From the Editor

The bulletin itself can do most of the talking this month, especially finding more of its voice and tone with the help of participating contributors, acknowledged experts in their field, while accessible to a broad readership interested in the dynamically growing field of Islamic finance and the panoply of financial markets which bring their bearing on it.

Joining us on our journey this month are Massoud Janekeh of Bank of London and The Middle East, Florence Eid of economic consultancy Arabia Monitor, and Kathleen Brooks of market commentator Forex.com. Their contributions are gratefully received, and we feel sure they will help enhance general understanding of our basic subjects.

It would be nice to think that our offering will work in harmony with the chatter that the world economy is moving up, well enough at least. Just as notable in January was the ominous, counterpart suggestion that bond markets, and related instruments, might be in for a rough ride as Western authorities seek reflation as the answer to the question of where growth might come from, since the ordeal of the global financial crisis.

As ever, we provide a digest of the latest developments in Islamic financial topics, and accountancy rules and regulations, also rounded coverage of global equity, bond and CDS, hard and soft commodity markets, comparing conventional and Shariah-compliant indices. In future we hope to develop discussion of these relationships, in line with the development of the document as a whole.

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Islamic finance outlook: Now that near-systemic crisis may have passed among the most developed countries and traditional markets, Islamic finance has not only emerged relatively unscathed but also reclaimed attention to its potential. Masseoud Janekeh of Bank of London & The Middle East examines the state of Islamic banking and the prospect for its players in the UK and global spaces (p.6). Florence Eid of Arabia Monitor foresees sukuk demand continuing to exceed supply, and providing the funds in particular for infrastructural projects across the Gulf and Asia (p.8).

Dubai: Recovering its confidence in the wake of its troubled experience of the global financial crisis, the emirate returned to the debt market with substantially oversubscribed issues in both Islamic and conventional bonds. Taken as a clear sign of the return of the distinctive story that is Dubai Inc., this success could also be read as a return to the expansive normality previously seen, besides a rediscovery of risk appetite. While doubters wonder whether lessons have been learned sufficiently from the crisis episode, the leadership’s next declared target is to become a hub for Islamic finance. (p.5, 19)

Asset markets: The sense of global economic recovery became a theme with momentum last month, upon US overcoming the initial obstacle of its so-called fiscal cliff. The Fed’s ongoing drive for monetary easing, alongside similar efforts around the world, including notably Japan, led to sentiment shifting further towards equities, but doubting of Treasuries and all other instruments dependent on the benchmark. Bond markets suffered, perhaps a sea-change, while commodities lacked direction. Kathleen Brooks of Forex.com explains why gold has lost its lustre. (p.15)
Recent Developments in the Islamic Finance Industry

Offshore sukuk by Australian solar consortium

A consortium of two Brisbane solar companies has decided to finance its entire Indonesian solar power project using Shariah-compliant financing. The Solar Guys International and Mitabu Australia are developing a 250 megawatt (MW) solar power project under an agreement with Indonesia’s Ministry of Energy. The deal is set to be Australia’s first issuance of sukuk.

The first 50 MW of the project will be financed through the issuance of a 7-yr A$100 million ($104 million) sukuk. It will be domiciled in Labuan, Malaysia’s offshore financial centre, and is expected to be placed almost entirely with Malaysian investors. The offshore structure has drawn interest from Australia’s government officials and could appeal to other local companies with overseas assets. The sukuk would seek to pay between 6.5 percent and 7.5 percent returns, part of a hybrid funding plan incorporating several Islamic contracts.

GOLCER perceives this as a robust step forward for the introduction of Islamic finance in Australia. In the past, Australian companies were reluctant to consider Islamic finance, owing to taxation issues. However, sukuk still can attract double tax duties since they require multiple transfers of title of the underlying asset.

Source: Reuters, February 5th

Launch of first dedicated Oman’s Islamic Bank

Oman’s first dedicated Islamic bank, Bank Nizwa, has officially opened its doors to the public. It is the first in the Sultanate to provide special services like account opening through identity cards for Omanis and resident ID cards for expatriates. This launch was announced soon after the release of the Islamic Banking Regulatory Framework (IBRF) by the Central Bank of Oman (CBO).

GOLCER views this initiative as signifying the start of a new era for Islamic banking in Oman, pushing it to a higher level of development.

Source: Global Islamic Finance, February 20th

Retail Islamic services offered by Egyptian bank

Egypt’s main agricultural bank is launching the country’s first Islamic retail services this month, with a portfolio of 50 million pounds ($7.5 million), and expectations to raise 100 million pounds. The offer of retail finance is based on Murabaha and Musharaka structures to cover areas including purchases of durable goods and agricultural equipment, the setting up of clinics and medical laboratories, and the financing of education fees. The bank has offered Islamic finance on a very small scale for several decades at ten branches, and in 2012 won the central bank’s approval to raise the number to 24 branches.

GOLCER considers that Islamic finance today in Egypt is flourishing after the overthrow of the previous president, Hosni Mubarak, as the government previously neglected the industry for ideological reasons. The new government, led by an Islamist president, aims to expand the sector. However, its share is likely to remain tiny for the foreseeable future, owing to political and regulation issues surrounding the passage of related legislation.

Source: Reuters, February 12th

Dubai aims to develop Islamic business

This month Dubai has launched a drive to develop its Islamic business sector. The government is currently
working on promoting Islamic banking and insurance including the arbitration of Islamic contracts and the setting of quality standards for halal food. The main purpose is to attract new investments from the Middle East and South-East Asia, through setting a formal committee to work on six major initiatives under the project.

GOLCER sees Dubai as a fast-emerging economy currently taking several initiatives to boost growth with trade and investment from around the region. Islamic banking and finance is expected to be an important niche, given its 25 percent share of the banking market in the six countries of the GCC, according to an estimate by Ernst & Young.

