

EYES ON WORLD MARKETS

Islamic Finance Report

Islamic Finance: Why it Matters

From real estate to derivatives, the list of Sharia-compliant investment products continues to grow, and that's bringing prices down. It's time to pay attention to this market.

By Edward Baker

Like a parallel universe in an old science fiction novel, the world of Islamic finance has been growing under the radar of most of the U.S. finance community. And it has been growing fast. From retail mortgages and mutual funds to real estate and asset-backed transactions to Islamic bonds to private equity and even derivatives, this parallel universe is now a market estimated at upwards of \$1 trillion, and it is expected to grow at 20 percent annually for the next several years, according to consultancy McKinsey & Co.

The distinguishing characteristic of Islamic finance is, of course, its compliance with Muslim religious law, or Sharia, which includes prohibitions on paying or collecting interest, on investing in companies involved in gambling, munitions, alcohol and other industries, and on speculation (see "Islamic Finance: The Core Concepts," page 52). That would seem to preclude a large swath of the world of finance. But thanks in large part to high oil prices, the Islamic world from the Middle East to Malaysia is awash in money, and the appetite for placing that money productively has grown dramatically. That in turn has driven an increase in the supply of more and more complex Sharia-compliant products.

Given these trends, a closer look at the world of Islamic finance is clearly warranted. How different, really, is Islamic finance from its counterpart in the world of conventional finance? What new products are coming on the market in response to increased demand? What is driving it to grow so rapidly? And why, finally, should the rise of Islamic finance matter to Western institutional investors?

What is Islamic finance?

The simplest example of an Islamic financial transaction might be a retail mortgage. A bank—whether it be an Islamic bank offering "loans" to anyone, or a conventional bank trying to attract business from the Muslim community—must find a way to work around the prohibition on the payment or collection of interest. So it might develop a product in which, rather than lending money to the mortgagee at a certain rate of interest, it buys the house, then sells it on to the mortgagee at a slight premium; the mortgagee pays off that total to the bank in installments over the agreed-on term of the transaction. A committee of Sharia scholars will have already issued a fatwa regarding such transaction, declaring them lawful, and everyone is happy.

Despite rumors to the contrary, that, in essence, is the basis of Islamic finance, no matter how complex: transactions structured in such a way as to win the blessing of Sharia scholars while conforming to the secular law of the jurisdiction governing it. Says **Michael J.T. McMillen**, chairman of the **American Bar Association's Islamic Law Forum**, "Islamic finance is just structured finance. Collateral security structures, for instance, are just like a leveraged lease." That's not to say the principles of Sharia that bear on financial transactions aren't complicated. "Sharia is a whole body of law, it takes a long time to learn, and it's not written down anywhere," he says.



Michael J.T. McMillen

Moreover, the interpretation of Sharia laws can vary depending on the jurisdiction. Malaysia, for instance, where debt can be sold above or below par, tends to be somewhat looser in interpretation than the Middle East, where it can't. Complicated as it seems, there's been a real movement over the last five years to unify the interpretations of Sharia from place to place, and to regularize the documentation for many of the more common types of deals. **Ijlat Alvi** is the CEO of the **International Islamic Financial Market (IIFM)**, a consortium of the central banks of Islamic countries from the Middle East to Southeast Asia formed with the goal of standardizing much of the complexity of Sharia-compliant finance in the capital and money markets. "Given the growth of the market, our goal is to develop methods of self-regulation through the creation of standards and benchmarks. The market is now so open that it's important to be able to move quickly to pre-approve transactions." To that end, the IIFM is working on master agreements for such transactions as Islamic bonds (sukuk) as well as more complex derivative-like structures.

Supply and Demand

Such efforts are coming in response to the increasing demand for Sharia-compliant products. The sources of that demand are many—some political, some financial. Most obvious is the significant, and growing, amount of petrodollars flowing into the Middle East and Southeast Asia, thanks to record-high oil prices. All that money needs to be put to work, portfolios diversified, risks managed, and while "some of it has been absorbed in the last few years by building in Dubai, Doha and elsewhere, you can only build so many buildings,"

says McMillen. "Investors are beginning to worry about the risks of concentrating money like that. So again, they're beginning to look out, to the U.S., Europe, China, India." Meanwhile, Western banks are finding themselves with a significant proportion of Muslim clients, and it behooves them to steer those clients into ethical investment in which they feel comfortable.

Some experts also see the rise in demand as a result of the attacks of Sept. 11. The U.S. response, which appeared, from the perspective of Middle East banks, to label all money there as "Islamic money," has led to what **Luma Saqqa**, an attorney in the Dubai office of London-based law firm **Linklaters**, calls "a religious wake-up call, a rise in the number of people turning to Islam. Those investors are saying, 'We want to invest our money on our terms, terms in line with our religious beliefs.'" Finally, **Walied Solimen**, an attorney in the Toronto office of **Ogilvy Renault**, notes the rise of a younger generation of Muslim investors "who are looking to establish their own legacy by doing deals and making some money. After all, the oil isn't going to be there forever."

