From the Editor

It may be that time is catching up with global stock markets. Uncertainty has been developing over just how far the US Federal Reserve can sponsor not only the elevation of American financial assets but also those overseas, which seem to have relied on the rocket fuel of quantitative easing and international funds flows to invigorate local sentiment.

Bond markets have already decided that tapering of stimulus is imminent, and/or inflation due, with economic recovery seemingly in the US system, if not so obvious elsewhere. Sukuk activity consequently has been evident more in primary issuance rather than any buoyancy in secondary trading. Commodities such as copper are signalling only modest expectations of GDP growth.

Apart from our usual round-up of Islamic finance news, this month we feature an in-house discussion of the tension between the many financial centres that wish to compete for the business of Islamic finance, not all of which can turn out to be hubs! While many in the industry are calling for harmonizing standards, the sector’s key motivating force seems to be for chasing market share.

Additionally, our guest article provides the explanatory viewpoint of legal firm Norton Rose Fulbright as to how Islamic finance can bring solutions to the problem of the lack of financial provision in key pockets of the world economy since the credit crunch. The transport sector needs, and in certain cases especially wants, to tap into Shariah-compliant liquidity to keep its businesses moving with momentum.

Contents

HIGHLIGHTS (p.3)
RECENT DEVELOPMENTS (p.4)
VIEWPOINT (p.7)
FEATURE (p.10)
STOCK MARKETS (p.14)
COMMODITIES (p.17)
BOND AND CDS MARKETS (p.20)
PERSPECTIVE (p.23)
DIARY (p.24)
Global stocks: Equity markets, like bonds, have become devoted to the pronouncements of the US Federal Reserve, hitting record levels in the States as the central bank’s monthly monetary stimulus has been prolonged since mid-year doubts arose. While a sweet spot has been found for American stocks, however, owing to a certain amount of recovery in key data series, the rest of the world appears unduly dependent on the liquidity surge. Soul-searching by policymakers in Europe, China and Japan, amid uncertain economic outlooks, has kept sentiment in the balance.

Islamic finance hubs: London’s pitch at the World Islamic Economic Forum for a leadership role in Islamic finance was marked by the much-awaited announcement of a sovereign sukuk, and the creation of a new Shariah-compliant stocks index. It represented another stepping up of the competition for the sector’s increasing business worldwide, which has seen several of the Gulf countries asserting their potential for hub status, without much sign of the collaboration that many feel is necessary for the industry’s improved development. Malaysia, meanwhile, continues to set the pace.

Asset finance: The global financial crisis to some extent hollowed out the available sources of funding to back the recovery in the world economy, whether in domestic business activity or the vital component of international trade. Norton Rose explains how Islamic financing is well suited to the big-ticket transactions that feature in the transport sector, notably in shipping and the airline industry, considering the critical presence of the real assets involved. However, deals have to be structured in ways that match Shariah-compliance with the realities of conventional practice.
Recent Developments in the Islamic Finance Industry

UK’s milestone steps in Islamic finance

Last month saw London heighten its appeal to the Islamic finance industry. It was marked by the World Islamic Economic Forum event, where UK Prime Minister David Cameron took the opportunity to announce initiatives involving the financial district, the City of London, in this industry currently expanding, as the premier noted, at a 50% faster rate than conventional banking.

It was unveiled that the UK Treasury is working on an Islamic bond (sukuk) that will raise about £200m ($320m), probably to be launched in 2014. Britain will be the first country “outside the Islamic world” to use this approach, and the London Stock Exchange will be launching new stock indexes of firms whose business is consistent with Islamic principles.

Prime minister Cameron identified clearly that the UK’s ambition today is to go further still; not just to be ranked as a great centre of Islamic finance in the Western world but to stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance globally.

This announcement on sukuk reverses the position taken by the UK’s Debt Management Office earlier this year, whose CEO stated that offering Islamic bonds is “not going to be value for money”, and that something would need to change before Britain would shift its view. However, the details of the sovereign issue have not yet been settled.

Source: Bloomberg, BBC, October 29th

GOLCER recalls that this is not the only initiative by a Western country in Islamic finance. For example, in 2004, the German federal state of Saxony-Anhalt issued $123 million in Islamic bonds, attracting investors from Saudi Arabia as well as the US, UK, Germany, Japan and Hong Kong. However, Cameron’s statements could be viewed as signalling serious intent, particularly as to the issuance of a sovereign sukuk. Many countries have already used this method to raise funds, e.g. Indonesia, Malaysia and Turkey. Issuing Islamic bonds and listing them on the London stock exchange would surely add to the wider global acceptance of Islamic finance trading in Europe. The decision is also consistent with the recent efforts of the Chancellor of the Exchequer (finance minister) George Osborne to promote London as a centre for trading in China’s currency, reasserting its internationalist reputation. GOLCER believes that the UK’s interest is largely a political and business-generating move, seeking to make London a major Islamic banking centre.

Hong Kong follows UK to offer sukuk

Representing a response from the global stage to the UK’s reported interest in Islamic banking, Hong Kong has also announced plans to sell a debut sukuk and so spur its development as an Islamic finance hub. The province will make the issuance under the Government Bond Program, but no further details were provided about the size of the planned sale or its timing. This July Hong Kong granted sukuk equal tax treatment relative to conventional counterparts in response to the apparent demand for bonds that comply with Islamic principles. Ernst & Young has estimated that outstanding global issuance of sukuk will triple to $950 billion by 2017.

Source: Khaleej Times, November 12th
GOLCER finds this to be an interesting response to the UK’s venture into global Islamic finance industry penetration. No doubt this initiative by Hong Kong, as a gateway to mainland China, will add support to the sector and provide an additional dimension to the competitiveness that Islamic banking is currently gaining, especially this year, against conventional counterparts. GOLCER thinks that Hong Kong’s issuance of sukuk will be closely watched as an example by other countries in the region.