Source: The Arabian Business News / Reuters, February 9th

Aiding smaller Tunisia firms

Tunisia plans to provide Islamic financing to small and medium-sized enterprises (SMEs) through collaboration between the public and private sectors. Tunis-based Bank of Financing Small and Medium Enterprises (BFPME) has made an agreement with the Jeddah-based Islamic Corporation for the Development of the Private Sector (ICD), a private investment arm of the Islamic Development Bank. The plans include a 50 million dinar ($32.3 million) Shariah-compliant SME fund. The Tunisian government has recently been working on a legal framework to cover issues associated with Islamic bonds. A draft is likely to be discussed by the authorities during the coming months.

GOLCER finds that this initiative might set a practical model for other Arab countries seeking to restore their economies after the political turmoil of the Arab Spring. Its success would serve to increase foreign direct investment and develop Islamic banking in the country.

Source: Reuters, February 14th

A boost for USAID’s Afghan farm fund

Given the economic instability and legal obstacles which have slowed the introduction of modern forms of Islamic finance in Afghanistan, Shariah-compliant loans have been playing a role in the farm sector through a US-funded aid programme. The Afghan government is using Islamic financial contracts to extend credit to farmers in areas where conventional banking has not fully satisfied demand for funds. The Agricultural Development Fund (ADF), set up in 2010 through a $100 million grant from the US Agency for International Development (USAID), offers both conventional credit and Islamic financing. About $11 million of its loans approved between May 2011 and April 2012 were Shariah-compliant. Demand for such financing has been particularly strong in rural communities because people there tend to be conservative.

Source: Global Islamic Finance, February 13th

Turkish banks consider subordinated sukuk issues

With strong investor demand and the need to improve capital adequacy ratios, Turkey’s Islamic banks are currently looking at subordinated sukuk. Longer-tenor issues would help balance mismatches between the maturities of banks’ liabilities and assets, and at the same time assist in the diversifications of funds. To date, Turkey’s four Islamic banks have issued only two such instruments, with 62% owned by Kuwait Finance House, raising a total of $450 million in 2010 and 2011. While subordinated issues are more expensive for borrowers than their secured counterparts, the current appetite for Turkish debt seems strong enough to translate into favourable pricing for the banks.

GOLCER believes that, with the newly-adopted Basel III global banking standards, Turkish Islamic banks can still use subordinated instruments to raise capital. With the current capitalisation levels of certain banks and the desire for innovation, both factors together might encourage banks to consider such a structure.

Source: Reuters, February 12th
Viewpoint

Prospects for Islamic banking in 2013 and the challenge for the UK Islamic banks

by Massoud Janekeh

With the continued growth of the Islamic banking industry, there is increased expectation from its stakeholders for its emergence as a true alternative to conventional finance.

In the banking industry size does matter. Scale permits better economic returns, standardisation of products, a harmonious regulatory framework and a wider supply of experienced and skilled workers.

While global Islamic banking assets are estimated to have grown from $1.3 trillion in 2011 to around $1.8 trillion in 2012, this is a relatively a small portion (<2%) of the global banking assets. There is still significant headspace for continued growth.

The scale disadvantage means lower profitability for Islamic banks, but the stakeholders need to view this as critical investment in the continuing growth of the sector.

Ernst & Young, in their industry report for 2012[1], highlight that growth in Islamic banking will outperform conventional banking for some time to come, and believe the industry will pass the $2 trillion mark with ease in 2014.

A significant portion of this growth is attributed to the development of Islamic banking in the key markets of Malaysia, Saudi Arabia, Turkey and Qatar, accounting for over 80% of total Islamic assets.

In these markets the Islamic banks have the demographic advantage, with significant nascent demand for Islamic finance as well as a legislative framework that allows the Islamic banks to compete on a more level playing field with other banks.

In Malaysia Islamic banking now accounts for 20% of all banking assets, which has given the sector meaningful scale for profitability and competitiveness. Malaysia is a model often viewed as a success story by many other countries trying to establish mainstream Islamic banking.

The key message from the Malaysian example is drive for standardisation and product simplification.

In the UK Islamic banks have the advantage of being at the heart of the most advanced financial centre in the world. Industry stakeholders should therefore rightfully expect more innovation and product specialisation from the UK banks.

In my view there are three key areas that UK Islamic banks can leverage their advantage - in wealth management, in capital markets and in adapting Islamic contracts in specialist areas of financing.

Islamic wealth management is critical to the future growth of Islamic finance. The next steps for most investors in Islamic finance are to have pension products, insurance products, and various types of investment products to manage their wealth in a Shariah-compliant manner.

The need for diversification in wealth management portfolios demands access to a wide asset base.

Wealth management is a key area where UK Islamic banks are making a significant contribution to the industry, by developing new products and accessing international markets for their investment assets.

In respect of capital markets, most of the focus has been on sukuk issues, in particular by sovereigns and financial institutions (FIs) in the GCC and Malaysia.

In its relatively short life (around 7 years) sukuk has now matured into an acceptable fixed-income instrument with wide appeal to all fund managers.

In Malaysia there are more corporate sukuk issuances than in any other jurisdiction, a fact that has attracted many international players to tap the liquidity in the Malaysian market.

The UK Islamic banks are well positioned to offer the liquidity of the sukuk market to their UK and European clients who wish to utilize the international market for diversification of their funding base, or to finance their exports by accessing the local markets.

The projected growth in some of the economies with significant potential for Islamic finance - such as Saudi Arabia, Indonesia and central Asian states - should offer UK companies doing business good opportunities for sourcing Shariah-compliant funding.

In the UK financing market, many mid-cap companies continue to suffer from shortage of bank finance from the mainstream lenders. This puts banks with liquidity in an advantageous position to take market share.