That cadre of young professionals is also a leading driver of the multitude of new products emerging in Islamic finance, some experts note. "You're getting a lot of young Muslims, and particularly Arab Muslims, who go to business school in the U.S.," says McMillen. "But rather than stay in New York or London, as they used to do, they go there to get trained in conventional finance. Then, because they want to do some Islamic finance, they go back to Dubai or Doha or wherever, and do it there. And they're very, very smart."

The history of Islamic finance over the past decade has been a story of the introduction of more and more financial products of increasing complexity. What used to be restricted to project financing has now proliferated into capital markets, private equity and even derivatives—some of them already in greater and greater demand, some still in their infancy. What is creating the demand in those markets, and how are they meeting that demand?

Real estate. **Harold Garrison**, chairman of real estate fund manager and property developer **HDG Mansur**, has been working with investors in the Middle East since 1996. In 2002, in response to the growing demand among clients of his private banking contacts there, his firm started up a Sharia-compliant fund, with \$65 million in equity from HSBC. That fund became the HSBC Amanah Global Properties Income Fund, now the world's largest Sharia-compliant real estate fund, with \$580 million in equity, and assets worth more than

\$2 billion. His fund's growth reflects the rapidly increasing interest in Sharia-compliant real estate investing.

The demand for Islamic real estate investment is coming primarily from the Middle East, says Garrison. And while a great deal of Sharia-compliant investment has already been done in Dubai, Abu Dhabi, Jordan and North Africa, you can only build so many buildings there. "Our investors, like all real estate investors, are interested in protecting capital, so diversification is important. For us, that means the U.S., U.K. and European property markets, which are well developed, have strong laws in place, and are transparent. But we're also moving into Eastern Europe, India and China."

Garrison concedes that the need to do Sharia-compliant deals makes managing the process more difficult. Yet he also believes that Islamic real estate investments are competitive with conventional products. Many investors invest in both, and no one is willing to take any significant difference in return for the sake of being compliant.

Project financing. Project financing is perhaps the most traditional side of the Islamic finance market, given the high comfort level many Muslim investors



Walied Solimen

have with financing large infrastructure projects in the Middle East and Asia. Yet the use of Sharia-compliant techniques has moved far beyond the borders of

the Muslim world. **John Inglis**, a London-based attorney with **Ashurst LLP** who specializes in multi-sourced and Sharia-compliant project financing, attributes the increase in Islamic project finance to "the wider base on which to sell the product. If part of the deal is not Islamic, you're cutting out a significant potential investor base."

The multi-sourced financings Inglis works on typically include funds from commercial banks to export credit agencies to normal bondholders. "But some of these projects are costing vast amounts of money to construct and finance, so banks are realizing that it's better and cheaper to diversify their funding sources to include Islamic finance tranches.

In Inglis's view, the Islamic finance market is growing to such an extent that any institutional investor must see it as a potential source of investment in its own right. "Islamic investments

provide a significant degree of diversification from their existing portfolios, which is a considerable benefit. And as the market continues to develop, products will arise that are not capable of being matched in the commercial market." That's worth paying attention to.

Sukuk. Given the strictures on the payment of interest, the concept of an Islamic bond might seem a contradiction in terms. Yet it is currently the fastest growing segment of Islamic finance, expected to total about \$86 billion this year, and rise to about \$100 billion in 2008. That's a small drop in the very large bucket of conventional worldwide bond issuance, but still meaningful, given that the market is only about six or seven years old.

While a few of these deals are backed by actual assets, most of them function like traditional bonds. About a third of the market is devoted to sovereign bonds—a market pioneered by Malaysia—and the rest taken up with corporates. Demand for these bonds isn't coming solely from Muslim investors—in some cases, Western investors have bought up the majority of the offerings as part of larger risk management programs. That's a tribute to

the underlying creditworthiness of many of these issues, which are only just beginning to be rated by the big rating agencies.

The downside, however, is that many investors are holding these instruments to term, which has slowed the development of a secondary market. Yet the demand for such a market is getting stronger, and that's a good thing, says Linklaters's Saqqa: "Islamic banks are sitting on a lot of cash, and there aren't a lot of tools for managing that cash, since they're restricted as to what



Luma Saqqa

they can buy. So a thriving secondary market would enable them to use more conventional cash and risk management techniques."

Private Equity. Muneer Khan, who heads up the Islamic finance group for law firm **Simmons and Simmons** in the Middle East, believes Sharia-compliant private equity has a big future in the world of Islamic finance. "Private equity doesn't currently play a huge role in Islamic finance," he notes, "but it is definitely growing. Most of the interest is coming from specialist Islamic PE firms and banks with a PE division such as HSBC Amanah."

Sharia-compliant private equity deals are not that hard to structure, says the ABA's McMillen. "The funds can be structured in different ways, but the individual transactions are typically lease structures, in which you set up a funding company, put some assets in it, and lease them back to the Islamic fund. The lease payments pay the debt service. The collateral security is structured so that the fund will eventually get the whole company. Thus the overall returns are still based on the company's growth."

