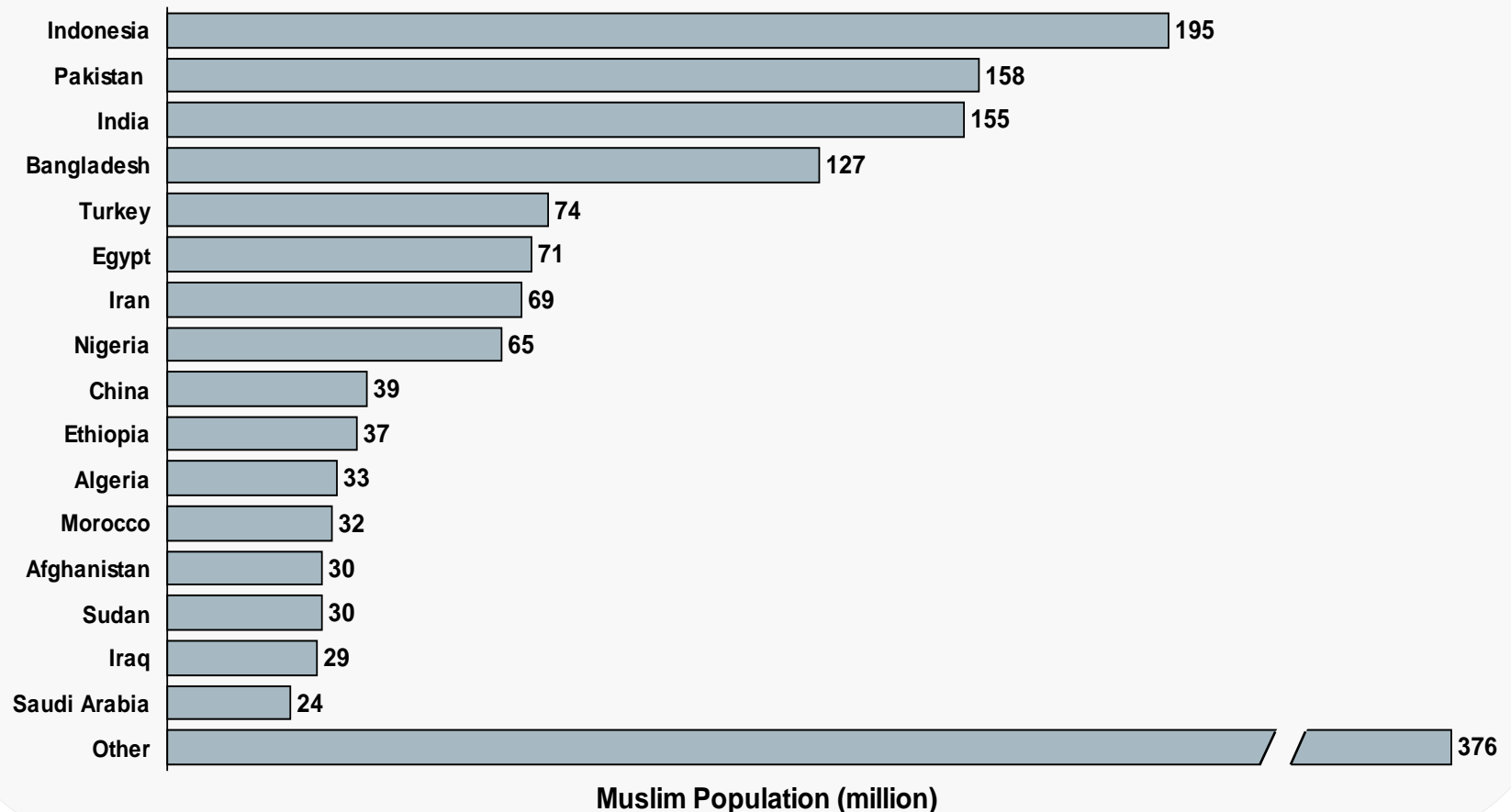


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Islamic Finance

Instruments (1/3)

'Asset-based' banking with profit sharing and equity participation principles

Illustrative list of Islamic Finance Instruments

Product Name	Category/ Nature	Characteristics
Murabaha	<ul style="list-style-type: none">▪ Asset based▪ Cost Plus Financing	<ul style="list-style-type: none">▪ Bank purchases the commodity and resells it at a predetermined higher price to the capital user, disclosing the margin of profit included in the sales price▪ The client pays for the goods in deferred payments or over a stated installment period▪ In case of default the client is liable only for the contracted sale price
Mudaraba	<ul style="list-style-type: none">▪ Asset based▪ Liability based▪ Profit Sharing	<ul style="list-style-type: none">▪ Under Mudaraba, one party provides 100% capital and the other party manages the investment project▪ Profits are shared in a pre-agreed ratio whereas losses accrued are borne by the provider of capital only▪ Mudaraba is often used for investment funds, where investor provides money to the Islamic bank, which the bank invests charging a management fee
Ijara / Ijara-wa-iktana	<ul style="list-style-type: none">▪ Asset based▪ Leasing	<ul style="list-style-type: none">▪ The bank buys and leases out the asset for a rental fee, which includes the capital cost of the equipment plus a profit margin▪ The ownership of the equipment remains with the lessor bank and in case of a finance lease, is transferred on pre-determined terms▪ Available under both operating lease and finance lease (Ijara-wa-iktana)▪ Widely used in house and aircraft financing

Source: International Islamic Financial Market, Freshfields Bruckhaus Deringer – IF Basic Principles and Structures

Illustrative list of Islamic Finance Instruments

Product Name	Category/ Nature	Characteristics
Istisna'a	<ul style="list-style-type: none"> ▪ Asset based ▪ Commissioned Manufacturing 	<ul style="list-style-type: none"> ▪ Under Istisna'a a party (bank) undertakes to produce a specific thing that is possible to be made according to agreed specifications at a determined price and fixed date of delivery ▪ As banks do not normally carry out manufacturing, a parallel contract for manufacture is instituted ▪ The bank charges the buyer the price it pays to the manufacturer plus a reasonable profit (monetary installment) and takes the risk of manufacture of the asset
Tawarruq	<ul style="list-style-type: none"> ▪ Asset based ▪ Monetization of commodity 	<ul style="list-style-type: none"> ▪ Tawarruq is the mode adopted by banks to lend cash ▪ The customer buys a commodity from the bank under Murabaha which is then sold to a third person on cash at a price less than the purchase price ▪ The customer hence obtains cash without taking an interest-based loan ▪ If the customer resells that commodity to the bank, it is called Al-'inah
Musharakah	<ul style="list-style-type: none"> ▪ Joint Venture 	<ul style="list-style-type: none"> ▪ Under Musharakah, all the partners contribute funds and have right to participate in the management of the business ▪ Profits are shared in an agreed ratio but losses are shared in the ratio of capital invested ▪ Contributions can be made either in cash or in kind