**Oman property developer sells first sukuk**

Omani real estate developer Tilal Development Co. has sold the country’s first Islamic bond, a 50 million rial ($130 million) sukuk. This issuance, which may pave the way for similar attempts by other companies in Oman, has a five-year tenor and profit rate of 5%, and is based on an Ijarah structure (a leasing arrangement commonly used in other Islamic markets).

Source: Reuters, November 5th

GOLCER interprets this as a belated step taken by Oman towards Islamic banking, given that the country is one of the six states of the Gulf Cooperation Council, a prominent region for the sector. It has taken the government a long time to lay plans to issue sukuk, which is now reported to be scheduled for next year. It is unusual for a government to allow a corporate sukuk to be issued before the first sovereign sukuk.

UAE establishes a new body to oversee Islamic finance

The UAE is working on creating an independent authority by the end of this year to be specialized in supervising the country’s Islamic finance industry.

This will be backed by specific legislation, as confirmed by the central bank governor. It will also entail a Shariah authority or Shariah board to be established outside the central bank. The UAE also announced the issuance of a new law in the new year seeking to support this approach. The main aim is to mitigate problems generated among different Shariah boards’ interpretations of Islamic financial institutions’ practices. These have resulted over several years in some forms of inconsistency as well as conflicts of interests among the boards’ members.

Source: Arabian Business.com, November 1st

GOLCER identifies this centralised approach as necessary, despite the country’s existing massive dominance in Islamic banking, alongside its announced plans during the last few months for an expansion of sukuk issuance. A concerted approach has been well applied globally in the case of Malaysia especially, and has shown some proven success in standardizing industry practices as well as promoting public trust.

Kazakhstan renews its Islamic finance ambitions

The new head of Kazakhstan’s central bank has indicated hopes for the development of Islamic finance in the country, which will soon have a sovereign credit rating from the Bahrain-based
Islamic International Rating Agency. Kazakhstan is also launching its first Islamic leasing company. These moves could herald a new start for the industry, in the words of a board member at the multilateral, Jeddah-based Islamic Development Bank. Abu Dhabi-based Al Hilal Bank is the sole Islamic bank in Kazakhstan, having opened its doors in March 2010.

Source: Reuters, October 31st

While about 70% of Kazakhstan’s population of 17 million is Muslim, no clear initiatives of this kind had previously been taken by the government. GOLCER attributes this fact to the government’s prior declaration of the country being secular, and officials not wishing to appear overtly religious, owing to political sensitivity in the country.

Focus

The UK’s proposal for a sovereign sukuk was warmly welcomed by delegates at the World Islamic Economy Forum held in London in late October. It was announced also that the London Stock Exchange would be devising an Islamic finance index, in another manoeuvre to enhance the City’s status as an international and multicultural hub. The decision on the Islamic bond reversed a statement made earlier in the year. Prime minister Cameron referred to the “pragmatism and political will” behind the decision. Others reacted as follows --

The Lombard column in the Financial Times: “The PM’s sukuk would have symbolic utility. It would show that the UK is comfortable with financial products that circumvent usury. The offering could also pave the way for novel securitisations of public sector contracts. The challenge for ministers is to create a framework that attracts new customers without disadvantaging old ones. For example, rules protecting Islamic securities from double taxation need to be carefully drawn to preclude abuse. A more immediate concern is to create a sukuk everyone will recognise as such. No body of scholars has a monopoly on determining whether a financial product is Shariah-compliant, as Aston University’s Omneya Abdelsalam points out.”

The National newspaper, UAE, found real value is what could be seen as merely a marketing gesture: “It would be easy to dismiss Britain’s £200m sukuk as a publicity stunt. The planned issue is so comparatively small that it might be viewed as a cosmetic exercise. [Yet] in tangible financial terms, the sukuk will offer Islamic investors a benchmark for sovereign debt in the Western world. [It] is timed perfectly to prove the point: London is open for business, as it is for Chinese currency trading, or Russian property investment, or Asian infrastructure funds.”

Pakistani newspaper Dawn.com said the British premier’s announcement “is not surprising, given the swift growth of Islamic finance in and outside Muslim countries. Islamic finance assets stood at $1.6trn at the end of 2012 and are projected to soar to $6.5trn by the end of 2020 ... Britain’s push is driven by its desire to replace Kuala Lumpur as the Islamic finance hub and to woo wealthy investors from the Gulf economies.”

Global Risk Insights, a consultancy, put the announcement in its domestic, political context: “Getting involved with sukuk can be seen as an attempt by Cameron to present a more open country, which might soften his image. How other European countries will act in response to the UK’s initiative will also be interesting to follow. The financial repercussions will probably take longer to manifest themselves, purely because of the complexity of the plan’s implementation, but these will be equally important to track.”
The transport sector was badly hit by the global financial crisis. Some reports suggest that in 2009 the gap between orders placed for new aircraft and committed funding amounted to $10-20 billion. In the shipping sector it was a similar story.

Although the economic situation has improved since then, it is clear that the pool of available finance from conventional sources for aviation and ship finance has shrunk in comparison to pre-crisis levels.

The situation is not aided by recent regulatory developments, such as Basel III, which have placed pressure on financial institutions to reduce their asset portfolios in order to comply with capital requirements. The search continues for alternative sources of finance.

Islamic finance is well suited to the financing of big-ticket assets such as ships and aircraft.

Asset finance is attractive to many investors because in return for their investment they receive a proprietary right in an asset, which may be subject to a lease providing a revenue stream and which can ultimately be sold to try to recoup that investment. As a result, there is sometimes a false perception that asset finance is always less risky than other forms of investment.

The key to any asset-based investment in the transport sector is to understand the nature of the asset and the business sector in which the investment is being made. In an Islamic financing, with its focus on the sharing of profits and losses, there can be no guarantee of a fixed return. In practice, this often means that the Islamic investor has a greater exposure to fluctuations in the underlying revenue stream derived from the asset and to the residual value risk of the asset itself than would be the case for a financier in a conventional debt transaction.