What's changed in the market is the willingness of Middle Eastern private equity firms to look outside the Middle East for deal flow. There is increasing interest in buying companies in the U.S., where such deals are relatively easy to transact, as well as in Europe, and now China.

Derivatives. Even derivatives are now becoming acceptable under Sharia law; after all, everyone needs to be able to hedge, whether it be traditional pricing risk, or currency risk. The difficulty in judging the strength of the Islamic derivatives market is that it is still very small, and as with the conventional derivatives market, most of the deals are private, one-off transactions, and the lack of transparency makes it difficult to judge their

continued on 76

FAILAKA IS FIRST

Comprehensive Reports on Islamic Funds

ONLINE
DATABASE
DEBUTS
2008



Failaka was the first research organization to present detailed information on Shariah-compliant equity funds. With information on over 260 funds, we remain the best source for information on Islamic fund investing and related research.

- Identifies institutions and fund managers
- Reports fund objectives, top holdings, geographic focus
- Details fund assets and performance

SUBSCRIBE NOW!

For more information, call us at (312) 873 4664.
Or email us at Chicago@failaka.com.

 **FAILAKA**
First in Islamic Fund Research

Chicago

Dubai

London

ISLAMIC FINANCE

THE CORE CONCEPTS

By Sara Catley

Islamic finance makes up a small part of the world finance industry, estimated to be worth around \$300 billion globally according to the Loan Market Association (LMA). However, it has grown by around 15 percent in each of the last three years and with the increase of wealth in Islamic states driven by high oil prices, this rapid growth shows no signs of slowing.

What is Islamic Finance?

At its broadest, Islamic finance covers all financial activity that enables Muslims to invest in conformity with Islamic law, or Sharia. In practice, Islamic finance involves using traditional investment techniques and structures that comply with Sharia to create arrangements that work in ways that are analogous to modern conventional finance.

Islamic banks and conventional banks that invest some of their capital in Islamic finance through an Islamic finance “window” have a religious board or committee composed of Sharia scholars (the Sharia committee). The Sharia committee examines proposed transactions and, in the case of Islamic banks, reviews the overall activities of the bank, for compliance with Sharia.

Key Principles

Key principles of Sharia relevant to finance transactions include:

Interest (Riba). Sharia regards money as simply a means of exchange, without intrinsic value and holds that money cannot be used to make money. Interest is the classic example of Riba. Payment or receipt of interest is strictly prohibited, and any obligation to pay interest is considered void under Sharia.

Speculation (Maisir). Sharia prohibits and treats as void transactions that rely on chance or speculation, rather than effort, to produce a return. This can create problems in relation to contracts that are seen as tantamount to gambling, which includes some conventional derivative transactions such as swaps, futures and options.

Uncertainty (Gharar). Sharia prohibits and treats as void contracts that are uncertain. All the fundamental terms of a contract (such as subject matter, price and time of delivery) must be absolutely certain at the outset.

Unjust enrichment/unfair exploitation. Sharia prohibits and treats as void contracts under which one party unfairly exploits the other or gains unjustly at their expense.

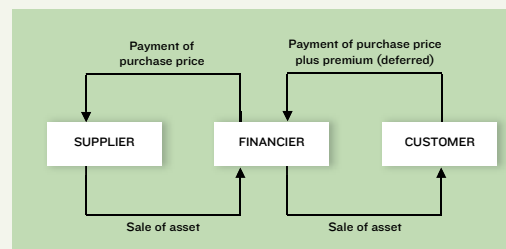
Unethical purpose. Sharia-compliant finance can be raised only for purposes that are permitted by Sharia and for the benefit of society.

Basic Transaction Structures

The main transaction structures used in Islamic finance are considered below. In practice, commercial transactions will often combine a number of different

techniques to produce the desired economic result and it is not uncommon for large fund-raising (such as significant infrastructure projects) to incorporate both Sharia-compliant and conventional tranches.

Murabaha



Murabaha techniques are often used for trade finance and are analogous to conventional loans. Like conventional loans, they can be syndicated.

In a basic Murabaha, the financier buys an asset from a supplier and sells it to the customer at a premium. The purchase price is typically payable in installments. The premium is generally based on a benchmark figure, such as LIBOR, plus a margin. The economic effect is similar to a conventional asset finance facility.

Reverse Murabaha can be used where the customer requires a cash lump sum. The customer buys an asset from the financier as in Murabaha but rather than retaining the asset for use in its business, the customer then sells it, either back to the original supplier or on to a third party.

It is possible to create a “revolving” reverse Murabaha, analogous to a conventional revolving loan facility (that is, a facility which allows a borrower to draw down, repay and re-borrow amounts throughout the life of the facility). However, the methods for achieving this vary and the techniques are not universally accepted.