Illustrative list of Islamic Finance Instruments

Product Name	Category/ Nature	Characteristics
Sukuk	<ul style="list-style-type: none">▪ Islamic Bond	<ul style="list-style-type: none">▪ Sukuks are similar to conventional bonds with the difference that these are asset backed and represent proportionate beneficial ownership in the underlying asset▪ Sukuk holders are entitled to a share in the revenues generated and in the proceeds of the realization of the Sukuk assets▪ The overall Sukuk market size is estimated to be close to USD 50 billion globally as of the end of 2006
Takaful	<ul style="list-style-type: none">▪ Islamic insurance	<ul style="list-style-type: none">▪ Takaful is insurance based on mutual co-operation, responsibility, protection and assistance between groups of participants▪ It is akin to a cooperative insurance wherein members contribute a specific sum of money to a common pool▪ Every policyholder pays his subscription to help those that need assistance▪ Losses are divided and liabilities spread according to the community pooling system▪ The current market size is USD 4.6 billion

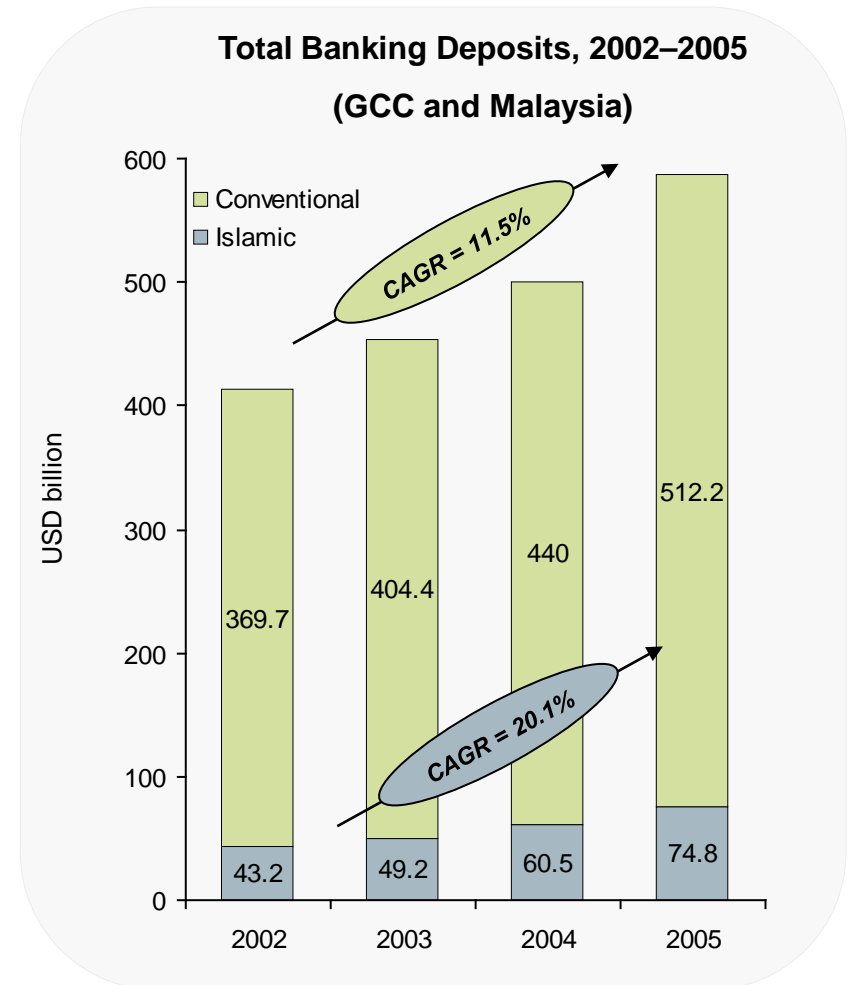
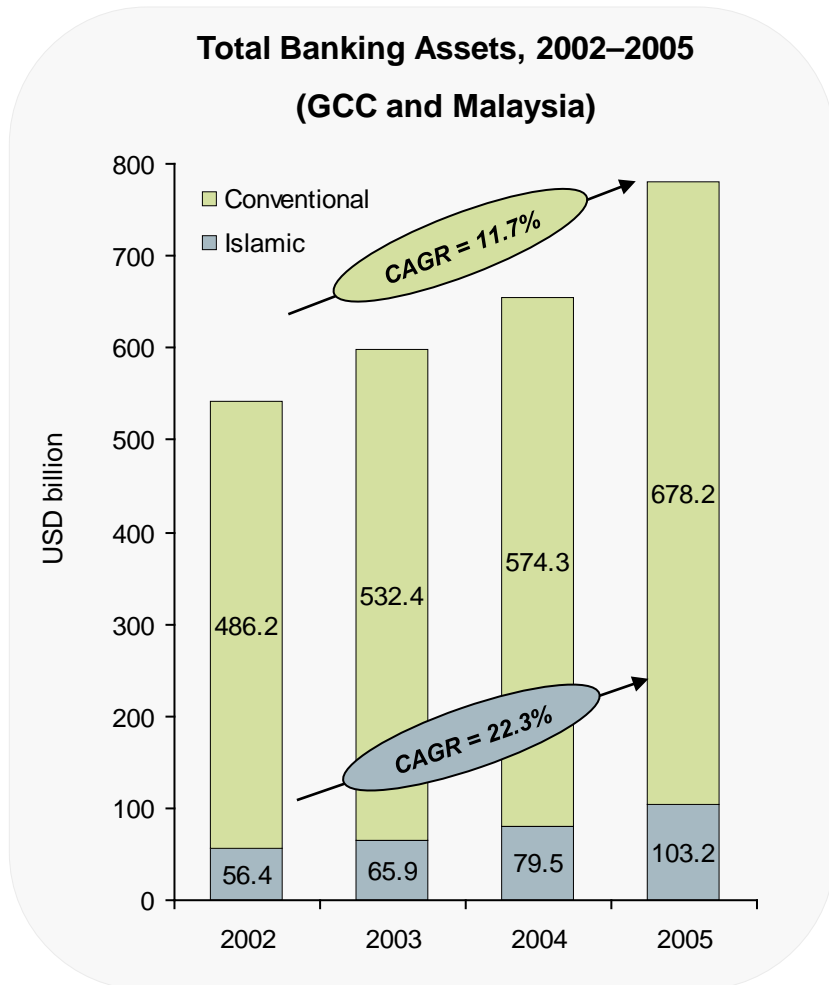
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Trends – Market Spread

Islamic banking assets and deposits have grown at a faster pace as compared to conventional banks