Issues such as the maintenance, operation and insurance of the asset, the validity and enforceability of security and title to the asset, the condition in which the asset will be redelivered upon the termination of the financing, the forecast of the future fair market value, the projected revenues derived from the asset, and the credit and business of the operator of the asset will therefore all be relevant to the assessment by the investor of its exposure to the deal.

These practical issues should not be ignored in the overall desire to structure the transaction in accordance with Shariah principles.

Most Shariah-compliant financing for big-ticket assets is structured using an Ijara. In this approach, Shariah-compliant financing resembles conventional financing’s extensive use of leasing (whether on a finance or operating lease basis) as a tool for asset finance.
A straightforward ijara is equivalent to an operating lease, whereby the economic owner of the asset is the lessor and the lessee is expected to redeliver the asset to the lessor at the end of the lease term. An ijara can be combined with a separate sale and purchase undertaking to create an ijara wa‘iqtina. This is a lease akin to a finance lease, whereby the real economic owner of the asset is the lessee and the lessee expects to purchase the asset on the termination or expiry of the lease.

Despite the similarity of an ijara to conventional leases, the requirements of Shariah challenge the traditional allocation of risk and responsibility between lessor and lessee.

In a conventional financing, it is normally the case that the lessee assumes all the risk associated with the operation of the asset. A lessee will be obliged to insure, maintain and repair the asset.

Shariah offers an alternative view. In an ijara, as the ownership of the asset is not transferred by the lessor to the lessee, the liabilities of the ownership of the asset remain with the lessor. As a consequence, the lessor will remain responsible for obtaining hull insurances and for the performance of major maintenance and structural repair.

Although in some circumstances Shariah principles may appear to conflict with conventional notions of risk allocation between a lessor and a lessee, for the transaction to work it is important that Shariah-compliant transaction documentation does reflect commercial reality.

It would be rare that a lessor would have sufficient maintenance and insurance capability to support the commercial operation of the lessee. The airline or shipping company will have in place existing insurance and maintenance arrangements for its fleet. Similarly it is usual for the airline or shipping company to maintain third-party liability insurances to cover operational risk, and to cover its exposure under any broad operational indemnity in its lease or financing documents.

As a way of reflecting this commercial reality, whilst at the same time adhering to Shariah principles, it has become common for the lessor to appoint the lessee as its service agent to obtain hull insurances and to perform major maintenance and structural repair to the aircraft or ship.

The differences in attitude to risk between Shariah-compliant asset financing and conventional asset financing come to the fore when the transaction is to be structured with a combination of Islamic debt or equity and conventional debt. This is often the case in transactions which establish funds for the purchase of a portfolio of assets.

“As it is common for an Islamic investor to assume more risk than would be usual for a lender or lessor in a conventional financing, Islamic investors will tend to look for investments offering a greater return to compensate them for this risk.”

A conventional lender would, for example, expect its loan to be repaid in full in the event that
the asset suffers a total loss and that loan would continue to accrue interest until it was repaid. In a Shariah-compliant structure, the rental stream which is the source of revenue for the return on the investment would cease upon a total loss of the asset.

The conventional lender would need to determine how it would deal with interest payments which would otherwise be due in such circumstances in a way which will not prejudice the Shariah-compliant nature of the deal for the Islamic investors. It would also be unacceptable for a commercial lender not to be fully indemnified by the airline or shipping company for any liability the lender may suffer as a result of the operation of the aircraft or ship.

In transactions whereby Islamic investment is to be contributed in the form of a sukuk, it is becoming increasingly common for the asset to be owned under a musharakah structure, to ensure that there is a greater linkage between the ownership of the asset and the interest in the asset held by the sukuk holders.

The concept of musharakah is based on the sharing of risk and reward, but conventional lenders will typically expect to be paid out first in a default situation. Reconciling the contrasting viewpoints of the conventional lender and the Islamic investor in a manner which does not compromise Shariah principles requires careful structuring -- but can certainly be achieved with the co-operation of all interested parties.

Although the credit crisis undoubtedly heightened the interest of airlines, lessors and shipping companies in Shariah-compliant financing, Islamic finance has not always been popular with the transport industry.

As it is common for an Islamic investor to assume more risk than would be usual for a lender or lessor in a conventional financing, Islamic investors will tend to look for investments offering a greater return to compensate them for this risk.

In addition, Islamic finance transaction documents are less standardised than those in conventional finance, which can result in higher legal fees for the transaction.

As a result, there has been a perception in the transport sector that Islamic finance is more costly than conventional finance. Furthermore, due to their potential exposure, Islamic investors have traditionally proven reluctant to invest in transactions with a tenor of more than 3-6 years. Islamic finance has therefore not been able to provide the 8-12 year financing terms often favoured in the aviation and shipping industries.

However in recent times the gap in pricing and tenor between conventional finance and Islamic finance has narrowed, with some Islamic financial institutions now being more willing to provide finance for a longer term. Old perceptions regarding Islamic finance may no longer be true and should be reassessed in the current market.

This is an abbreviated version of an article that previously appeared in Islamic Finance News.
Differentiating the Gulf and Malaysia in Islamic finance

by Rachel Latham and Andrew Shouler

In an industry that is experiencing double-digit growth, it is hardly surprising that Islamic finance is attracting eager entrants. London is the latest to jump on the bandwagon, with its proposed sovereign sukuk and other announcements at the recent World Islamic Economic Foundation forum (WIEF).

Even so, any newcomer will have a long way to go to challenge the pre-eminence of Malaysia and the Gulf in fronting the sector in its current profile and likely paths of development.