It is fundamental to Murabaha and reverse Murabaha arrangements that the financier actually acquires title to the asset in question, taking some commercial risk in relation to it. However, in practice this may be only for a very brief period.

Bai al Salam

Bai al Salam can be used to provide working capital. The key difference to Murabaha is that, while the financier still buys an asset, delivery is deferred (see box, next page).

Usually, the financier will receive a discount for advance payment, typically calculated by reference to a benchmark, such as LIBOR, plus a margin. The



With branch campuses of 5 world renowned universities and 2.8% of its GDP dedicated to research, the pulse of Qatar's

The endowment of \$8 billion

growth is quickening. The Qatar Financial Centre is at the heart of this social and economic development. For opportunities

for a digital teaching hospital

in project finance, insurance, reinsurance, corporate and private banking, asset management and Islamic finance,

shows the health of

the QFC provides access, facilities and an independent regulatory authority

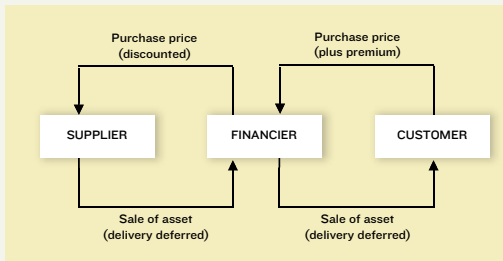
the Qatar economy



qatar

FINANCIAL CENTRE

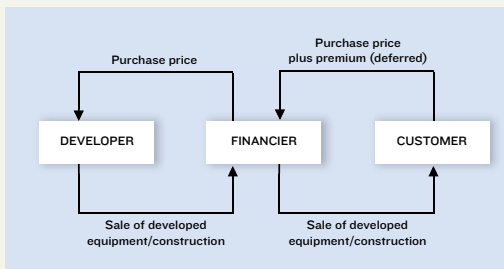
operating to internationally recognised standards. For more information please contact: stuartpearce@qfc.com.qa



financier may at the same time enter into a parallel but separate Bai al Salam with a third party to resell the asset for an increased price (also calculated by reference to a conventional benchmark such as LIBOR), as illustrated in the diagram, or it may simply sell the asset on delivery.

Istisna'a

Istisna'a is a technique similar to Bai al Salam and is used to provide advance funding for construction and development projects.



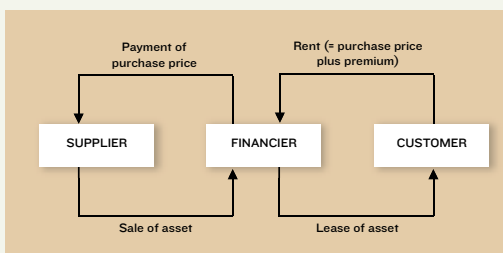
The key practical difference to Bai al Salam is that, instead of buying a finished asset with delivery deferred, the financier pays an amount to fund the manufacture, development, assembly, packaging or construction of an asset to an agreed specification. On completion, it will typically sell the asset to the customer or lease it back to the developer under an Ijara (see below).

The financier's return usually takes the form of a premium on resale, typically calculated by reference to a benchmark, such as LIBOR, plus a margin.

Ijara

An Ijara is a lease, often used to provide asset finance. In a financing context an Ijara is invariably preceded by an asset sale or Istisna'a.

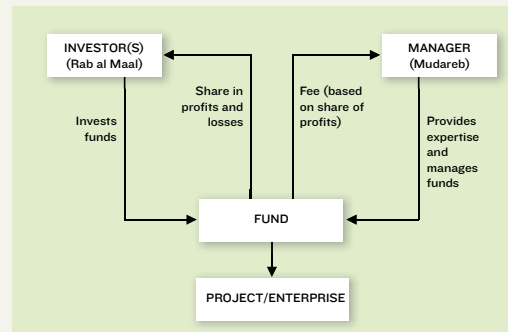
In a simple financing Ijara, the financier buys an asset from a supplier and leases it to the customer. The customer pays rent representing an agreed profit, typically calculated using a benchmark, such as LIBOR, plus a margin.



One feature that distinguishes an Ijara from a conventional finance lease is the increased and ongoing risk the financier takes in relation to the asset. In an Ijara, the financier must take responsibility for insurance and major (as opposed to day-to-day) maintenance of the asset.

Mudaraba

Mudaraba is an investment arrangement under which an investor or group of investors (Rab al Maal) place funds in the hands of a fund manager, usually a bank or financial institution (Mudareb), which provides expertise and manages the fund by investing in Sharia-compliant investments in return for a fee, typically based on a share of the profits.



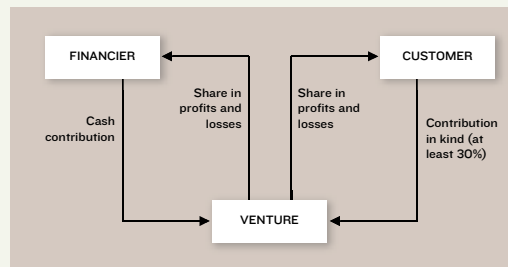
In a commercial context, Mudaraba can be used as a tool to syndicate other Sharia-compliant financing arrangements (although conventional investment agency agreements are usually also Sharia-compliant). More commonly, Mudaraba is used to establish investment funds and Sharia-compliant retail bank accounts.