UK Islamic banks with access to liquidity could deploy their balance sheets to establish their products in the current UK market. Bank of London and The Middle East (BLME) has been building on its product expertise to become an emerging player in the UK.

In the equipment leasing market, for example, leasing and hire purchase agreements can be easily adopted to an Ijara contract. Through standardisation of its Ijara product, BLME offers customers a real commercial choice in using a Shariah-compliant lease.

Ijara assets are an important asset class for Islamic banks because many FI sukuk issues rely on the pool of Ijara contracts that can be pledged as sukuk assets.

Other areas of specialised financing include adapting the Murabaha contracts to trade finance transactions, where the demand is for a short-term, fixed-price return, such as in financing inventory and sales of a business.

The UK Islamic banks don’t benefit from the scale of their counterparts in the main Islamic markets; but a targeted approach that allows them to play to their strength in the UK should put them in a strong position for continued growth in 2013.

Massoud Janekeh is the Director of Islamic Capital Markets at the Bank of London & The Middle East (BLME)
In 2012 sukuk products had a record year in the primary markets, with issuance totalling $139bn in 2012, a 64.1% increase year-on-year. We expect demand for sukuk to continue exceeding supply, though secondary markets will take time to deepen, owing to the sizeable number of investors still viewing sukuk as hold-to-maturity instruments as part of their overall portfolio allocation.

Ongoing political turbulence in the Middle East has not had a meaningful impact on primary markets, although the composition of new issuance in MENA is primarily from countries that have remained stable, mainly in the GCC. This will continue to be the case, as many of the countries impacted by the Arab Spring do not yet have laws in place governing the issuance of sukuk, despite interest by many Islamist governments that have come to the fore.

Sukuk issuance accelerated rapidly in the years leading up to the financial crisis, with a significant amount coming from quasi-sovereign or sovereign issuers, and a heavy concentration within the UAE (58% of total issuance in 2007).

The financial crisis was initially viewed as a vindication of Islamic finance over conventional finance by sector practitioners, with sukuk prices first holding up. However, contagion in the real economy soon ushered in a correction.

High exposure to the real-estate sector in Dubai sharply affected both sukuk issuance and prices. Dubai development companies were sizeable sukuk issuers (due to the “fixed asset” nature of real-estate), and the fall in the real estate market impacted sukuk negatively. The Dow Jones Sukuk index declined more significantly than the US investment-grade corporate or global bond market indices, and sukuk issuance dropped from $19.3bn in 2007 to $11.1bn in 2008.

A two-year historical analysis of emerging market (EM) bond prices versus MENA sukuk prices allows us to assess the price behaviour of the asset class relative to conventional EM bonds. We conclude that:

(i) Sukuk volatility is relatively low compared to EM debt, due to limited secondary market trading and the typically higher credit quality of issuers;

(ii) EM bond prices have been more sensitive to developments in the developed markets than...
MENA-issued sukuk have, whether through the different iterations of quantitative easing (QE) in the US, or the various episodes of the Eurozone crisis;

(iii) Political unrest and the Arab Spring have had limited impact on sukuk prices, though this is in part explained by the origin of most MENA issuers – the more stable GCC;

(iv) Demand for sukuk continues to exceed supply, leading many investors to view sukuk as hold-to-maturity instruments.

The upgrading and expansion of infrastructure will continue to be a cornerstone of government expenditure programmes in both the GCC and Asia. We believe infrastructure is a perfect fit for Islamic financing, with projects typically providing returns on hard assets, and stable long-term cash flows derived from the asset. This could, in conjunction with the MENA region’s sizeable infrastructure development plans, lead to a significant rise in sukuk issuance over the next five years.

In the GCC, infrastructure sukuk represented a total of 30% of total sukuk issuance in 2012H1, versus 7% in the whole of 2011. Also, at a time when banks are shortening the tenors of their issuance to comply with Basel III maturity guidelines, the long tenor of infrastructure sukuk should enhance investor interest for this asset class. Furthermore, the Saudi infrastructure boom will continue to provide attractive investment opportunities in the sukuk market, as civil authorities (such as public ports and airports) choose to issue Islamic bonds in order to fund expansion.

Given the growing populations of the MENA region as well as those of other Muslim countries such as Malaysia, Indonesia, Pakistan and Turkey, and assuming a three percentage point increase in the portion of the Muslim population that uses Islamic banking, the client base would increase from 192 million in 2010 to 440 million by 2030.

This trend is accentuated by the fact that populous Muslim countries are generally under-banked. Only 22% of Pakistan’s population, for example, owns a bank account.

We are also of the view that banks in Abu Dhabi, Qatar and Saudi Arabia are likely to use sukuk to bridge the gap between rapid credit growth and slower deposit growth.

Dr Florence Eid is CEO and chief economist of Arabia Monitor.

Waleed Shoukry is the Head of MENA Credit & FX Strategy.

Said Benmehidi is an Analyst.

Supplied image
Stock Markets

**GCC**

Buoyed by global benchmarks, Gulf markets sustained an uptrend in January, with momentum ahead of Q4 corporate results and the most awaited dividend season of the year. Towards the end of the month the rally was given further impetus by investors seeking to join in after the mid-month pause.

Saudi Arabia’s Tadawul index, representing virtually 50% of GCC market capitalization, was boosted especially by a clutch of tourism projects and the associated flow of investments into the country.

The UAE bourses stood out. Dubai led the way, up over 15%, upon rebounding real estate, and the tourism sector again, with impressive airport traffic numbers. The banking sector also showed signs of revival, as Abu Dhabi’s banks notably posted robust numbers.

Kuwait’s index reflected a period of calm having settled politically, and the rolling out of economic development plans, epitomizing a regional sense of newfound optimism. Qatar’s participation in this mood related also to the relative generosity of its companies’ dividend payouts.

Oman’s market trod water by comparison, while Bahrain’s index was lifted modestly by an unexpected outlook upgrade from S&P from negative to stable.