The numbers bear out that de facto leadership. Global Islamic financial assets total in the region of $1.5tn at present, with the banking sector holding approximately 80% of the total. Although that is in fact an indistinct figure -- at roughly 1%, relative to global financial assets as a whole -- the sector has grown at an impressive compound annual rate of 15-20% over the past decade, and is expected to continue along this trajectory, catering for a rapidly-growing Muslim population, to reach 25 billion by 2020.

Many may not know that, in fact, Iran accounts for over a third of the overall amount of Islamic financial assets, at some 35%, but the country has remained rather off the radar in a global sense, of course for political reasons.

In terms of the industry’s international perspective and cross-border flows, Malaysia and the GCC stand out in accounting for roughly 12% and 40% of the given total respectively, with Saudi Arabia representing the largest of the Gulf states in this respect with around 14% of the overall sum.

Malaysia, though, is the leader (with a 60% share) in global sukuk issuance, perceptibly the cutting edge of the sector, with its high visibility to emerging-market and Shariah-compliant investors. Just over a fifth of the country’s banking system by assets is Islamic; the average for Muslim countries is more like 12%.

Motivating forces

While we hear a lot about these respective regions as dominating Islamic finance, it is fair to ask what is the basic differentiation in terms of their motivating forces and development, in a world in which the sector internationally appears very segmented and unevenly developed. Even modest research unveils that very different models of evolution are entailed.

What is striking is the impression that, whereas Malaysia has embraced the sector in a focused way as part of developing financial services within a national economic strategy, the Gulf’s attitude towards Islamic finance, for all its longevity and natural affiliation, has been sporadic, individually pursued rather than integrated, and lacking
anything like the same focus.

Malaysia’s population of just 30 million has a Muslim component of 60%. Effectively next door, Indonesia, the world’s largest Muslim country, has a population of 220 million. Yet it is Malaysia that has blazed the trail, making itself the predominant centre for Islamic finance with a concerted agglomeration of support from the government, central bank, securities regulator and institutional investor base.

Having realized that it could not continue to compete with the industrial competition around the Pacific Rim, Malaysia set about developing the financial sector per se, and gaining pre-eminence in its Islamic niche, as a business proposition regionally and for the world.

In the words of Oxford Business Group, with that commitment, and especially dedication to education and training, “Malaysia is on the way to becoming the Switzerland of Islamic banking”, having created “a very attractive environment”.

With its innovative, outward-looking, market-driven approach, it was responsible for initiating sukuks in 2002, and creating the Islamic Financial Services Board (IFSB) as a benchmark institution. It houses a comprehensive, user-friendly legal framework, and has dominated takaful insurance. These are merely scattergun and familiar observations of the country’s achievement, the point being merely to give a flavour of the nature of the undertaking.

The Economist has argued that Malaysia, with its links to other internationally-oriented centres like Britain and Singapore, was “a natural candidate to bridge the worlds of religion and capitalism”, and its range of incentives and programmes for the sector’s development has produced “a complete ecosystem for Islamic finance”.

It is a process that seems well co-ordinated; and it continues apace. With its proposal of a new financial district, Malaysia intends to compete with regional financial superpowers such as Singapore and Hong Kong, in keeping with its programmed vision to 2020, in particular by meeting the market requirements of issuers and investors, clients and providers.

By comparison, the Gulf states are playing catch-up, despite being more obvious sponsors of the Islamic finance industry from an historic and cultural perspective. The sector’s growth has been organic rather than, until recently, systematised, and promoted as much by banking institutions seeking to develop their opportunities with customers rather than instigated and nurtured by governments. The region, of course, has had enviable energy resources to rely on, often argued to have limited imaginative policy incentives.
In essence, Saudi Arabia dominates within the region in terms of established business, with Islamic finance assets exceeding $270bn. Its embrace of the sector reflects its desire to enhance its capital markets and marshal resources to meet its substantial infrastructure needs. It has demonstrated considerable dedication to education and research, but, according to a new barometer devised by Thomson Reuters, does not score so well on governance and disclosure.

Bahrain has history on its side as an Islamic centre, claiming the largest concentration of Shariah-compliant institutions in the world, and having provided the templates for many instruments now common in the marketplace. Of course, it hosts the standard-setting body AAOIFI, seeking ‘best practice’ for the industry, and, in the same vein, may be viewed as providing intellectual leadership, owing to its embedded, qualified manpower. It is seeking to retain that mantle.

Although there have been legislation and guidelines at the federal level, the UAE tends still to address Islamic finance, as much else, in a splintered fashion between its two powerhouse emirates. Recently, however, an independent authority has been announced to bring overall oversight.

Already supremely wealthy, Abu Dhabi has benefited from sustained high oil prices, and has recognised the need to cater for Shariah-sensitive HNWIs. It has also perceived the merit of diversifying its economy to some extent, following Dubai’s example while differentiating itself, aiming to build a financial centre that features the Islamic component, which is relatively nascent in its formation.

Dubai, meanwhile, has re-emphasized the diversification theme since its experience of the financial crisis, and sought to further enhance its commercial and financial activities. Now, though, it has declared its intention to become the global leader of the Islamic economy, featuring plans for a unified Shariah board and an academic institution to promote training of professionals. Its ambition has become its hallmark.

With relatively newfound and enormous wealth, Qatar has reaffirmed its own identity in the field of Islamic finance as in other spheres. Indeed it is the fastest-growing of the Gulf’s financial centres in terms of the balance sheets of Islamic banks. It wishes to harvest local liquidity to fund its expansive investment projects, and perceives itself as having both the resources and the expertise to build an Islamic finance platform that would have the potential to rival Dubai’s position.

Kuwait has experience in Islamic finance that dates back several decades, but has adopted a low-key profile in the sector, despite the presence of what may be perceived as a flexible and conducive legal environment. While the country’s prior concerns have perennially been to overcome an impasse between government and parliament that has impeded economic development generally, there is said to be an appetite for competing in the Islamic finance arena.