Musharaka

Musharaka is similar to a conventional partnership or joint venture and is often used in long-term investment projects.

The financier will usually contribute cash and the customer will contribute assets into a joint venture or enterprise. They share in the profits of the enterprise in agreed proportions but must share the losses in proportion to their initial investment. In a financing context, the profit-sharing arrangement is usually structured so that the financier receives his initial investment plus a return based on a benchmark, such as LIBOR, plus a margin.

A variation is the diminishing Musharaka, so called because the financier's participation diminishes over time as the customer essentially buys out the



financier's share of the joint enterprise. Residential mortgages sometimes use structures that include a diminishing Musharaka.

Sukuk

Sukuk (singular Sakk) are financial instruments, such as certificates, that can be bought and sold on the capital markets.

Sukuk represent an undivided ownership share in an underlying asset or interest held by the issuer. This distinguishes them from both conventional bonds (which represent debt obligations of the issuer) and conventional equities (which represent ownership interests in the issuer itself).

The basic principle is that an ownership share in the underlying asset entitles the Sakk holder to a proportionate share of the returns generated by the asset. The overall economic effect is similar to a conventional bond.

Sukuk are used in combination with other Sharia-compliant financing techniques to give rise to a Sharia-compliant return on an underlying asset. Many different structures can be used for Sukuk, but Sukuk al Ijara and Sukuk al Musharaka are the most common.

Key features

In a typical structure, the entity looking to raise funds (the originator) will establish a special purpose vehicle (the issuer) in a suitable tax neutral jurisdiction. The originator will sell the underlying assets to the issuer, which will hold them under an English law trust in favor of the Sakk holders, to whom it issues certificates. The issuer funds the purchase of the assets with the issue proceeds.

While Sukuk are based on assets, the Sakk holder does not necessarily have any claim over the underlying assets in the event that the issuer fails to distribute the holder's profit share: that will depend on whether the issuer's obligations are secured on those assets in such a way that they can be made available to satisfy the holder's claim in the event of the issuer's default.

This is not typically the case, and the Sakk holder normally relies instead on an undertaking given by the originator to re-purchase the underlying assets at an agreed price on maturity or earlier in the event of default (the purchase undertaking).

This feature distinguishes the asset-based Sukuk that have been issued to date from the asset-backed securities issued by a conventional securitization vehicle. In practice, this means that, unless some additional credit enhancement element is included to improve the rating, Sukuk tend to have the same credit rating as the originator because repayment relies on the robustness of the purchase undertaking.

As might be expected, credit rating agencies do not verify Sharia compliance of rated Sukuk and do not take Sharia compliance into account as a relevant factor in rating Sukuk, unless non-compliance constitutes an event of default.

The terms and conditions of Sukuk are typically governed by English or New York law and are subject to the jurisdiction of the English or New York courts to help create legal certainty within the international financial community as to the nature and effect of the certificates.

However, in practice, some legal uncertainty can remain where judgment has to be enforced elsewhere (for example, in the jurisdiction in which the originator

Sukuk: landmark deals

June 2002	Malaysia Global Sukuk (a special purpose vehicle established by the Government of Malaysia) makes the first high profile international Sukuk issue.
March 2004	A special purpose vehicle established by National Central Cooling Co. PJSC (Tabreed) issues \$100 million Sukuk, the first corporate issue of Sukuk.
September 2004	The German State of Saxony-Anhalt becomes the first non-Muslim issuer, raising around 100 million euro (about \$145 million) through a Sukuk al Ijara.
May 2005	The Islamic Development Bank launches a \$1 billion Sukuk program, similar to a medium term note program; the first such program for repeat issues of Sukuk.
January 2006	PCFC Development FZCO (a special purpose vehicle formed by Ports, Customs & Free Zone Corp.) issues \$3.5 billion Sukuk al Musharaka, incorporating pre-IPO convertible trust certificates.
July 2006	A special purpose vehicle for National Central Cooling Co. (Tabreed) PJSC issues the first corporate Sukuk to be rated.
November 2006	Nakheel Group issues \$3.52 billion Sukuk al Ijara, listed on the Dubai International Financial Exchange, which attracted a significant number of non-Muslim investors.
March 2007	Aldar Properties issues \$2.53 billion exchangeable Sukuk al Mudaraba, around 80 percent of the issue was bought by Western buyers.

is domiciled). In addition, some of the underlying documents, such as sale and purchase agreements, may be governed by local law.

The Future

Sukuk issuance is the fastest-growing segment of the Islamic finance market and the volume out of the Middle East this year is expected to be phenomenal. However, the Islamic finance industry faces a number of challenges, including:

Skills shortage. There are very few appropriately qualified Sharia scholars: it

Need for assets. Much Sharia-compliant finance is assets-based, relying in some way on an income stream generated from assets. In practice, this can limit fund-raising to the assets available.