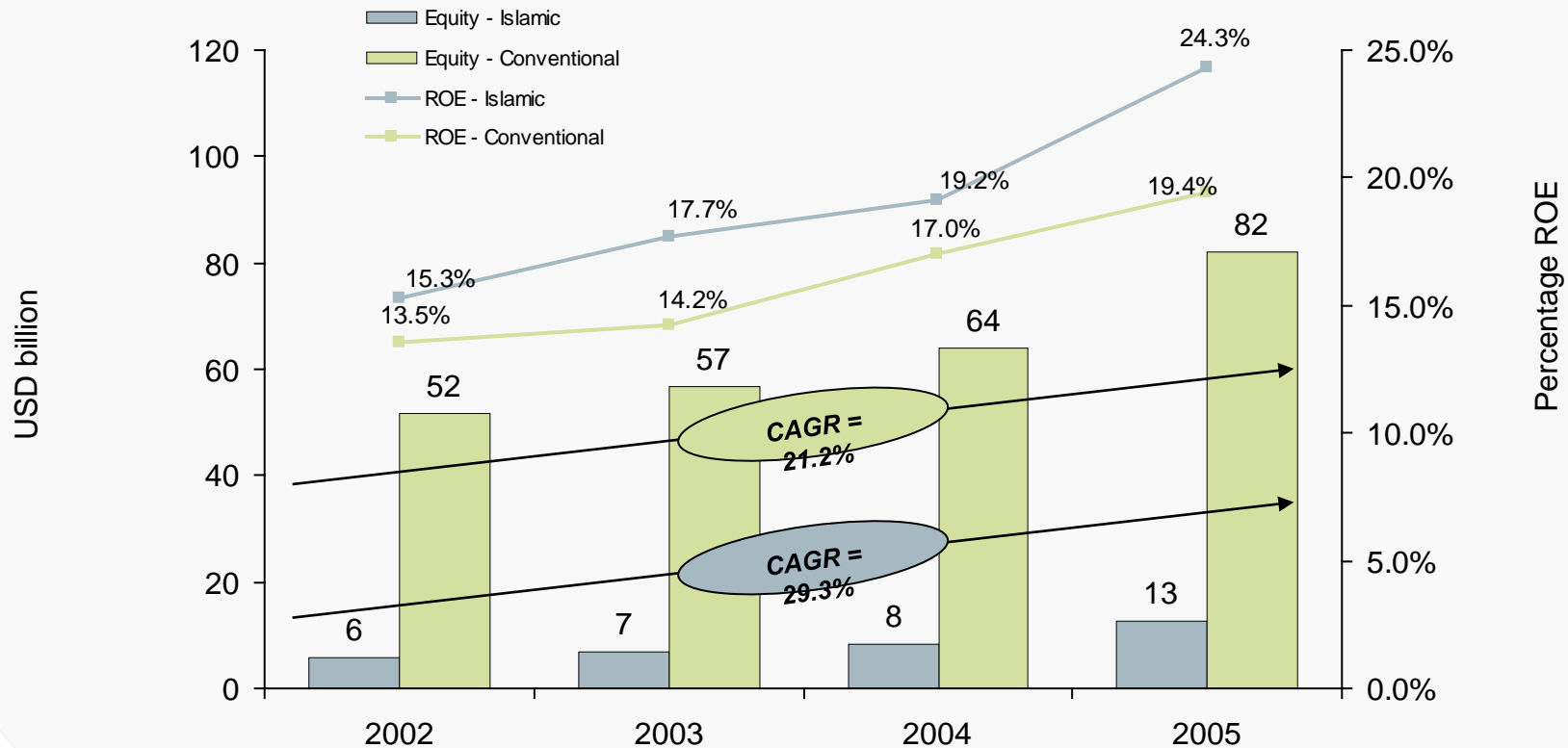
Source: Institute of Banking Studies (Kuwait), Bank Negara Malaysia

Islamic Finance

Key Trends – Equity Capital Markets (1/3)

Islamic banking equity has grown at faster rate than conventional banking equity and has also displayed higher return

Banking Equity & ROE, 2002–2005 (GCC and Malaysia)

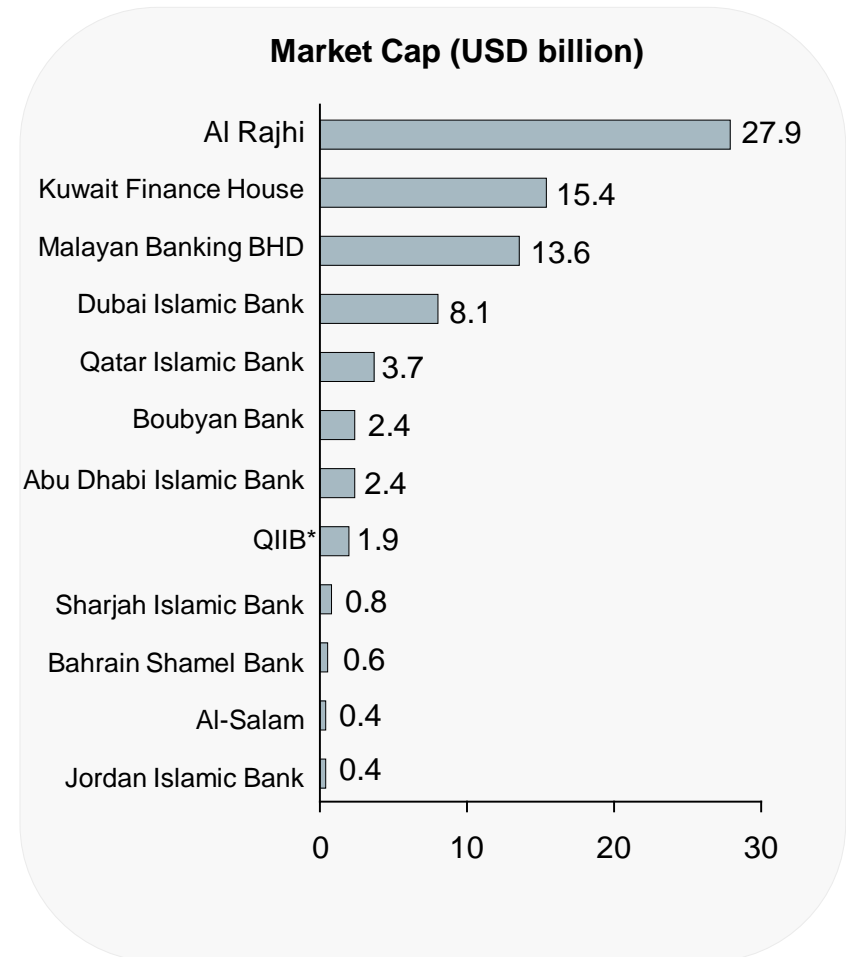
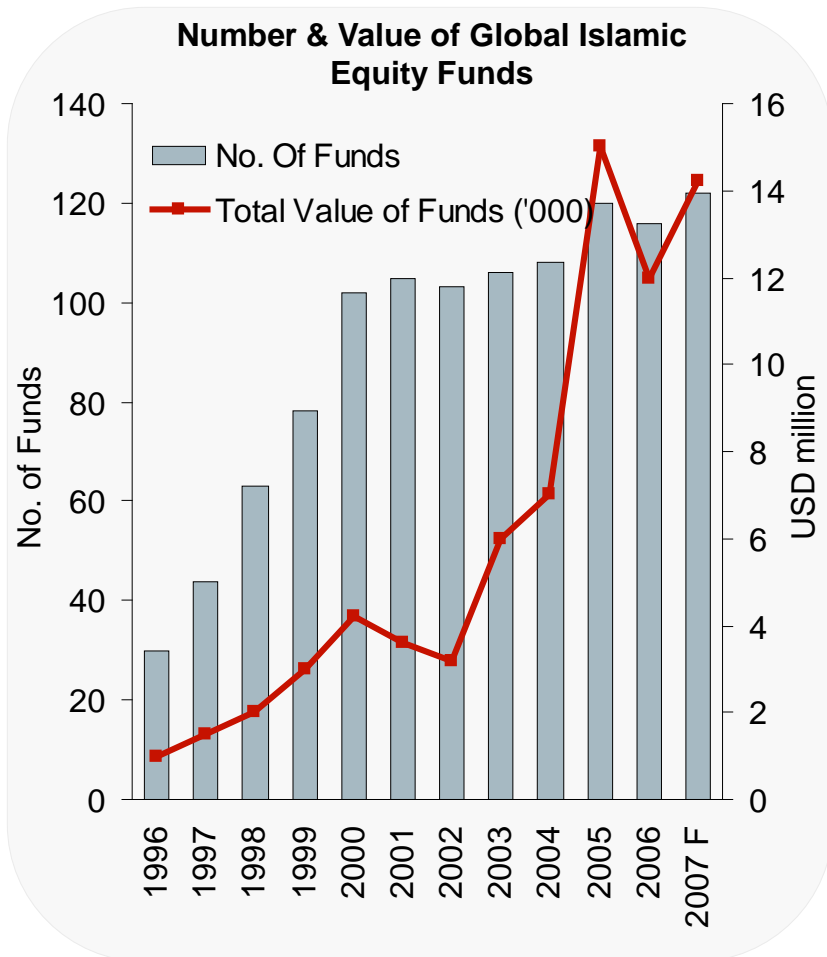