Oman is a definite latecomer to the sector, as Islamic finance was in fact prohibited until two years ago, so as not to be distinguished from conventional forms of banking and investment in regulatory terms. The region’s increasing call upon liquidity for expensive projects seemed to lead to a change of heart, and now the country advertises the merit of its modern approach, with strict application, combining the best of others’ past knowledge in a unique model.
Global competition

Overall, there seems little doubt that Malaysia has stolen the march in a globally competitive sense and is ahead in the game, practically speaking, particularly in trained staff. As Standard & Poor’s rating agency has commented, “the GCC has much to learn from Malaysia”.

The impression is that a unified, consolidated approach is actually not on the agenda in the Gulf, although, clearly and by definition, not every centre in the Gulf can be a hub.

Indeed, the recent signing of a Memorandum of Understanding between the central banks of Malaysia and the UAE, aiming to foster closer economic ties between the two countries, including in the area of Islamic finance, may suggest that ‘external’ co-operation could actually be easier than ‘internal’ GCC bonding.

In some sense, it is not surprising that the six Gulf states, as sovereign nations, should have forged their own way ahead until now, especially considering differing priorities as to the balance between business expediency and religious precepts. The inability or unwillingness so far to develop Gulf monetary union is evidence of this disjuncture.

At the same time, the Gulf is deemed by some to have some kind of advantage in terms of its deeper association with Shariah-compliance. Indeed, Malaysia itself is to some extent deferential to that point, citing its own lack of an authoritative presence in the sector. Some Gulf scholars view Malaysian regulation as too liberal, permitting structures which too closely mimic conventional finance.

Hong Leong Islamic Bank CEO Raja Teh Maimunah has referred to the country’s own apologetic behaviour or lack of confidence. “The difference [is] not in the superiority of the product,” she told a conference last year, “but rather in the different schools of thought”.

Evidently, the Gulf likes the implied edge it retains. Bahrain’s Crown Prince Salman bin Hamad Al Khalifa told London’s WIEF that it was vital that, while ensuring the industry had the scalability to meet growing demand, there was adequate protection of “the spiritual and ethical mandate that gives it fundamental acceptance among the consumer and maintains its integrity.”

Will the different schools of thought prolong an enduring schism? Maybe not. Besides the UAE’s tie-up with Malaysia, Dubai has a chance to find a way between the two pillars, utilising its strategic location and ingrained entrepreneurial mentality, and saying for instance that it will issue sukuk standards that are designed to resolve conflicts between the regions.

A recent interview by The Banker with Noor Investment Group CEO Hussein Al Qemzi exemplified the dichotomy between the reality of competition but equally the need for collaboration. “The lack of such efforts is limiting the growth of Islamic finance,” he admitted. “There is a need for balanced, globally accepted regulations that [both] drive growth and stem misuse.”

Does it matter which way the bias tilts in resolving that tension? Is it more important for the national participants to grab market share unilaterally, or find some means of compromise to allow common progress for the industry, or even to hold out for overriding principles? These are perhaps unknowns, and a topic for another day.
Stock Markets

GCC

Relative to other emerging markets and world indices, Gulf equities have underperformed in recent weeks. A key reason cited was disappointing earnings data, particularly out of Saudi Arabia, the dominant economy. While the lead given by overseas markets was also comparatively lacklustre, investors locally took the opportunity to take profits. Dubai stood out among the seven bourses tracked, driven by the real estate and investment & financial services sectors, reflecting the distinct and interwoven pick-up being identified in those sectors of the economy. In addition, foreign funds seem increasingly to be associating the emirate with safe-haven status in the regional context. Overall, although the established uptilt in the markets has remained in place, a certain caution has developed, in line with global attention to the US’s policy stance on extending monetary liquidity (QE). Brokers spoke of anticipating rotational behaviour ahead, perhaps range-bound.

MENA

By contrast with other emerging-markets trading, which has complied with globalized reaction to the fallout from the US Fed’s policy uncertainty, Egyptian stocks have held their ground at the elevated levels reached since the troughs that have punctuated this year’s performance. The modicum of political and economic stability that has been sustained since the military’s intervention in mid-year has most recently encouraged local investors to venture back into the market. The periodic instances of violence on the streets, and the show trial of deposed president Morsi, seem not to have upset the measure of confidence that has taken hold since supportive monies were secured from key Gulf states. At the same time, the Cairo bourse suffers institutionally from the loss of three key names since foreign firms took majority stakes earlier in the year, with a tendency to volatility owing to thinness of trading.
Far East

As has become familiar, Asian stocks have continued to take their cue from impressions of the prospects for the US’s QE programme, that has been revealed to have fuelled much of the international surge in stock markets this year. Having recovered from previous suggestions that tapering would soon be taking effect, which were then reversed, they leaned to the defensive, fearful again of retreating global funds flows. When the latest US monthly jobs report emerged, it suggested an economic strengthening that weighed on sentiment. Additionally, stocks in Thailand have been hampered by disturbances over a political amnesty bill, while the Philippines market was shaken by the tragedy of Typhoon Haiyan. Indonesian shares were hit by a surprise interest-rate hike designed to curb the country’s current account deficit.

Rest of the World

Concerns through the middle of the year about US policy tapering, and the uncertain condition of the Chinese economy, gave way in benchmark markets through October to a generally positive sense of direction. That was based partly on economic data that appeared sufficiently strong to promise world economic recovery over the medium term, but not so strong as to force any immediate policy tightening. In the US the pending appointment of Janet Yellen as Fed chairman has emphasized a continuation of the dovish monetary stance. China’s most recent key policy forum has offered the promise of enhanced, growth-sponsoring liberalization. Meanwhile, Europe’s difficulties have avoided the headlines for a while, and the jury remains out in Japan whether the three-arrow government stimulus programme will impact as well as intended.

Sources: GIC, Global Investment House, Emirates NBD, Bloomberg, Reuters, broker rpts
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.