Restrictions on hedging. Traditional hedging techniques using derivatives are not always Sharia-compliant (for example, some derivatives fall foul of the prohibition of gambling). This means that hedging risks relating to currency, fair value or profit volatility is not easily achieved in Sharia-compliant finance. This

At-a-glance glossary

Bai al Salam	A forward purchase of a specified asset.
Gharar	Uncertainty.
Ijara	A lease.
Istisna'a	A funding agreement for the production of an asset to an agreed specification.
Maisir	Gambling.
Mudaraba	An investment fund arrangement.
Murabaha	An installment sale arrangement.
Musharaka	A joint venture arrangement.
Riba	Interest or unjustified increase.
Sharia	Islamic principles and jurisprudence.
Sharia committee	The group of scholars appointed by a financial institution to scrutinize activities for compliance with Sharia.
Sukuk	Sharia-compliant financial instruments, such as certificates, that have economic similarities to bonds.

can take up to 30 years before a person is considered qualified, and there is no universal agreement on what makes a person “qualified” in this context.

No global consensus on Sharia. There is no international consensus on Sharia interpretations, especially in relation to innovative products. There are, however, some signs that the market may be settling.

Lack of standardization. Lack of consensus on Sharia, a high level of innovation and low transaction volumes mean that documents for the Islamic finance market (and the Sukuk market in particular) tend to be tailor-made for individual transactions, leading to much higher transaction costs than conventional finance alternatives. These costs should diminish as transaction volumes increase, and various industry bodies are taking steps to speed up the standardization process.

Limited secondary market. Until very recently, there has been only a shallow and limited secondary market for Islamic finance products (again, Sukuk in particular) as most traditional investors have tended to hold their investments until maturity.

is set to change as Sharia-compliant alternatives are developed and work on an ISDA master agreement for Sharia-compliant derivatives is underway.

Tax disadvantages. The tax treatment of Sharia-compliant structures may not follow the treatment of their conventional finance alternatives. For example, where the financier's return is structured as a profit share rather than interest, a tax deduction may not be available for the Islamic funding cost. In practice, this can necessitate careful structuring to ensure that Sharia-compliant finance does not become a more expensive fund-raising method than conventional finance.

Sara Catley is an analyst with PLC (Practical Law Company), the UK's pre-eminent provider of legal know-how, transactional analysis and market intelligence for business lawyers. Catley would like to thank Andrew Calderwood and Natalya Pilbeam of Herbert Smith LLP, Luma Saqqaf of Linklaters LLP, Simon Sinclair of Clifford Chance LLP and Farmida Bi of Denton Wilde Sapte for their assistance with this article.

Following the Money in the Middle East

The Middle Eastern financial markets are maturing rapidly. The rise of news and information services like Zawya can only aid in that transition.

By Edward Baker

When Ihsan Jawad founded his Middle Eastern business information service in 2000, he chose the name “Zawya,” which in Arabic means “angle.” That’s an old journalism term for the point of a story, and Jawad’s goal was to cover every story from as many angles as possible. Now his startup, based in Dubai, has more than 100 employees, and he does indeed



Ihsan Jawad of Zawya

cover Middle Eastern business and finance from just about every angle—public companies, private equity, corporate and sovereign Islamic bonds (sukuk), mutual funds and IPOs. Last year he formed a joint venture with Dow Jones to launch the Zawya Dow Jones Newswire, which collects and disseminates news of all kinds related to doing business in the Middle East.

Recently, the 35-year-old Jawad, who began his career as an investment banker in London, spoke about the success of his news service, the growth of the Middle Eastern financial markets, and why Western investors should be paying attention. An edited version of that discussion follows.

Can you describe your vision for Zawya?

Our focus is the Middle East, where we’re trying to solve two problems. The first is the need for greater transparency in the financial markets in the Middle East. The second is the need to provide a single source of complete information for both issuers and investors here.

Interest in our service is coming about 60 percent from inside the Middle East and 40 percent from outside the region. The demand is strong, and increasing, primarily because the Middle East has become more attractive to investors, thanks in part to the high price of oil.

Has it been difficult to collect the information you provide?

Private companies are always going to be tough to get information from. But we deal mostly with public companies here, and there has been a lot of pressure on them to open up and become more

transparent, and the situation has changed over the past five years. Even the governments have opened up some, though they tend to remain fairly opaque. It’s all about accountability. That’s why we teamed last year with Dow Jones—specifically to reveal more about public companies.

Why do you think that is changing?

Governments and the big corporate players realize that it is in their interest to develop local and regional financial markets here, whether it be equity or debt markets. That’s in part because of the need to absorb some of the huge amounts of money that’s already come into the Middle East, and is about to come in from future oil revenues. Instead of it flying out again, which has happened in the past, the large players in this market are hoping to keep some of it here by creating deeper and more developed financial markets. If investors can handle a billion-dollar IPO or a sukuk worth a few billion dollars, then that’s great.