Overall trading activity across the GCC region rose by 174% month on month.

Sources: Markaz, GIH, Al Masah Capital

**MENA**

Following the sharp run-up in December, Mena markets were more subdued in January.

News was dominated by Egypt again, two years on from the revolutionary uprising in 2011. Political disturbances in the form of protests, violence and states of emergency hampered sentiment, but nevertheless did not prove a significant deterrent to overseas interest in the longer-term outlook for the economy, deemed positive. Trade was sluggish, and domestic investors were marginal net sellers, but other Arab and non-Arab portfolio flows had an offsetting effect. Fitch Ratings cut Egypt’s sovereign rating in the last week of the month.

The regional index was restrained particularly by the retreat of Turkish stocks, which reacted badly to the decision of the Moody’s credit rating agency not to upgrade Turkey as had been anticipated. The country’s financial fundamentals appear overstretched, with concerns for the structural condition of the current account deficit and private...
sector’s external borrowing.
Sources: Reuters, Bloomberg, Bank Audi, BlomInvest

Far East
Asian stocks mostly rose on the month in reflection of improving developments in the world economy, denoted by data releases in the US and China especially, but also in Europe, notably Germany. Favourable Chinese manufacturing and trade data combined with US corporate earnings figures to boost regional markets generally.

Singapore and Taiwan were restrained, however, by reaction to China’s latest inflation statistics. Having reached a two-year high, Singapore’s index slumped also upon sweeping measures locally taken to put a dampener on the property market, driven to record highs with speculative support.

An influx of foreign interest, against the optimistic outlook globally, was responsible also for rising indices in Thailand and Indonesia.

The distinct exception was Malaysia, where, having completed four years of annual gains, and reached a record high in early January, the market plunged upon the prospective dissolution of parliament, with elections in March potentially easing the government’s grip. To this point Malaysia has been perceived as a reasonable proxy for the China growth story, as well as feeding off a national construction programme.

Sources: Reuters, Bloomberg

Rest of the World
January marked a noticeable uplift in benchmark stocks, and signs of a rotation away from bonds upon increased confidence towards risk assets.

The apparent passing of danger in respect of the US fiscal cliff and a Chinese hard landing led to a decisive shift in sentiment, validated by a range of economic data in both countries. The 5.9% climb of the Dow Jones Industrial Average was its best monthly outcome since 1994, with earnings announcements mostly exceeding expectations.

Japan’s index led gains in the Asia-Pacific region, aided by a sharply declining yen, induced by the incoming administration’s stated policy commitment. South Korea’s index fell back in light of that competitive threat. Bombay’s Sensex index, the best performing among the BRIC economies in 2012, continued strongly into 2013.

With inflation easing to its lowest for three years, the central bank chose to reduce repo rates and the banks’ cash reserve ratio.

Sources: Reuters, Bloomberg, Markaz, Emirates NBD
Islamic or Shariah compliant indices exclude industries whose lines of business incorporate forbidden goods or where debts/assets ratios exceed 33%. The increasing popularity of Islamic finance has led to the establishment of Shariah compliant stock indices in many stock markets across the world, even where local Muslim populations are relatively small, such as in China and Japan.

### Islamic Stock Indices

<table>
<thead>
<tr>
<th>Country</th>
<th>Index</th>
<th>Price</th>
<th>MTM Change (%)</th>
<th>Volatility (%)</th>
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Evolution of Islamic Stock Markets in January 2013 for GCC, Far East, Middle East North Africa (MENA) and Rest of the World markets. Prices represent the closing price of the respective index at 31/1/2013. Percentage Month-to-Month (MTM) Change and percentage Volatility. Source: Datastream

### Conventional Stock Indices

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<tr>
<th>Country</th>
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<th>Price</th>
<th>MTM Change (%)</th>
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<td>Taiwan SE Weighted</td>
<td>7,830.02</td>
<td>1.94</td>
<td>0.70</td>
</tr>
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<td>Straits Times Index</td>
<td>3,282.06</td>
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<td>PSEI index</td>
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<tr>
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<td>Bank of Malaysia KLCI</td>
<td>4,433.70</td>
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</tr>
<tr>
<td>South Korea</td>
<td>Korea Composite Index (KOSPI)</td>
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<tr>
<td>Japan</td>
<td>NIKKEI 225</td>
<td>11,138.66</td>
<td>1.91</td>
<td>1.91</td>
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<tr>
<td>South Africa</td>
<td>FTSE/JSE All Share</td>
<td>40,482.92</td>
<td>3.09</td>
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</tr>
<tr>
<td>Hong Kong</td>
<td>Hang Seng</td>
<td>23,729.53</td>
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<td>India</td>
<td>BSE (100) NATIONAL</td>
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<td>0.58</td>
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<tr>
<td>China</td>
<td>Shanghai SE A Share</td>
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<td>S&amp;P 500</td>
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<tr>
<td>UK</td>
<td>FTSE 100</td>
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<td>France</td>
<td>CAC 40</td>
<td>3,732.60</td>
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<td>DAX 30</td>
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<td>Spain</td>
<td>IBEX 35</td>
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</tr>
<tr>
<td>Portugal</td>
<td>PSI 20</td>
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<td>1.02</td>
</tr>
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<td>Italy</td>
<td>FTSE MIB</td>
<td>17,439.06</td>
<td>6.92</td>
<td>1.13</td>
</tr>
<tr>
<td>Greece</td>
<td>Athens Composite</td>
<td>986.76</td>
<td>3.33</td>
<td>1.50</td>
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</table>

Evolution of Stock Markets in January 2013 for GCC, Far East, Middle East North Africa (MENA) and Rest of the World markets. Price represent the closing price of the respective index at 31/1/2013. Percentage Month-to-Month (MTM) Change and percentage Volatility. Source: Datastream