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: 

\[ \sigma = \sqrt{\text{E}[(X-\mu)^2]} \]
Commodities

Oil

The spread between Brent and related series versus WTI widened again as US crude inventories climbed sharply, with output in October rising to a two-decade high (nearly 8 million barrels per day, according to the EIA), while refinery demand has fallen. Despite US economic recovery, and the Fed’s support for continuing stimulus, perceptions were of a market oversupplied and unlikely to tighten soon. WTI dropped significantly, while Brent also eased, upon the European Central Bank’s surprise decision to cut benchmark interest rates again, which sparked the US dollar higher, a prompt typically for lower commodity prices. Prices softened also as the risk premium associated with Middle East tensions were pared back.

Natural Gas

Gas prices undulated gently through October without overall direction, ending marginally up. The absence of a sustained cold weather period meant that traders were disinclined to bet on firmer levels, although technical support was found to keep interest away from the downside. Stockpiles were described as comfortable, while production was said to be flowing at a record pace. Ultimately, as ever, the driving force in the market was the forecasts for temperatures due and therefore prospects for the heating season, and moderate enough conditions prevailed sufficiently to keep prices within a sideways range.

Gold

Participants in the gold market, which faces its first annual decline in thirteen years, have paid particular, in fact almost exclusive, attention to the outlook for QE. Without much evidence of inflation in the world economy (or the solid growth that might help produce it), investors
have been disappointed, while still holding out hope that the US Fed’s determination to maintain monetary stimulus would bring the precious metal back to life. The modest gyrations of recent weeks reflected a mixture of stronger and weaker economic data, signalling that the policy outlook remained on a knife-edge. Positive signs in latest GDP and monthly employment data bolstered expectations of tapering, bringing a negative slant again to gold.

Copper/Base Metals

Copper’s tone also has been subdued, convinced more by the vagaries of the Chinese economy than by US recovery. Initially buoyed by a combination of declining stockpiles and firm warehouse orders, prices slipped upon a tightening of interbank interest rates as the authorities in China seek to quell incipient inflation. Local commentators have identified overheating in the housing market. Traders were sidelined too by the pending plenum of the Communist Party, which would indicate policy direction and prospects, besides doubting the orientation of the US Federal Reserve’s QE strategy.

Sugar/Agriculturals

A warehouse fire in Brazil amplified a price surge in sugar through October, as rains curbed output expectations in the main growing region. Prices then retreated smartly upon a market reappraisal of inventories building in China and exports quickening out of India. The downshift was given momentum by the decline of emerging-market currencies against the rebounding US dollar, with higher sales anticipated to try to offset the purchasing power effects of weakening currencies.

Edible Oils

While soybean oil prices kept an even keel, palm oil experienced sharp volatility in October and into November, initially rising, then falling back by the same amount. Behind the run-up was wet weather in Malaysia and Indonesia that threatened the harvest, and lower stocks than imagined. The market then reacted to a sense that the momentum had been overdone, and that stockpiling as a consequence would leave an inventory overhang.

Sources: OPEC, Reuters, Bloomberg
Bonds and CDS markets

GCC

Gulf bonds improved smartly once the change of heart had been delivered in the US as to the possible curtailment of quantitative easing. The backing away from that suggestion gave the promise of sustaining the liquidity impetus that has been seen as vital to upholding fixed-income generally and globally. GCC credits responded accordingly, though by not as much as broader emerging markets did, given their prior sell-off. However, secondary trading suffered in some cases as investors’ focus on primary issuances led to overpricing and then reaction, which thereupon weighed on sentiment. Regional investors were loath then to take fresh positions, seeking market direction. The mood soured slightly as strong US jobs data emerged, and the overall market locally slipped into watching technical indicators.

Egypt / MENA

It was a measure of improved market stability in Egypt that the basic shape of falling then rising trends for its international bonds through October and into November essentially mirrored the global example. A sharp hike in the country’s purchasing managers’ index to almost 50 (and above 50 in the output component) suggested an economy on the up, despite its damaged condition. That said, past series data are somewhat lacking, and the political tensions surrounding the Morsi trial are liable to continue to exercise a drag on business activity. Central Bank of Egypt decided not to cut interest rates following its latest monetary committee meeting, despite a relative buoyancy in FX reserves, perhaps to check inflation and retain support for the balance of payments.

Malaysia / Far East

Malaysian bonds in the period covered had a mixed experience similar to that of other regions in the wake not only of global market uncertainty towards the US’s monetary stance on tapering support for government debt but also its relevance to volatility in international funds flows to and from emerging markets, especially Asian. On balance, the market mood weakened as a strengthening of critical employment data in the US -- both weekly jobless claims and monthly payrolls -- pointed firmly to the likelihood that the flood of liquidity would be tempered within the foreseeable future. While
benchmark series have guided global bonds generally, Far East markets have shown special sensitivity to exchange rates against the US dollar, which has tended to be lifted by any sense of policy tightening.

Global Benchmarks

A market that had been on the defensive since mid-year over the US Fed’s noises on tapering was heartened by the central bank’s reconsideration of its guidance. Saying that it needed additional evidence of the economy’s upswing, it decided to continue with $85bn of Treasury and mortgage bond purchases monthly, providing the necessary fillip to sentiment. The mood subsequently has been edgy. The hearings to confirm Janet Yellen as Fed chairman in place of Ben Bernanke have emphasized an essentially dovish stance but not so much as to remove the risk of sudden fallout.

Meanwhile, the European Central Bank’s latest interest rate cut has reflected both a disinflationary environment but commitment to policy response, while Japan’s JGB market has become virtually a creature of the central bank, whose purchases now so dominate that trading liquidity has drained and yields barely reflect normal market risk.