What is causing the growth of Islamic finance?

Given the choice, a lot of Muslim investors favor Sharia-compliant products if the returns are equal to or close to conventional products. The rapid innovations in Islamic investment products that took place in the past few years is providing this

choice and opening the doors to millions of Muslim investors.

Islamic finance is gaining popularity in mutual funds, private equity, sukuk and sukuk funds. By far the fastest growing investment tool is sukuk, whereby an investor is compensated through a series of cash flows generated from leases, profits or sale of tangible assets.

Why is it important for Western institutional investors to pay attention to Islamic finance, and especially to sukuk?

In the Gulf Cooperation Council (GCC), a lot of balance sheets are being made Sharia-compliant, with the result that many attractive investment opportunities will be offered through this structure. Western investors looking to have fixed income exposure to assets in the GCC will need to pay attention to the sukuk market.

Yet it is important that investors new to this market familiarize themselves carefully with the different types of sukuk, and the underlying strength of the credit they are exposed to. Most sukuk issues

are not yet being rated, although the major rating agencies are just now beginning to understand the importance of this market.

Has a secondary market for sukuk been established yet?

In the past few months, Zawya has been moving into pricing for sukuk in the secondary market. We've signed up three providers who will be feeding prices to us. Our estimate is that the secondary market is currently about \$150 million a day worth of sukuk, on average. Our focus is on issuers, advisers and, increasingly, the asset managers who manage sukuk funds. These funds are new, but three sukuk funds have been announced quite recently, thanks to the increase in institutional buying of sukuk. And that will eventually help push up the liquidity in the secondary market.

It has been argued that sukuk are not yet economically competitive with their more conventional counterparts. Do you agree?

In my view, overall, sukuk can provide at least as good a return to investors than conventional

issues. That's because issuers of sukuk are trying to diversify their funding sources, so they have a motive to price well. A lot of issuers have overexposed themselves to local investors. But now, they can tap into Western institutions who haven't previously had exposure to the Middle East. And that's another reason for the strong returns. The Middle East is a youthful, well-educated region with a lot of natural resources and increasing liquidity. A lot of people around the world have bought that macro picture, and they want the exposure, whether it be through equity or debt.

And in many ways Islamic investments are safer than conventional bonds. By definition, for instance, as Islamic global equity fund should be less risky, because it must invest in companies with little or no leverage. If the two funds produce historically similar returns, then I'll definitely go with the less risky Islamic fund. It's a no-brainer. Ultimately, in the Middle East, like everywhere, funds will flow to where the returns are the best. Money has no religion.



continued from 69

success, or even how they are conducted, given the complexity of the Sharia principles involved. Yet organizations such as the IIFM are pushing the Islamic finance world to work to standardize the documentation for derivatives, as they are in other areas, which will also serve to reduce the transaction costs involved in these structures.

A Parallel Future

The ongoing efforts to simplify and standardize the many financing structures possible in Islamic financing seem barely able to keep up with the innovative products that are transforming this marketplace. All those new products are merely a reflection of the creativity of financiers—both Islamic and Western—in coming up with alternative investment vehicles that satisfy Islamic ethical considerations, and the demand on the part of Western institutional investors for new ways to attract Islamic investors and investments in the Islamic world.

Despite the current burst of creativity, however, it is important to remember that Sharia-compliant finance is just another form of structured finance. As Ogilvy's Solimen puts it, "Successfully completing Islamic deals has more to do with the ability to structure complex transactions than it does with our understanding of Sharia." Managing deals, in his view, involves working with Sharia committees to get transactions approved, of course. But the wrong approach is to start

off by assuming you have to do a certain transaction a certain way. "The right approach is to start off with the principles, take a look at the transaction as you would do it normally, then look at what tweaks must be made to adhere to those principles. You might find that it needs no tweaking at all, or a lot." The key is to strive to structure as much like a conventional transaction as possible.

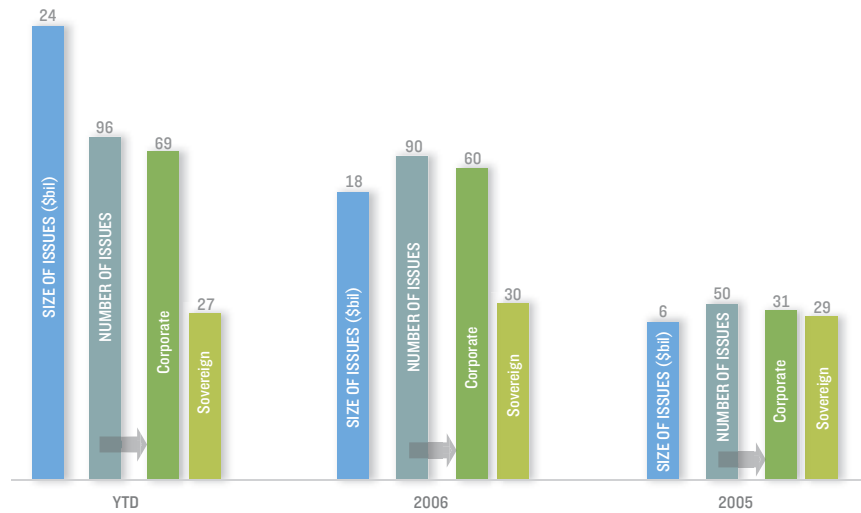
That approach is particularly useful in jurisdictions that aren't already designed to accommodate Sharia-compliant finance; like the U.S., for instance. Yet U.S. institutional investors have been slow to catch on to the opportunities available to them in Islamic finance, especially compared with their British and German brethren. That may be an unfortunate reaction to the events of Sept. 11, 2001. It may be a function of distance from the Middle East and Southeast Asia, but it's probably just a matter of supply and demand.