Volatility is a measure of uncertainty of market returns. It is calculated as the standard deviation of the returns in the reported month. The formula for the standard deviation is: $\sigma = \sqrt{E[(X-\mu)^2]}$.
Commodities

Oil
Oil maintained a gently upward tack in January, Brent crude averaging $112 and breaching $115 by month-end. Prices were motivated by a combination of better demand indicators and lower supply estimates. On the demand side, imports were strong from China, and a cold snap in the US promoted the use of heating oil, besides the various, although modest, indications of global recovery. On the supply side, the IEA reported Saudi Arabia and Iraq had restricted output, and geopolitical risk arose in Africa, apart from ongoing concerns in the Middle East. Rising US crude inventories, and a restrained IMF world economic forecast, checked the uptrend. WTI’s discount to Brent narrowed slightly upon the easing of production and bottleneck issues, notably the return of the Seaway pipeline.

Sources: Banco Itau, OPEC, Commodities Weekly Trader

Natural Gas
Movements in the Henry Hub natural gas index were essentially sideways in January, having dipped sharply in December. Prices are prone to fluctuate in line with US weather forecasts. Normal winter weather, though including colder conditions in the West, meant that weak market fundamentals and high inventories kept prices mildly defensive. The same factors dominate the short-term outlook, while the positive impact of coal-fired generation on natural gas demand is a longer-term prospect.

Sources: OPEC, Reuters

Gold
The generalized rally in commodities omitted gold last month, and helpful speculative forces dropped out. In particular, signs of an improving macroeconomic outlook globally took the shine off the metal’s appeal as a haven in crisis. An announcement by the European Central Bank that eurozone banks would be repaying cheap loans that had helped in the region’s bailout arrangements added specific weight to the general sense of upturn from economic data in the US, China and others. India, the largest bullion consumer, more than doubled its import duty on gold alloys in an effort to curb its current account deficit.

Sources: OPEC, Markaz, Reuters
Copper/Base Metals

Improving global economic conditions provided a positive backdrop for copper and other base metals last month, although news was not so uniformly encouraging as to sustain speculative support. Profit-taking was seen in a market described as lacking conviction, notably as copper breached a technical level at $8200 per metric tonne. Data from both the US and China, the world’s largest copper buyer, suggested rising demand ahead, while there was evidence also of some short-covering in what was becoming a ‘risk-on’ environment. On a fundamental supply and demand basis, a degree of uncertainty over output continued to give underpinning, with miners facing higher production costs from energy prices and lower grades. Iron ore jumped over 20% in price on the month as Chinese mills rebuilt inventories.

Sources: Banco Itau, Financial Times, Reuters, OPEC

Sugar/Agriculturals

Sugar was substantially down in January owing to investors’ expectations of a bumper crop from leading producer Brazil. Strong output figures also from China implied reduced imports, adding to awareness of surplus global stocks. Speculators chose to exit long positions. Record US output pointed to the need for government to hold stockpiles to support farmers. Later in the month sugar perked up upon reports that millers in Brazil may direct more cane towards ethanol in the wake of a gasoline price hike. Softs generally were flatish on the month, though grain was lifted by a USDA report showing improved demand.

Sources: Banco Itau, OPEC, Reuters, Bloomberg

Vegetable Oils

Palm oil moved higher anticipating that Malaysian exports will probably increase, helping clear stockpiles, as Indonesia set higher taxes on February exports. A projection suggesting higher soybean demand than previously thought provided basis for a rally, with dry weather also hampering output in Argentina. Palm oil was expected to benefit from its discount to soybean. Meanwhile, it was reported that China’s oilseed imports would rise to a record level for the current year to September.

Sources: Banco Itau, Bloomberg, Reuters
Gold has been the uber-asset class of the last ten years – the trade of the decade, some say. It has appreciated nearly 500% since 2000. However, since September last year it has dropped $200. So is gold the washed-up starlet of the financial world?

To answer that we have to look at gold’s attributes, and find out whether or not they are still valuable to today’s market. The first thing to look at is the inflation hedge.

Apart from the UK, where inflation is likely to run high for some time, inflation pressures elsewhere are mostly contained. In the Eurozone, ECB President Mario Draghi is actually worried that a strong euro could cause deflation. In Japan, the government and Bank of Japan are trying their hardest to stoke inflation as the economy is now dealing with deflation and price declines. In the US, inflation pressures have been fairly benign.

Importantly, wage inflation across the Western world has remained fairly moderate since the financial crash five years ago. Even in the fast-growing BRIC economies, like China, inflation has trended lower in recent months.

The West, particularly the Eurozone, the world’s largest economy, is in deleveraging mode. People and governments need to cut their debts dramatically in the coming years. This is a multi-year process which should keep inflation pressure at bay for the foreseeable future. No price pressures equals no need to own gold.

Some argue that inflation could get out of control owing to the liquidity being pushed into the global economy from central banks’ asset purchase programmes, which should keep gold bid. However, the link between quantitative easing (QE) and inflation is not that simple.

QE in the US and the UK, for example, may have kept bond yields low and had a big impact on financial markets, yet it has not had a big impact on the real economy. The US is still not creating enough jobs, and the UK is on the cusp of a triple-dip recession -- even though their central banks have had the monetary taps running on full flow in recent years.

Even the Euro 1 trillion of bank liquidity that the ECB pushed into the European financial system at the start of 2012 hasn’t helped credit conditions especially in the troubled periphery.
The problem for gold is that deleveraging means scaling back, sluggish growth and no inflation.

In this environment there are very few reasons to buy gold. Some buy it to protect against inflation, others to hedge against currency de-basement in an age of quantitative easing -- and of course a lot of people buy it to wear it. Other than that, and for a very few industrial uses, people don’t really need to own gold.