Source: GIC, InvestAD, Capital Economics, Bloomberg, Financial Times, broker reports

---

**Credit Default Swap Markets**

<table>
<thead>
<tr>
<th>Country</th>
<th>CDS Spread (bp)</th>
<th>MTM Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>245.89 ▲</td>
<td>3.06</td>
</tr>
<tr>
<td>Qatar</td>
<td>65.77 ▼</td>
<td>-15.36</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>61.29 ▼</td>
<td>-7.73</td>
</tr>
<tr>
<td>Dubai</td>
<td>212.41 ▼</td>
<td>-7.94</td>
</tr>
<tr>
<td>Abu Dhabi</td>
<td>102.28 ▼</td>
<td>-10.19</td>
</tr>
<tr>
<td>Egypt</td>
<td>664.16 ▼</td>
<td>-6.84</td>
</tr>
<tr>
<td>Thailand</td>
<td>105.62 ▼</td>
<td>-17.14</td>
</tr>
<tr>
<td>Indonesia</td>
<td>191.58 ▼</td>
<td>-25.21</td>
</tr>
<tr>
<td>Malaysia</td>
<td>103.91 ▼</td>
<td>-17.59</td>
</tr>
<tr>
<td>India</td>
<td>296.55 ▼</td>
<td>-14.27</td>
</tr>
<tr>
<td>China</td>
<td>115.18 ▲</td>
<td>3.01</td>
</tr>
<tr>
<td>Italy</td>
<td>206.38 ▼</td>
<td>-21.24</td>
</tr>
<tr>
<td>Portugal</td>
<td>370.45 ▼</td>
<td>-38.50</td>
</tr>
<tr>
<td>Spain</td>
<td>182.51 ▼</td>
<td>-27.35</td>
</tr>
<tr>
<td>France</td>
<td>58.00 ▼</td>
<td>-16.29</td>
</tr>
<tr>
<td>Germany</td>
<td>23.26 ▼</td>
<td>-13.91</td>
</tr>
<tr>
<td>UK</td>
<td>29.13 ▼</td>
<td>-15.05</td>
</tr>
</tbody>
</table>

Evolution of CDS Spreads in October 2013 relative to the previous month. The index reported here represents the average basis points (bp) of a 5-year CDS for protection against sovereign bonds. Data as of 31/10/2013. MTM Change refers to the change relative to the previous month.
Islamic Bonds (Sukuk)

As across conventional debt markets, the sukuk space was much relieved by the passing of the US governmental shutdown in mid-October and the unexpected U-turn by the US Federal Reserve of its previously announced tapering plans. Temporary resolution of the debt ceiling at least allowed markets to revert to their state of artificial normality, bolstered by the central bank’s QE programme.

In the Gulf sukuk on the secondary side outperformed conventional equivalents. The HSBC Nasdaq Dubai USD Sukuk TR Index (Bloomberg: SKBI) rose from 145.6 to 147.8, while the HSBC Nasdaq Dubai GCC Conventional USD Bond TR Index (Bloomberg: GCBI) rose from 159.7 to 161.7.

Even so, nervousness prevailed and risk appetite diminished, as the Fed made it clear its position was data-dependent, and signs were increasing that the US economy was recovering further, implying a near-term limit to ongoing official support on the same scale. In most recent weeks yields on both conventional and Sharia-compliant fixed-income have risen on that basis.

Global sukuk on the primary side were steady and able to be quite tightly priced.

Malaysian utility Syarikat Prasarana Negara’s MYR1bn ($319m) Islamic bond was well received, its 7-year and 15-year tranches 1.7 times and 5.5 times oversubscribed, carrying profit rates of 3.78% and 4.56%, respectively. The spread on the 7-year tranche was compressed to 28bps over Malaysian Government securities. The proceeds are intended to finance the extension of a light rail network.

Gulf schools operator GEMS Education issued a $200 million, perpetual hybrid sukuk, only the second US dollar example from a Gulf firm apart from banks. However, the par-priced deal came on the high side of initial price estimations of 11.75-12%, and raised $100 million less than preferred. Most buyers were from the Gulf region, but Asian, London and Swiss accounts were also present.

State-backed mortgage lender Cagamas Bhd raised 3.8 billion ringgit ($1.22bn) in Malaysia’s largest sukuk this year. The issue offered tenors of 1-20 years, and was oversubscribed by 3.2 times during book-building.

Riyad Bank, Saudi Arabia’s third-largest lender by market value, sold an Islamic bond worth 4 billion riyals ($1.07 billion) through a private placement. The issue was priced at 68bps over the three-month Saudi interbank lending rate. The sukuk has a lifespan of seven years but can be called by the bank at the five-year mark.

The UK announced its plans to become the first Western country to issue a sovereign sukuk, amounting to around 200 million pounds and expected next year. Though a modest sum in terms of the UK’s national finances, it would provide a much-needed liquidity management tool for Britain’s six Islamic lenders, and serve to promote the UK as a leading Islamic finance hub.

Malaysia Building Society Bhd (MBSB), a loan provider, said it would issue a 7 billion ringgit ($2.22 billion) sukuk, having received approval from the country’s securities commission.

Sources: GIC, Reuters, Rasmala

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.
Hailed as the first such forum outside the Islamic world, London’s hosting of 2700 delegates at the ExCel centre in the docklands last month certainly seemed motivational, with an internationalist dimension.

The British Government’s announcement of a sovereign sukuk created headline news, but was essentially symbolic in attracting the Islamic finance audience and their potential business rather than significant as regards funding. Conditions for fixed-income issuance don’t look so promising in the period ahead, although strategic positioning by the issuer and investors is likely if and when the offering appears.

The potential creation of an enhanced Islamic stock market index by the London Stock Exchange, meanwhile, created genuine interest. At the same time, offering London’s services as a continuing locum on the sector’s evolution was a logical enough invitation.

Yet, perhaps the clearest sense emerging from the occasion was that the key issues for Islamic finance in its overall development -- in terms of harmonization of regulation, products, accounting, interpretations of Shariah-compliance, and risk and liquidity management -- remain very much up in the air. A succession of podium and side sessions served to emphasize the point.