Source: Institute of Banking Studies (Kuwait) , Bank Negara Malaysia

Islamic Finance

Trends – Equity Capital Markets (2/3)

There has been remarkable growth in the number of Islamic equity funds since 1996; the largest Islamic Bank is among the top 50 banks in the world by market cap



Note: * Qatar International Islamic Bank
 Source: KFH – Asian Economic Outlook & Prospects in IF, Bloomberg

Islamic Finance

Trends – Equity Capital Markets (3/3)

The Islamic banking equity has grown at faster rate than conventional banking equity and has also displayed higher return



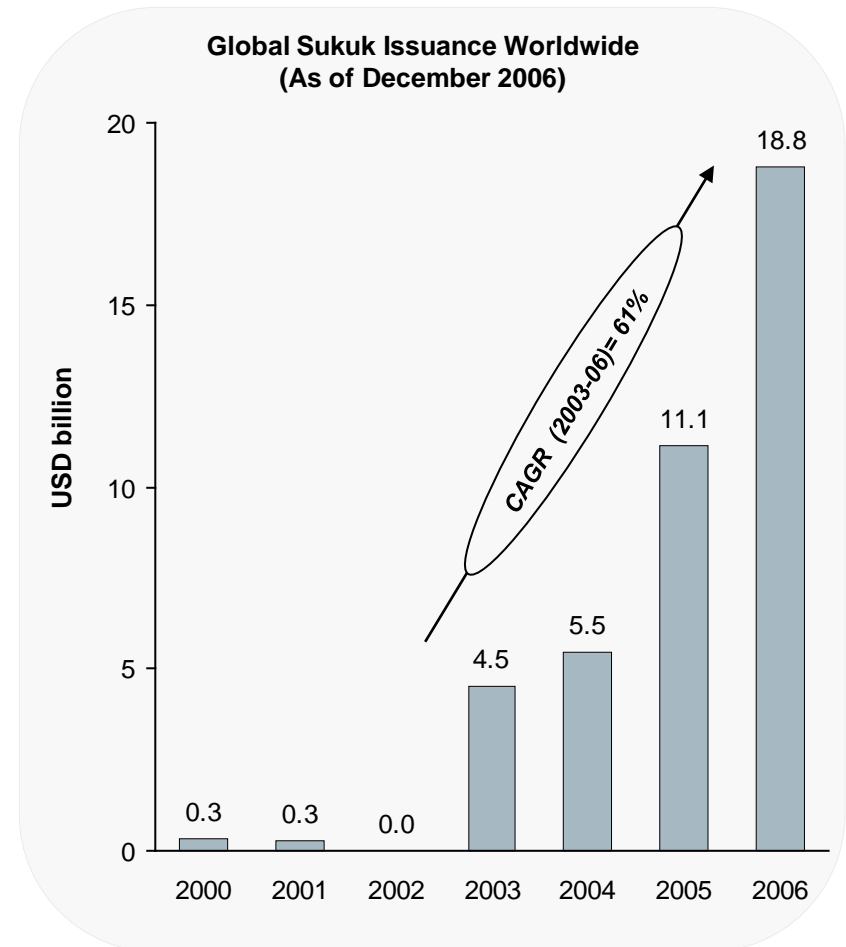
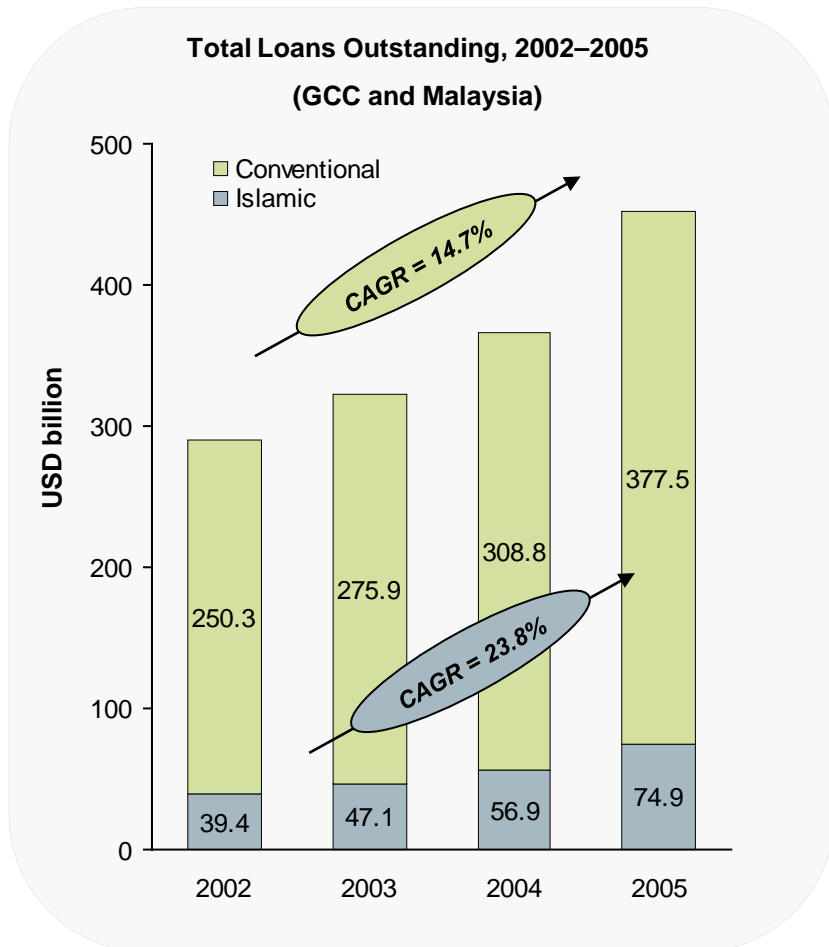
Note: The Dow Jones Islamic Market Index was introduced in 1999 as the first benchmarks to represent Islamic-compliant portfolios