Would you want gold bars lying around your house? Probably not, they are heavy, need polishing and would mostly get in the way.

We could be in an anti-gold era. Loose monetary policy and QE, far from increasing the attractiveness of gold, may actually put people off it even more.

QE and asset purchase programmes have depressed government bond yields, traditional sources of income for some investors, to such an extent that the market is now hungry to hold an asset that pays them something.

Gold yields nothing, so investors have instead moved into dividend-paying equities and high-yield debt to try and “earn” something from their investments after a number of lean years. The reasons not to hold gold are compelling, which is why buyers for the yellow metal have dried up. To make matters worse, gold bugs may be using their holdings in the precious metal as an ATM. They cash in on some of their profits to move into other assets that are trending or looking attractive – as mentioned above, this includes equities and high-yielding debt, but it could also include other metals.

In contrast to gold, base metals have had a strong rally since the summer of 2012, as the global economic outlook has improved and the Eurozone sovereign debt crisis started to stabilise.

The Bloomberg base metal index is close to 12-month highs, while gold is close to 12-month lows. Base metals may not sparkle or reflect the light like gold, but they have one key attribute the yellow metal is missing – they are useful.

People need base metals. Zinc, copper and aluminium may not have the glamour of gold, but they play into some of the most exciting global financial themes of the next ten years, including a pick-up in global growth, the end of the sovereign debt crisis in Europe, and the continued rise of the middle class in India and China.

Gold’s best days may be behind it, for now. Its cheaper cousins could be about to steal the limelight.
Bonds and CDS markets

GCC

GCC bonds seemed to come virtually to a halt in January, perhaps turning a corner, while ending the month roughly flat, biased to the downside. A notable rally at the start, in response to relief over the US fiscal cliff and a swathe of reports indicating recovering growth in the US and elsewhere, gave way to a period of consolidation, and then to a negative bias in response to a tidal shift out of US Treasuries. The majority of the market was looking for opportunities to sell, or became camped on the sidelines. Amid generalized weakness, however, pockets of strength remained for certain names, such as Kipco, Burgan Bank and Bahrain. Investment grade outperformed, while there was a degree of tightening still in CDS spreads.

Sources: GIC, Invest AD, Bank Audi

Egypt / MENA

Mena news was led by the tumultuous events in Egypt. Besides the shifting sentiment affecting bond markets generally, Egyptian sovereigns slumped in conjunction with the unrest that returned to the country. The second anniversary of the uprising in January 2011 coincided with severe political tensions that suggested that crisis could linger near the surface. Fitch’s downgrade towards the end of the month added to the downward pressure. The agency’s negative outlook focused on the stresses in the budget finances and foreign exchange reserves, and evident societal divisions. Five-year CDS spreads rose by over 100 basis points (bps) to 550 bps.

Sources: Bank Audi, Fitch Ratings

Malaysia / Far East

While Malaysia’s attractions remain, with fundamentals that rivals may envy, its bonds nonetheless reflected January’s turnaround in global benchmarks once the initial benefit of resolved debt talks in the US had lapsed. Malaysia has a relatively liquid market compared to Indonesia and Thailand, and exempts foreigners from tax on bond earnings. The current account exceeded 10% of GDP last year, and a growth rate of around 5% is expected in 2013 on the back of a $400bn infrastructural development programme. Analysts noted the poor outcome of Asian emerging market bonds on the month, but believe the dynamics remain for outperformance.

Sources: Bloomberg, BPA Malaysia
Global Benchmarks

Mixed feelings were evident in the key government bond markets in January. Any relief felt over the avoidance of the US fiscal cliff was rapidly overtaken by the sense that economic recovery might gain pace. The safe haven aspect of Treasuries weakened in the face of better economic news, including in China. Europe’s difficulties appeared also to recede, with support growing for the peripheral names like Spain, Portugal and Ireland, with the pledge of a backstop from the ECB. Investors were willing to engage with riskier exposure in pursuit of higher income. The weight of additional issuance from Asia was thought to help keep the global tone defensive, while the attitude of US traders was that Treasuries might range-trade at best in uncertain, directionless trading.

Sources: GIC, Invest AD, Markaz

Sovereign Bond Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Price (%)</th>
<th>MTM Change (%)</th>
<th>Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>137.94</td>
<td>1.97</td>
<td>3.63</td>
</tr>
<tr>
<td>Qatar</td>
<td>363.94</td>
<td>-0.61</td>
<td>2.41</td>
</tr>
<tr>
<td>Egypt</td>
<td>221.01</td>
<td>-2.55</td>
<td>6.88</td>
</tr>
<tr>
<td>Tunisia</td>
<td>230.47</td>
<td>4.06</td>
<td>5.03</td>
</tr>
<tr>
<td>Jordan</td>
<td>97.51</td>
<td>0.57</td>
<td>4.84</td>
</tr>
<tr>
<td>Lebanon</td>
<td>524.84</td>
<td>1.01</td>
<td>5.00</td>
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<tr>
<td>Thailand</td>
<td>194.22</td>
<td>2.14</td>
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<tr>
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<td>Singapore</td>
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<td>0.99</td>
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<td>Malaysia</td>
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<td>China</td>
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</tr>
<tr>
<td>Turkey</td>
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<tr>
<td>Spain</td>
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<td>France</td>
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<td>Germany</td>
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<tr>
<td>UK</td>
<td>1048.70</td>
<td>-4.57</td>
<td>1.93</td>
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</table>

Evolution of Bond Markets in January 2013 relative to the previous month. The table reports the price index on which the MTM Change is calculated (month-to-month) and the Yield of sovereign bond maturities typically between 6 months and 25 years. Data as at 31/1/2013.