The rather non-committal and varied voices on the matter of consolidating disparate views globally presented an unconvincing aspect to the assembly, relative to the evident potential of the sector and its likely market themselves. For instance, governors from various central banks in the Gulf and Malaysia were evidently preoccupied by their localized issues, and it took their counterpart from Nigeria to say that ‘one-size-fits-all’ should be bypassed in favour of “balanced rules” that could be mutually respected.

Different centres and jurisdictions are clearly trying to bring consistency to their own affairs, including aspects of transparency and governance, at home before any thought of agreeing on creating global standards. Indeed, as they act as rivals for hub status around the world, comprehensive progress seems liable to be fitful.

Undoubtedly, though, this landmark gathering was quite a networking opportunity for the bankers and associated service industry representatives eyeing the Shariah-compliant sector again, following the considerable distraction of the global financial crisis.

However, the uncertainties and arguments about the scholastic/religious aspects of the subject and industry is inevitably seen to bring another, third and complicating dimension to what is an already dispersed dialogue between governments, market players and comparative regimes.

In sum, the need to find collective motivation towards shared objectives is exposed and clarified by assemblies on this scale. Whether the necessary compromises can be reached is debatable, as some argue for absolutist definitions and ideals while others seek merely sufficient agreement on the practical, and indeed pragmatic, measures that have to be found to create a realistic and timely way forward.

Lastly, another clear observation transpiring from market practitioners is that, from an investment perspective, there is plainly an overlap between Shariah-compliance and non-compliance in terms of the expectations of customers and clients. That’s to say: institutions are competing for funds, and consumers want competitive returns, even if what’s understood to be ‘wealth creation’ is a point of distinction between Islamic and conventional finance.
CALL FOR PAPERS

4th Islamic Banking and Finance Conference (IBF 2014)

23rd to 24th June 2014
Venue: Lancaster University Management School

Keynote Speaker
Thorsten Beck
Professor of Banking and Finance, Cass Business School

The constraints applied by Islamic banks rendered them more resilient in the recent financial crisis compared to their conventional counterparts. This has attracted the attention of market participants and researchers to their liquidity buffers, leverage ratios, managerial efficiency and bespoke financial products. Islamic banking products are now offered in more than twenty countries and their expanding suite includes bonds, equity indices and insurance. The sector is estimated to exceed $1trillion in value, while growing at about 15% per annum. Among many issues still subject to debate is the purity of Islamic finance in practice, given the need to compete and to operate with customers whose expectations have been formed by conventional banking practices.

EIBF centre at Aston Business School in collaboration with GOLCER Lancaster University Management School is organising a conference on Islamic Banking and Finance. The conference aims to provide a forum for an exchange of views on recent developments and to identify key issues/challenges underlying the paradigm of Islamic Banking and Finance in the 21st century.

Original contributions are invited on any of the listed topics:

- Financial risk and stability
- Transparency, governance and corporate social responsibility
- Earnings management and impression management
- Performance, efficiency and convergence
- Mutual funds
- Risk Management, Accountability and auditing
- Competition
- Microfinance and SMEs
- Behavioural finance

Conference Organisers: Dr Omneya Abdelsalam (Aston University), Dr Marwan Izzeldin (Lancaster University)

Special Issue
Journal of Economic Behaviour and Organisation (JEBO)
Ana Timberlake Best paper Research Award: £500

Co-editors for the JEBO Special Issue
Omneya Abdelsalam, Aston University
Mohammed El-Komi, American University of Cairo
Ana-Maria Fuertes, Cass Business School
Stergios Leventis, International Hellenic University
Gerald Steele, Lancaster University

Scientific committee
Omneya Abdelsalam (Aston University), Nathan Berg (University of Otago), Rachel Croson (University of Texas at Dallas), Manthos Delis (University of Surrey), Mahmoud El-Gamal (Rice University), Mohamed El-Komi, (American University Cairo), Meryem Fethi (Leicester University), Ana-Maria Fuertes (Cass Business School), Iftekhar Hasan (Fordham University), Mohamed Shahid Ibrahim (Bangor University), Marwan Izzeldin (Lancaster University), Jill Johnes (Lancaster University), Stergios Leventis (International Hellenic University), Kent Mathews (Cardiff Business School), Khelifa Mazouz (Bradford Business School), Philip Molyneux (University of Bangor), Andrew Mullineux (University of Bournemouth), Steven Ongenaa (University of Zurich), Vasilios Pappas (Lancaster University), Mohamed Shaban (Leicester University), Mustapha Sheikh (Leeds University), Gerald Steele (Lancaster University), Emili Tortosa-Ausina (Jaume I University), Mike G. Tzionsas (Lancaster University)

For paper submissions please email: islamicfinance@aston.ac.uk

Important Dates

<table>
<thead>
<tr>
<th>Conference Abstract Submission</th>
<th>Conference Full Paper Submission</th>
<th>Submission for JEBO Special Issue</th>
<th>Special Issue Publication</th>
</tr>
</thead>
<tbody>
<tr>
<td>31st March 2014</td>
<td>27th April 2014</td>
<td>1st October 2014</td>
<td>October 2015</td>
</tr>
</tbody>
</table>

For paper submissions please email: islamicfinance@aston.ac.uk
DISCLAIMER

This report was prepared by Gulf One Lancaster Centre for Economic Research (GOLCER) and is of a general nature and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive or to address the circumstances of any particular individual or entity. This material is based on current public information that we consider reliable at the time of publication, but it does not provide tailored investment advice or recommendations. It has been prepared without regard to the financial circumstances and objectives of persons and/or organisations who receive it. The GOLCER and/or its members shall not be liable for any losses or damages incurred or suffered in connection with this report including, without limitation, any direct, indirect, incidental, special, or consequential damages. The views expressed in this report do not necessarily represent the views of Gulf One or Lancaster University. Redistribution, reprinting or sale of this report without the prior consent of GOLCER is strictly forbidden.