Source: Bloomberg

Islamic Finance

Trends – Debt Capital Markets (1/2)

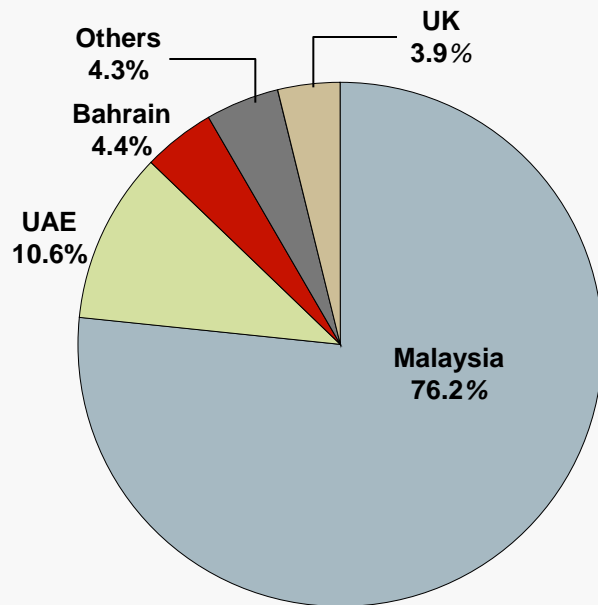
Islamic banks' share of DCM is growing faster than conventional banks; Sukuks have grown at 61% over the past 3 years and are expected to reach USD 100 billion by 2011



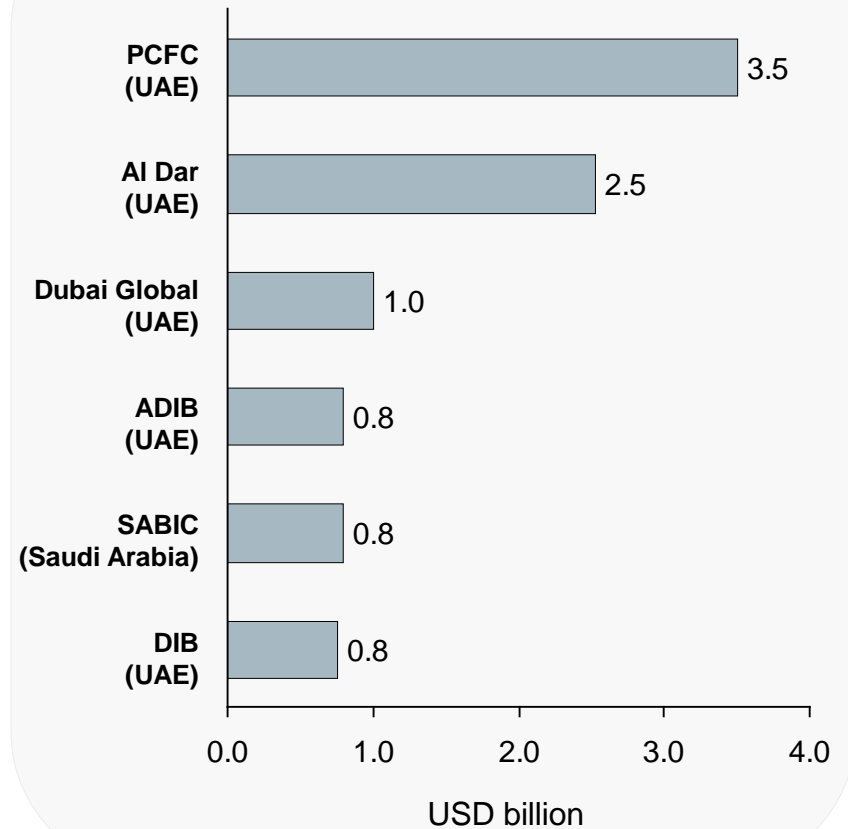
Source: Institute of Banking Studies (Kuwait), Bank Negara Malaysia, Trade Arabia, Bloomberg, International Islamic Financial Market, KFH

Malaysia remains the leader for global Sukuks market

Breakdown of Local Currency and Dollar Sukuks in Global Market



Examples of Sukuks issued in 2005 and 2006

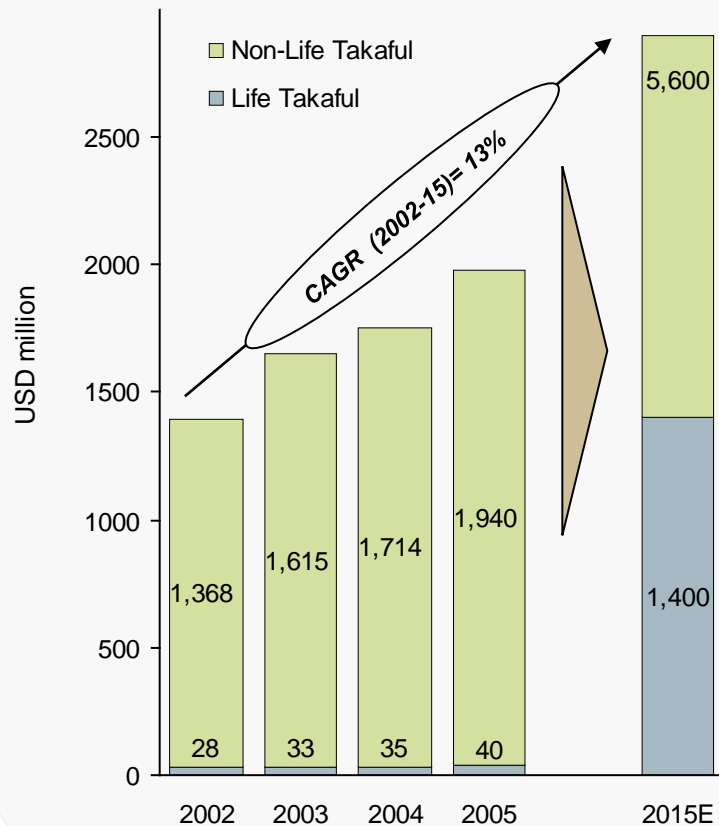


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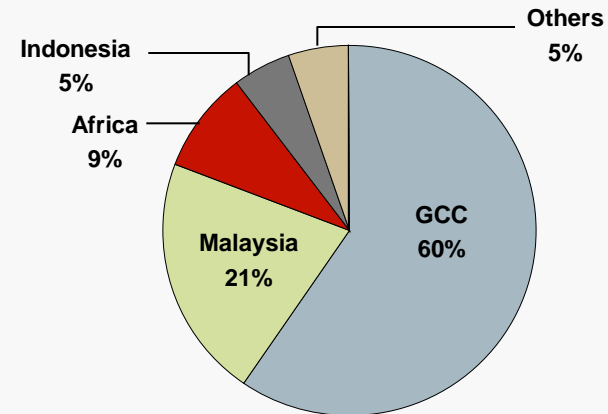
Trends – Insurance (Takaful)

The Takaful industry is expected to reach USD 7 billion by the end of 2015

Takaful Premium*, 2002-2015E



Market Size*



- Life Takaful is expected to grow at an annual rate of 35% while non-life Takaful is expected to grow at 12-15% annually
- Muslim countries account for only 5% of global insurance premiums, despite representing almost 25% of the world's population

Note: *excludes Iran

Source: E&Y - Islamic Funds & Investment Report, Takaful Re Ltd. - SECP Conference, Bank Negara Malaysia, AME Info, Bernama

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Islamic Financial Institutions

Regional Players (1/5)

Islamic Banking is highly fragmented and dominated by a few regional players

Bank	Description	Assets, Deposits, Net Profit (FY06)
Al Rajhi	<ul style="list-style-type: none"> ▪ Established in 1987, the Al Rajhi bank is headquartered in Riyadh ▪ The bank operates in Saudi Arabia and Malaysia ▪ Islamic products offered include deposit accounts, financing (credit cards, vehicles, real estate, shares, projects, trading and working capital) and online share trading service ▪ The bank also offers mutual funds based on commodities, local & global equity, real estate and regional funds like the India & China Fund, European Fund and GCC Equity Fund, etc. ▪ The bank has recently launched Watani (Share financing) and Irad (Income mortgage) financing instruments under Shariah 	<ul style="list-style-type: none"> ▪ USD 28,053 million ▪ USD 19,492 million ▪ USD 1,946 million
Kuwait Finance House	<ul style="list-style-type: none"> ▪ Established in 1977, KFH is the first and largest bank in Kuwait ▪ The bank has presence in Kuwait, Turkey, Bahrain and Malaysia ▪ Islamic products offered include deposit accounts, debit & credit cards, aircraft leasing, vehicle financing and leasing, trade financing, project financing, asset management, FX trading, etc. ▪ The bank has been awarded the 'Best Islamic Bank' by Euromoney for 3 consecutive years ▪ KFH plans to acquire a bank in Indonesia and start business in China ▪ The bank also launched the 'KFH Trade' service for dealing in Kuwaiti equity 	<ul style="list-style-type: none"> ▪ USD 21,724 million ▪ USD 12,836 million ▪ USD 662 million

Source: Annual reports, Banks' websites, Zawya, Bloomberg

Islamic Financial Institutions

Regional Players (2/5)

Bank	Description	Assets, Deposits, Net Profit (FY06)
Bank Of Islam Malaysia	<ul style="list-style-type: none"> ▪ Established in 1983, Bank of Islam is Malaysia's first Islamic bank ▪ The Islamic products include deposit accounts, financing, debit & credit cards, personal, working capital, property auctions, Takaful, etc. ▪ The bank recently introduced products like savings-linked Takaful and tourist MasterCard prepaid cards 	<ul style="list-style-type: none"> ▪ USD 4,136 million ▪ USD 4,074 million ▪ USD 352 million
Dubai Islamic Bank	<ul style="list-style-type: none"> ▪ Established in 1977, Dubai Islamic Bank is the world's first full-fledged Islamic bank having presence UAE, Syria, Pakistan, Sudan, Turkey, Lebanon, Cayman Islands, Egypt, Bahamas, Ireland and UK ▪ Financial solutions cover term deposits, debit & credit cards, corporate finance, investment banking, project finance, trade and commodity finance, capital and debt market products, treasury and corporate banking, international banking services, and securities ▪ The bank co-managed with Barclays the USD 3.5 billion Sukuk issued by PCFC ▪ The bank is aggressively pursuing to expand its business in high potential countries like Saudi Arabia, Iran, Turkey, Sudan, Pakistan, etc. 	<ul style="list-style-type: none"> ▪ USD 9,799 million ▪ USD 6,533 million ▪ USD 155 million

Islamic Financial Institutions

Regional Players (3/5)

Bank	Description	Assets, Deposits, Net Profit (FY06)
Qatar Islamic Bank (QIB)	<ul style="list-style-type: none"> ▪ Established in 1982, QIB is Qatar's first Islamic bank ▪ The bank is among the world's 5 largest Islamic banks ▪ Islamic product portfolio includes deposit accounts, financing (vehicle, house, assets, credit cards, projects, infrastructure, securitization). It also manages portfolio and investment funds in France, Germany, USA and UK ▪ The bank has investments in finance houses like AFB-Malaysia, AFH-Lebanon, QInvest-Qatar, EFH-London and GFH-Bahrain. These finance houses are now expanding into countries like Indonesia, Brunei and Singapore 	<ul style="list-style-type: none"> ▪ USD 4,072 million ▪ USD 960 million ▪ USD 278 million
Boubyan Bank	<ul style="list-style-type: none"> ▪ The bank was established in 2004 as a Kuwaiti shareholding company ▪ Islamic products include deposit accounts, asset financing, credit cards, investment funds (financial and real estate), and corporate financing (investment finance, real estate finance, project finance, working capital finance, trade finance, capital leasing and foreign exchange), etc. 	<ul style="list-style-type: none"> ▪ USD 504 million ▪ USD 168 million ▪ USD 10 million
Abu Dhabi Islamic Bank	<ul style="list-style-type: none"> ▪ Established in 1997, Abu Dhabi Islamic Bank has a presence in UAE ▪ The bank is one of the fastest growing Islamic banks in terms of assets (grew at 74% in 04-05) ▪ Islamic products include deposit accounts, financing (goods, home, vehicle, education, travel, boats, shares) and investment (global equity, leasing, realty funds), etc. 	<ul style="list-style-type: none"> ▪ USD 9,799 million ▪ USD 6,533 million ▪ USD 155 million