Credit Default Swap Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>CDS Spread (bps)</th>
<th>MTM Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>190.89</td>
<td>-6.00</td>
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<tr>
<td>Qatar</td>
<td>71.35</td>
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<td>69.30</td>
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<td>Dubai</td>
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<td>Abu Dhabi</td>
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<td>Egypt</td>
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<td>14.75</td>
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<tr>
<td>Thailand</td>
<td>99.06</td>
<td>9.79</td>
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<td>Indonesia</td>
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<td>Malaysia</td>
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<td>India</td>
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<td>China</td>
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<td>Portugal</td>
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<td>Spain</td>
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<td>France</td>
<td>84.92</td>
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<td>UK</td>
<td>50.77</td>
<td>23.18</td>
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</table>

Evolution of CDS Spreads in January 2013 relative to the previous month. The index reported here represents the average basis points (bps) of a 5-year CDS for protection against sovereign bonds. Data as at 31/1/2013. MTM Change refers to the change relative to the previous month.
Islamic Bonds (Sukuk)

Traded sukuk retreated in January upon the distinct change of mood towards debt markets. Initial resilience was overtaken by a shift into risk assets with stronger economic data out of Asia, good signs from the US corporate reporting season, and the ECB reporting that many troubled banks would accelerate repayments of emergency loans.

The apparent rotation of investor allocations from fixed-income to equities, marked by the sell-off in US Treasuries, put GCC sukuk under pressure, and they led the declines among emerging-market Islamic bonds. For example, the yield on Dubai’s notes due 2014 rose 15 basis points, the most in over a year.

That said, Asian dollar sukuk underperformed Gulf bonds, as investors switched in search of higher yields. Suspecting that the local rally had passed, brokers said there were really no developments signifying fundamental change, and that credit quality in the Malaysian and Indonesian space would encourage a rebound.

Nevertheless, the quest for income was set to become a lasting theme, considering the dedication of the world’s key central banks to retain an extremely accommodative monetary stance to support sluggish economic growth. In the case of Dubai, the signs of real estate recovery have provided a particular boost to investor interest.

According to HSBC, global Islamic bond sales should exceed the 2012 record this year, surging to $30-35bn in 2013, as Gulf issuers especially tap reduced borrowing costs. The government of Dubai sparked that action in January with $750 million of 10-year Islamic notes, its borrowing costs having dropped 40%.

The sukuk market may grow by around 30% this year, buoyed by sovereign issues that will continue to dominate, with the emergence of new countries, Kuwait Finance House (KFH) has advised. Slow economic growth in Europe, for instance, has led to capital flows to the developing world and into alternative investments.

Sukuk is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds. Since fixed income, interest bearing bonds are not permissible in Islam, Sukuk securities are structured to comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.
Malaysia, home to the world’s largest Islamic debt market, is also due for growth this year, alongside the rest of the Asia Pacific region. Moreover, others such as Turkey, Hong Kong and Australia might also be seen coming to the market.

So far, however, data from Bloomberg showed sales down in January. Some 90% of issuance in the month was Malaysian. Liquidity remains an issue, both in domestic and cross-border markets. Deals have sold quickly to buy-and-hold investors, so the volumes viewed in conventional markets are not matched in the Islamic counterpart.

Apart from Dubai’s offering, Malaysia’s Sime Darby international deal made a splash. Its issuance of five- and ten-year sukuk, for a total of $800m at record-low yields, was seized on as potentially opening up the local Islamic market to international investors. The conglomerate’s foray into the sector was oversubscribed tenfold, for listing on the Kuala Lumpur and Singapore exchanges.

Until now the majority of issuances in Malaysia have been ringgit-denominated, particularly on the corporate side. Another evolution is that some past sukuk structures in Malaysia have not been viewed as Shariah-compliant by other countries, whereas now Gulf investors are paying closer attention, following efforts by the Malaysian government to introduce measures promoting acceptance of its sukuk structures, a multi-currency sector and attracting more foreign investors.

To some fanfare, Malaysia has also launched its first Shariah-compliant retail bond, for DanaInfra Nasional Bhd, government-guaranteed, to fund the first phase of the Mass Rapid Transit (MRT) project. The prime minister declared “Malaysia now accounts for three-quarters of the global sukuk market, and we are a hub for issuing, trading, regulation, standards, marketing and training.” He spoke further of making sukuk part of the global investment mainstream.

January also saw a debut SR1.5bn issue from Savola Group of Saudi Arabia.

Sources: GIC, Bloomberg, Emirates NBD, Financial Times, Zawya
Accountancy Issues Rules and Regulations

Mixed takaful rules impact profit margins

The takaful sector, which has its core markets in the Gulf and South-East Asia, is attracting consumers of Islamic finance products. However, the slowing growth in core markets is raising pressure on the sector to boost profits.

Inconsistent regulation across the Gulf’s takaful (Islamic insurance) industry is adversely affecting profit margins and credit ratings, and hence allowing regulatory arbitrage. It seems that jurisdictions for takaful rules in different countries - including the UAE, Bahrain, the Dubai International Financial Centre (DIFC) and Qatar Financial Centre (QFC) - still do not provide specific regulations.

Global takaful subscriptions were expected to reach $12.4 billion in 2012, but profitability remained below that of conventional insurers, according to a report by Ernst & Young last April.

The regulatory environment is complicated by the relative youth of the takaful industry. Other regulatory safeguards, such as ring-fencing assets, have yet to be tested.

Source: Reuters, February 12th

Qatar and Turkey cited as most tax-friendly

As reported by International Advisor and based on a study sponsored by the QFC, Turkey and the QFC have the most Islamic finance-friendly tax systems out of eight countries in the MENA region. This study was conducted by three tax experts in partnership with the International Tax and Investment Centre (ITIC).

The study reviewed the tax treatment of four common Islamic finance structures (commodity murabaha, sukuk, salaam and istisna) in eight MENA locations: Egypt, Jordan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Turkey, and QFC. Its results showed that while simpler Islamic finance transactions can be carried out in some countries without prohibitive tax costs, of the countries reviewed only Turkey and the QFC have a tax system that enables sukuk transactions to be carried out without excessive tax costs.