The Islamic finance market is still tiny, so why should American institutional investors worry about creating products—or investing in vehicles—that still appear to be more trouble than they're worth? There's little real demand, and less standardization, and that just drives up transaction costs, making them appear economically uncompetitive. But the trend elsewhere is to the regularization of such deals, and to highly competitive pricing. The opportunities are there. It's just a matter of time.

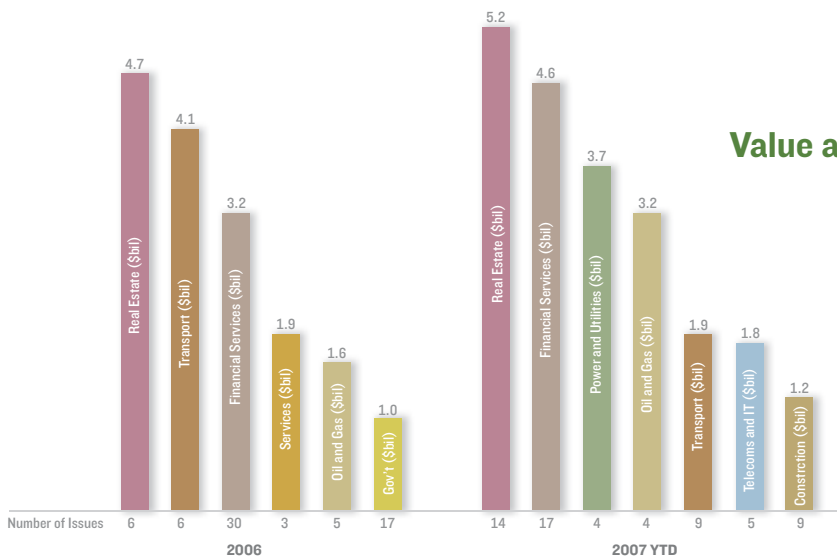
SUKUK BY THE NUMBERS

The Zawya Sukuk Monitor (www.zawya.com) provides a wealth of information on the market for this rapidly growing asset class, including issuers, advisors and news. The data below is offered as an indication of the strength of this market.

Value and Number

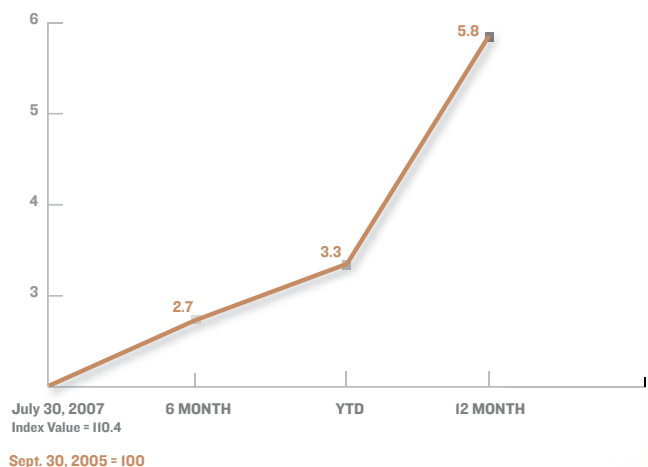


Value and Number by Sector



The Dow Jones Citigroup Sukuk Index

This index, which tracks the performance of investment-grade, U.S. dollar-denominated bonds that comply with Islamic investment guidelines, has climbed steadily since its inception in Oct. 2005.



For more data and information on the market, contact Zawya at +971.4.3635663.

“ There is no better place to conduct business in the Islamic Finance sector; the DIFC offers an ethical and transparent foundation to conduct business in the Middle East and beyond ”

Hussein Rifai
MANAGING DIRECTOR
Injazat Capital



The Dubai International Financial Centre (DIFC) is a custom-built financial hub that serves the world's largest untapped market for wholesale financial services. With an internationally recognised legal framework, independent regulator and modern financial exchange, the DIFC is the established home for over 400 registered firms. Companies benefit from zero tax, 100 percent foreign ownership and a growing institutional client base. For more information, visit www.difc.ae