Source: Annual reports, Banks' websites, Zawya, Bloomberg

Islamic Financial Institutions

Regional Players (4/5)

Bank	Description	Assets, Deposits, Net Profits (FY06)
Qatar International Islamic Bank	<ul style="list-style-type: none"> ▪ Incorporated in 1990, the bank is headquartered in Doha, Qatar ▪ The bank is primarily engaged in retail banking, financing, and investing activities in Qatar ▪ Planning to set up an Islamic insurance firm in Pakistan 	<ul style="list-style-type: none"> ▪ USD 2,297 million ▪ USD 1,859 million ▪ USD 110 million
Shamil Bank	<ul style="list-style-type: none"> ▪ Established in 1982 in Bahrain, Shamil bank is a full-fledged investment bank ▪ The bank has affiliates and subsidiaries operating in Switzerland, Pakistan, Yemen and Qatar ▪ Product portfolio consists of deposit accounts, credit cards, home financing, vehicle financing, asset financing, treasury services in commodities, FX and Sukuks, structured finance services, investment funds (global realty, global equity and commodities), asset management, wealth management ▪ Entered into an agreement with Solidarity company, one of world's largest Takaful providers 	<ul style="list-style-type: none"> ▪ USD 1693 million ▪ USD 112.3 million ▪ USD 61.6 million

Islamic Financial Institutions

Regional Players (5/5)

Bank	Description	Assets, Deposits, Net Profits (FY06)
Jordan Islamic Bank	<ul style="list-style-type: none"> Jordan Islamic Bank for Finance and Investment was established as a public shareholding company in 1978 and is headquartered in Amman, Jordan The bank operates as a full-fledged Islamic bank and offers products including deposit accounts, leasing, financing, credit cards, letters of credit, buying and selling of foreign currencies, etc. 	<ul style="list-style-type: none"> USD 1,821 million USD 1,737 million USD 22 million
Bank Aljazira	<ul style="list-style-type: none"> Established in 1975, the bank has presence in Saudi Arabia Converted from a conventional bank to an Islamic bank Islamic products include deposit accounts, financing (projects, trade, export, FX, leasing, debt factoring, hire purchase) and investments (global equities, international stock brokerage services, various funds, commodities), etc. Pioneer in the field of stock broking services in Saudi Arabia 	<ul style="list-style-type: none"> USD 4,190 million USD 2,911 million USD 526 million
Bank AlBilad	<ul style="list-style-type: none"> Headquartered in Riyadh, the bank was established in 2004 with the merger of eight money exchangers in the Kingdom of Saudi Arabia The bank has 70 branches under Enjaz Banking services, providing fund remittances and cash currency exchange in Europe, Middle East and Africa Product portfolio consists of deposit accounts, financing, share trading services, investment funds, etc. 	<ul style="list-style-type: none"> USD 3,008 million USD 2,121 million USD 47 million

Source: Annual Reports; Company Websites, Bloomberg

Islamic Finance

Western Players (1/4)

Almost all the big western banks are entering the sector with strong expansion plans

ABN AMRO

- ABN launched its first Islamic banking branch in Pakistan in 2007
- The bank has plans to roll out services in other markets in Asia such as the UAE, Indonesia, Malaysia and Singapore and intend to add two more exclusive branches and six to eight windows by end 2007.
- The bank received the approval of Bank Negara Malaysia in February 2007 to open an Islamic window and plans to open an Islamic Banking subsidiary in Malaysia
- Provides a comprehensive range of Islamic products including trade financing, export refinancing, mortgages, personal loans, car financing, credit cards and insurance
- In 2006, the bank launched the world's first Shariah compliant index-tracking investment product which was listed on the SWX Swiss Exchange

Barclays

- Barclays provides Islamic products in US, UK, Pakistan, Kenya and South Africa
- In 2000, the bank introduced a USD 30 million Islamic Mutual Fund in UAE
- The bank has recently opened a branch in UAE and is considering offering Islamic banking in the country
- The bank was ranked number one in the Islamic bonds Underwriter League Table with 23% market share according to the Bloomberg 2007 Q1 European Fixed Income Rankings
- For the full year 2006, the bank was involved in Sukuk issues totaling USD 7 billion

Islamic Finance

Western Players (2/4)

BNP Paribas

- BNP's association with Islamic Finance started way back in 1985, when it structured the first Murabaha deposits providing Islamic banks with short-term liquidity placement/lending opportunities
- Since then the bank achieved various milestones and in 2003 it officially announced setting up an Islamic banking unit in Bahrain and representative offices in Dubai and Beirut
- In late 2006, the Unit was renamed to BNP Paribas NAJMAH
- The unit mainly focuses on Middle East and South East Asia markets
- Services provided include asset-liability management & treasury, fixed income, equity, project finance & export finance, structured finance, etc.
- Officials from the bank have held discussions with Banque de France (the Central Bank of France) and the Commission Bancaire (the regulatory authority) to promote Islamic Banking in France
- The bank is also looking at starting an open-end, Islamic equity fund shortly in India, which will replicate BNP Paribas' Global Islamic Fund in Luxembourg

Citi Islamic Investment Bank

- Established in 1996, the Citi Islamic Investment Bank operates in UAE and Bahrain
- The core business of the bank includes originating, structuring and distributing transactions in structured finance, trade finance, leasing, fund management and Islamic securities
- In October 2006, the bank created the first ever currency swap under Islamic finance worth USD 233 million for Dubai Investment Group. Since then the bank has developed many hedging and money market instruments
- Citibank aims to make Malaysia its development hub for Islamic products and has approximately USD294 million worth of assets under Islamic banking
- The bank has launched Home Partner -1 offering in order to target the Islamic mortgage market in Malaysia and it is expected to account for 50% of Citi's mortgage revenue in Malaysia

Islamic Finance

Western Players (3/4)

Deutsche Bank

- In 2005, Deutsche Bank and Abu Dhabi Commercial Bank (ADCB) completed the first ever Shariah compliant transaction linked to a basket of commodities
- The bank offers Shariah compliant retail and institutional banking products to investors in Bahrain and UAE
 - Plans to expand offerings to other countries including MENA, Asia and Europe in 2007
- In addition to retail and private banking products, the bank also offers Shariah compliant asset and liability products for capital raising, hedging and yield enhancement purposes
- In December 2006, the bank, through its investment wing DWS Investments, launched its first Shariah compliant mutual fund 'DWS Noor Islamic Fund'
- The bank has recently announced a Joint Venture with Ithmaar Bank of Bahrain and Abraaj Capital of Dubai to launch a USD 2 billion Shariah compliant financial fund

HSBC Amanah

- HSBC started its global Islamic finance services division in 1998. The division is headquartered in UK and has locations in US, Saudi Arabia, Malaysia, Bangladesh, Indonesia, UAE and Brunei
- Services offered include both personnel and commercial banking products, including private banking, credit cards, home, personal and vehicle finance, investments, trade services, working capital and term finance, asset finance, etc.
- In Malaysia,
 - Approximately 15% of total assets are in Shariah compliant products
 - Profit before tax and zakat for the year ended December 31, 2006 was USD 273 million, 28.8% higher than the previous year
- HSBC has recently submitted an application to the Bank Negara Malaysia to set up a full-fledged Islamic banking subsidiary in the country and has proposed to use Malaysia as regional hub for Islamic banking
- 86 different Sukuks totaling USD 5.6 billion issued by bank since 2002

Islamic Finance

Western Players (4/4)

Lloyds TSB

- Lloyd is UK's largest provider of Islamic products
- Provides Shariah compliant services like current account, business bank accounts, student account, home finance and fund management
- The bank has received tremendous support from the UK government in the last few years in the form of concessions and amendments favoring Islamic Finance
- The bank has constantly been expanding the number of branches offering Islamic Financial Services. In 2005, the number stood at 32 branches and is still increasing
- The bank has recently announced its plans to offer re-Takaful from its newly incorporated offshore re-insurance unit in Labuan (Malaysia)

Standard Chartered

- Standard Chartered Bank currently has Islamic banking operations in Malaysia, Indonesia, Pakistan, UAE and Bangladesh
- Standard Chartered was the first international bank to offer Islamic banking in Malaysia in 2003
 - Islamic banking assets in Malaysia at the end of 2006 stood at RM 2,047 million (5.23% of total portfolio)
- Services offered include deposit accounts, credit cards, personal and vehicle finance, corporate accounts, SME financing, revolving credit, leasing, etc.
- The bank has recently launched its Global Islamic Banking brand 'Saadiq' in the Middle East to offer products in consumer and corporate banking including accounts, credit cards, personal and auto finance, etc.

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A strong regulatory regime is required for sustainable and long-term development of Islamic Finance

Global Overview

- The Shariah Board forms an integral part of every Islamic bank. The board monitors the workings of the Islamic bank and every new transaction that is doubtful from a Shariah standpoint has to be cleared by the board
- AAOIFI and IFSB are the two main international standard-setting organizations that promote and enhance the soundness and stability of the Islamic financial services industry
 - The standards are used as guidelines by the regulators in different countries
- Because of the absence of a single authority every bank appoints a Shariah committee to oversee the compliance of new products or services
- Various Islamic countries have their own regulatory framework pertaining to Islamic Banking

Basel II

- IFSB has come out with a set of standards for Pillar 1, Basel II norms dealing with capital adequacy
 - These standards are proposed for 'non-insurance' institutions offering only Islamic products
 - Like Basel, the application of these standards is entirely on the discretions of country's regulatory authority
 - The regulatory authority while implementing these standards, may apply them with or without modifications to institutions with 'Islamic windows'
 - The standards have been made mandatory in Qatar, and the regulators in Bahrain and Saudi Arabia have asked the institutions to implement them by 2008

Islamic Finance

Regulatory Environment and Key Developments (2/2)

Middle East and North Africa

- Bahrain: Bahrain Monetary Agency provides regulatory framework. IFIs are required to adhere to AAOIFI standards
- Kuwait: Fatwa Board of the Ministry of Awkaf and Islamic Affairs acts as regulator. Standards issued by IFSB for Pillar 1, Basel II norms are mandatory
- Qatar: Qatar Financial Centre Regulatory Authority is member of IFSB and AAOIFI and as of 2005 has issued rules to govern IFIs
- Saudi Arabia: Saudi Arabian Monetary Agency acts as a regulator for all IFIs. The IDB also plays an important role in promoting Islamic banking
- UAE: All IFIs must comply with Federal Law No. 6 of 1985
- Iran: Since 1979, the entire banking system is strictly Islamic
- Oman & Egypt : The Central Banks have implemented various restrictive policies preventing the establishment and expansion of IFIs

South East Asia

- Malaysia: The Shariah Advisory Council (SAC) of Central Bank, established in 1997, acts as the sole regulator for IFIs. Initiatives like tax deductions are adopted by the government to promote IF. All the IFIs have to comply with IF standards issued by IFSB by the end of 2010
- Indonesia: Shariah Bureau of the Bank of Indonesia acts as regulator. The Government will need to change the laws (including taxation) on state debt securities or state treasury to promote growth in the sector

Others

- India: No separate legislation by Reserve Bank of India. No initiatives undertaken to promote Islamic banking
- Pakistan: State Bank of Pakistan acts as a regulator for Islamic banking
- Bangladesh: Bangladesh Bank acts as regulator and introduced reforms like lower Statutory Liquid Ratio to promote Islamic banking
- US: IFIs must comply with State and Federal regulations, no separate approvals are required
- UK: Financial Services Authority (FSA) provides regulatory framework. The government has undertaken various initiatives such as modifying tax legislation to promote IF
- Germany & France: In very initial stages of development, no major initiatives undertaken as yet

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Islamic Finance

Key Issues

'Ability to operate as an integral part of the international financial system' and 'developing a sound and stable regulatory regime' are the two fundamental challenges to be addressed by the Islamic Financial Institutions

Taxation & Legal Issues

Various products under Shariah - Murabaha, Ijara, Tawarruq, etc. attract government taxes at multiple levels. This is because, in a single transaction the property/ commodity is bought and sold more than once. The issue has been addressed in many countries like UK and Bahrain but still poses problems in most Western countries

Risk Management

Since IFIs are prohibited from investing in debt markets, 'impure' sectors and hedging instruments like derivatives, etc. the element of risk is higher as compared to other conventional banks. Also, inability to charge default interests for late payments and imposition of preconditions to levy penalties result in higher business risk for IFIs

Regulatory & Disclosure

The disclosure norms are less stringent and the absence of a single global regulatory regime creates issues in cross-border transactions

Excess Liquidity

Due to prohibitions on investing in debt markets, 'impure' sectors and hedging instruments, the secondary and inter-bank market is very thin and underdeveloped. This causes a major threat on excess funds with banks remaining unutilized and failing to earning adequate returns

Fragmentation

The industry is fragmented with small players who are unable to compete with international players for large-scale project finance deals



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