The report is the first of a series, and extended studies will cover issues related to the impact of consumption taxes such as Value Added Tax on Islamic finance transactions, the cross-border treatment of Islamic finance transactions within international double tax treaty arrangements designed primarily with conventional finance in mind, the Zakat treatment of Islamic finance transactions, and the Shariah governance framework for Islamic finance.

Other countries in the MENA region may be reviewed in subsequent reports.

Source: Global Islamic Finance, February 19th

Islamic banking helps meet capital adequacy rules

It has been reported that, with credit rating downgrades under Basel III raising the interest rates that have to be paid on bonds, banks need to consider Islamic financing as an alternative to meet the added capital requirements of new regulations.

According to Ernst & Young’s World Islamic Banking Competitiveness Report 2013, Islamic banking assets held by commercial banks worldwide are expected to exceed $1.8 trillion this year, a 38% increase compared with $1.3 trillion in 2011. While capital requirements are onerous, sukuk provide an opportunity for banks to raise capital ratios and meet regulatory capital requirements.

It is expected that raising funds through Islamic bonds is on a persistent increase. Therefore, it is reasonable to suppose that sukuk may be relied on intensively by Islamic banks during the coming months, complying with Basel III as conventional banks would.

With Islamic banking rules converging to conventional accounting and capital rules, GOLCER’s view is that still the profitability of Islamic banking might lag behind that of conventional banking, especially with the long transformation period required between the two systems and the passage of new laws to support this transition.

Source: Global Islamic Finance, February 20th
Perspective

The investment dogs that may follow reflation’s dogged pursuit

by Andrew Shouler

Has debt had its day, in market terms? That’s shorthand for asking whether the great rotation that has seemingly taken hold of the key asset classes, i.e. from bonds to equities, has brought a belated halt to the tidal advance of US Treasuries and other related stock.

The pendulum did swing a tremendously long way towards sovereign credits and all others related to it, promoted so determinedly by state authorities through the application of monetary easing to keep yields down, a process not over yet.

Now that signs of global economic recovery have appeared, convincing or otherwise, investors were prepared last month to ditch these supposed safe havens and make sure they didn’t miss out on the upswing, with its implications for corporate earnings.

This bulletin has documented the effect on bond markets around the world, including the sukuk arena, while finding reasons to think that those regions exhibiting decided financial surplus, essentially broader Asia, have a cushion that may protect against declining benchmarks.

Whether governments and central banks at the helm of reflationary efforts can possibly find a path between deliberately deflating their accumulated debt burdens and avoiding a decisive reversal in sentiment that would drive interest rates crippling higher is a thoroughly moot point.

As the protagonistic precursor to the global financial crisis, the charge into borrowing for property speculation was a common phenomenon. In the Gulf, for instance, the readiness of similar backing for stock market participants was present too.

Today, when the nature of that artificial boom is so evident, it is extraordinary that learned commentators can convince themselves, and attempt to convince others, that a lingering bust can be avoided and deleveraging shunned.

It’s as if infinite recourse to indebtedness, and its remarkably magical but repeatedly unproven powers, means never having to say you’re sorry. Far from it, in fact. It means you can continue to promise results unlikely ever to be fulfilled. Likewise recourse to the printing press.

That argument chimes with the idea that the West is only in deficit because the East is in surplus, or that public deficits exist only because the private sector is in financial surplus. Redistribution is all that’s needed for a virtuous circle to get under way.

Truisms of national accounting aren’t instructive, however. Not an argument for recycling so much as for allowing exchange rates to reflect market forces and ease those imbalances. In the event, talk is of official manipulation and currency wars instead.

Asymmetric dedication to reflation on the basis of imprecise output gaps won’t pay the mounting bills, unless the theoretical multipliers of committed fiscal bias are suddenly to be far greater than history says. With national debt ratios already high, it is not retrenchment that is the dangerous experiment.

Clearly, too, low interest rates are not an indefinite panacea, even for investment returns. Fund managers, though, tend not to be in favour of cash. We don’t need them just to deposit savings and watch the bank’s liabilities steadily erode in real terms.
Diary of Events

March: 11-13, 2013
Lahore, Pakistan
Global Forum on Islamic Finance (GFIF) 2013

COMSATS Institute of Information Technology Lahore, Pakistan is hosting Global Forum on Islamic Finance with the collaboration of Lancaster University UK to provide an opportunity to share latest developments among scholars from around the globe in the field of Islamic finance. The theme of the Conference is “Islamic Finance: New Realities, New Challenges”. The GFIF will consider the political and socio-economic developments and their likely effects on Islamic financial institutions.

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March: 17-18, 2013
Muscat, Oman
Oman Second Islamic Banking and Finance Conference

Oman Second Islamic Banking & Finance Conference is to take place on the 17th & 18th of March 2013 at the Al Bustan Hotel in Muscat, to shed light on latest developments in the banking industry of the Sultanate and explore outlook and challenges of implementing Islamic banking.

Contact: OIBF@iktissad.com
More Information: [http://www.iktissadevents.com/events/OIBF/2](http://www.iktissadevents.com/events/OIBF/2)

June: 26-28, 2013
Nottingham, UK
5th International IFABS Conference

This year, IFABS will be celebrating its 5th Anniversary in Nottingham at the East Midlands Conference Centre. From the 26th -28th June, experts from over 60 countries around the world will come together in this historic city to consider, collaborate and create ideas and solutions for the coming years. More information and a call for papers (deadline is March 15) can be found online.

Contact: Ms Sandra Hopkins: IFABS2013@le.ac.uk

Training Courses:
GOLCER Training Courses in Finance, Management and Statistics: