EUROPE: A RISING OPPORTUNITY FOR ISLAMIC FINANCE

A recent spike of interest in Islamic finance from Europe is creating opportunities for global Islamic finance hubs. Following monumental sovereign sukuk issuances by the UK and Luxembourg, several signposts lead to increased opportunities. Expanding trade links between Europe and OIC countries, growing preference for ethical financial solutions, massive infrastructure requirements to meet 2020 targets, governmental support for the Islamic finance sector plus the structure of the EU single market system are all are seen to be providing opportunities for sukuk issuances, Islamic banking products and services, trade financing and Islamic funds.

MALAYSIA
WORLD'S ISLAMIC FINANCE MARKETPLACE

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Europe-Malaysia Opportunities in Islamic Finance: The UK Focus

Islamic finance is now a USD2.1tln industry, and the industry's assets are expected to expand further to USD3.4tln by end-2018. Realising this potential, the global financial community is actively pursuing collaborative efforts and exploring opportunities in this niche sector.

In Europe, interest in Islamic finance in Europe has been reignited following monumental sovereign sukuk issuances by the UK and Luxembourg in 2014. The Islamic financial sector in Europe, although small in size, has promising potentials to gain traction given the fast expanding bilateral ties between European countries and Islamic financial hubs of the GCC and Malaysia.

Of particular interest is the symbiotic relationship between Malaysia and the UK. In year 2012, the countries agreed to double bilateral trade to GBP8bln (MYR43bln) by 2016[1] , and investors from both sides are keen to continue exploring economic and financial opportunities. The UK's growing interest in Islamic finance is expected to significantly complement the two jurisdictions' existing economic and financial linkages including facilitating business transactions through Shariah-compliant means.

[1] Office of The Prime Minister of Malaysia

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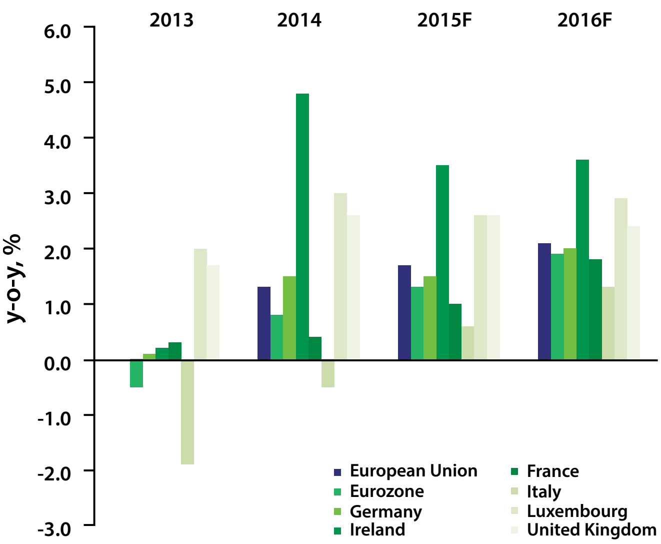
The prospects of the Islamic finance industry in Europe are broadly positive and expected to be reinforced partly by a modest economic recovery of the Eurozone and the greater European Union (EU). Reduction in fiscal drag, accommodative monetary policy and improving lending conditions may help sustain recent gains in the European economic recovery process. Recent data prints have allowed the GDP growth forecast for 2016 to rise slightly. Greatly reduced tail risks have buoyed financial markets, with marked compression in sovereign yield spreads in some economies. Domestic demand in the Eurozone has stabilised, with net exports also contributing positively. The EU is estimated to have expanded 1.3% in 2014, while the Eurozone might have grown 0.8%[2]. For 2016, the EU and the Eurozone are projected to expand 2.1% and 1.9%, respectively.

Europe: Real GDP Growth (2013-2016F)



Source: European Commission

Recent developments in key European financial markets represent promising potentials for the Islamic finance industry to gain deeper traction in Europe. Historically, Islamic finance has progressed gradually in Europe since its initiation in the early 1980s. The momentum has picked up post global financial crisis in view of Islamic finance's sustained growth and increasing global traction. The development of Islamic finance has been beneficial for multiple stakeholders, both within and outside of the region. As such the offering of Islamic banking products and services in Europe has made it possible for the Muslim population and the halal sector in the region to resort to Shariah-compliant financial services.

Although the overall magnitude of Islamic finance is still limited and fragmented, Islamic banking and Islamic funds sectors have made considerable progress in the region. Particularly, in recent years, Islamic funds have been gaining greater interest, and several European financial centres have taken a number of steps to facilitate the sector. The sukuk market has also stepped into the limelight recently owing to debut sovereign issuances by the UK – which earned the spot of the first non-Islamic sovereign sukuk issuer in the world – and Luxembourg. The sukuks by these countries have been welcomed by the global Islamic finance community.

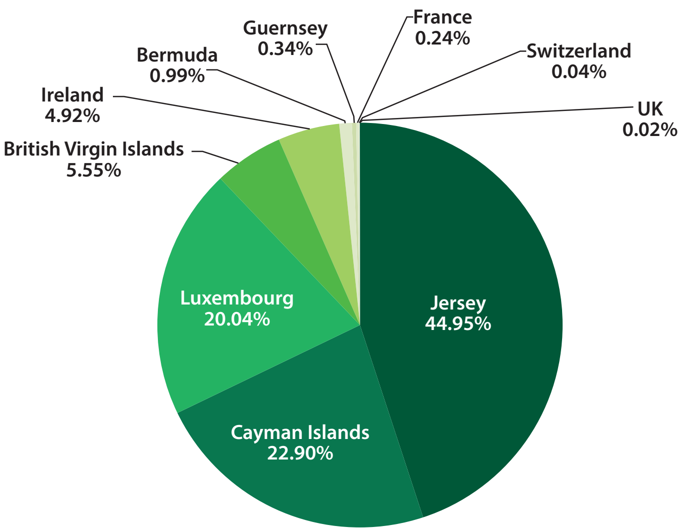
The share of Europe as a region in global Islamic finance assets remains marginal. As of 1H14, the regional Islamic banking assets (excluding those under Islamic non-banking institutions) accounted for just 0.5% of the global Islamic total[3]. Islamic funds domiciled in European jurisdictions fared slightly better, cumulatively holding USD14.4bln in assets as of 15 December 2014 and accounting for 20% of the Shariah-compliant assets under management worldwide[4]. On another more positive note, last year was notable for the European sukuk scene, with the debut sovereign sukuk issuances from the United Kingdom (UK) and Luxembourg.

[2] European Commission
[3] KFH Research
[4] KFH Research

Islamic Funds in Europe: Steady Growth

Islamic funds domiciled in Europe held approximately USD14.4bln in assets under management (AuM) as at 15 December 2014[5]. This accounted for about 20% of the global aggregate Shariah-compliant AuM, up from 12% in 2012. Generally, the appeal of European domiciles for fund managers lies in the attractive combination of tax benefits, regulatory sophistication and operational efficiency. For the benefit of Islamic fund managers, the financial regulators in a number of European states – from Ireland to France to Malta – have also issued guidelines facilitating the registration of Shariah-compliant investment schemes in their territories.

European Islamic Fund Assets by Domicile (15 December 2014)

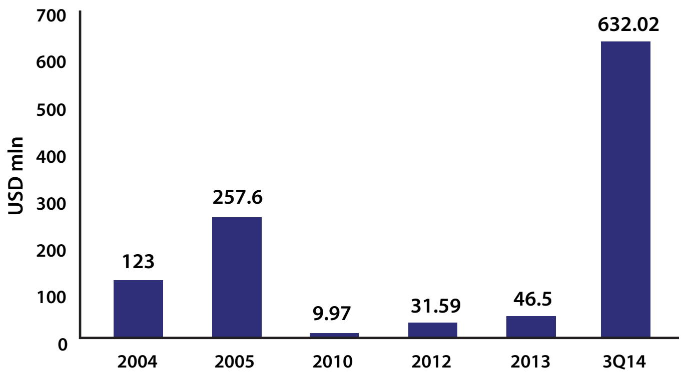


Source: Zawya, Bloomberg, Eurekahedge, KFH Research

Sukuk Market in Europe: Growing Interest

Europe's very first sukuk programme was launched in 2004, through a German federal state of Saxony-Anhalt. The following year, the UK issued the region's first corporate sukuk; in 2010, Europe's second corporate sukuk also came from the UK. The successive corporate issuances of sukuk in Europe originated from France, Germany, the UK and Luxembourg. In 2014, the UK and Luxembourg entered the Islamic capital market with highly anticipated debut sovereign sukuk issuances. These took the outstanding sukuk amount 112.2% up from end-2013 to USD719.9mln as of 3Q2014, which accounted for approximately 0.24% of the global sukuk outstanding figure[6]. We expect a gradual growth in the number of sukuk issuances coming out of Europe in the next few years, especially from European corporates that may follow in the footsteps of sovereign issuers and also because of European investors' rising appetite for alternative investment opportunities.

Europe: Historical Trend of Sukuk Issuances



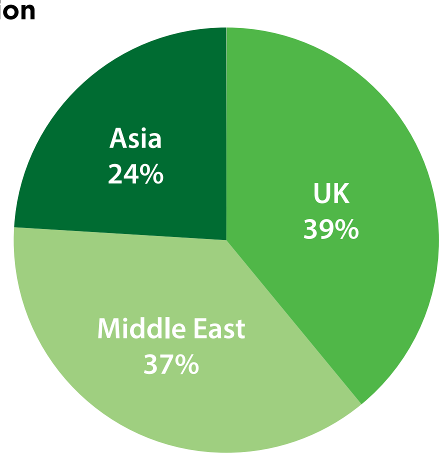
Source: IFIS, Zawya, KFH Research

[5] KFH Research
[6] KFH Research

UK Sovereign Sukuk

The UK made an entry into the global Islamic capital market with the Sanctuary Building Sukuk in 2005, which was the region's first corporate sukuk. Europe's second corporate sukuk issued by International Innovative Technologies Ltd also came from the UK. Gatehouse Bank issued Islamic corporate debt papers in 2012 through Milestone Capital. Finally, on 25 June 2014, the 5-year British sovereign sukuk, the world's first sovereign Islamic paper from a non-OIC country, was distributed to investors, raising GBP200mln (USD339.5mln) for the government and providing investors a profit rate of 2.036%. The issuance had attracted significant interest from a wide range of investors, reflecting the latent demand for sukuk globally. Order books totalled GBP2.3bln, which represented an oversubscription of nearly 12 times the issuance size.

UK Sovereign Sukuk (June 2014): Investors by Region

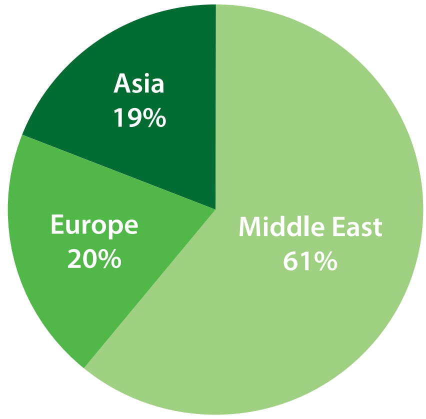


Source: Zawya, KFH Research

Luxembourg Sovereign Sukuk

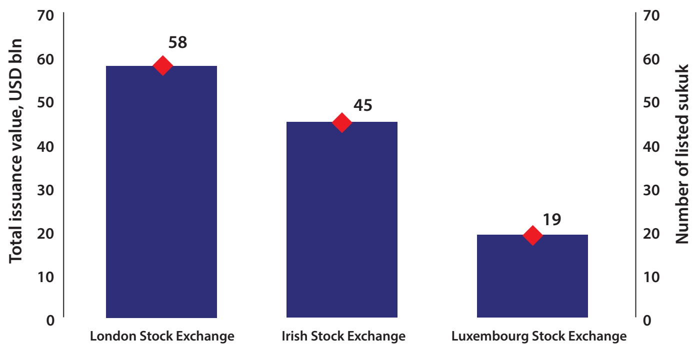
In July 2014, the Parliament of Luxembourg passed a bill that authorised the government to issue a sukuk using tangible real estate assets. On 7 October 2014, Luxembourg issued a EUR200mln (USD253mln) 5-year sukuk, only the second EUR sovereign sukuk issuance in the global Islamic capital market. The sukuk was twice (or 200%) oversubscribed.

Luxembourg Sovereign Sukuk (October 2014): Investors by Region



Source: Zawya, KFH Research

Europe: Sukuk Listings



Source: IFIS, KFH Research
Notes: As of 29 January 2015.

Europe is also an important listing destination for international sukuks of both Asian and Gulf issuers. Established European exchanges such as the London Stock Exchange (LSE), the Irish Stock Exchange (ISE) and the Luxembourg Stock Exchange (LuxSE), have been able to attract Islamic issuers with their efficient and transparent listing processes and attractive trading liquidity profiles. As of 29 January 2015, the LSE has listed sukuk with an aggreate issuance volume of about USD58bln; the equivalent figures for the ISE and the LuxSE are USD45bln and USD19bln[7].

[7] IFIS

Islamic Finance Outlook in Europe: Opportunities for Malaysia and Europe

Overall, the economic and financial characteristics of the European region enable several key growth areas for Islamic financial players across the region, including: (1) growing trade and financial linkages between the EU and the Organisation of Islamic Cooperation (OIC) countries; (2) increasing preferences for ethical financial solutions in the EU; (3) growing interest in developing the halal food business sector in Europe; (4) need for an alternative pool of liquid funds in the aftermath of the economic difficulties in the conventional finance markets in recent years; and (5) increasing governmental support for the Islamic financial sector in various European jurisdictions.

Since the inception of the Islamic finance industry, a number of countries across the European continent have implemented initiatives aimed at facilitating the inroad of the alternative Shariah-compliant financial activities. Several regulatory authorities in Europe have also forged linkages via cooperation agreements with key Islamic finance jurisdictions such as Bahrain, Malaysia, Qatar and the United Arab Emirates. Aside from regulators, private sector organisations, including industry associations and professional training institutions, have started exploring Islamic financial business opportunities, including cross border ventures.

Following London's hosting of the World Islamic Economic Forum (WIEF) in October 2013, the Global Islamic Finance and Investment Group (GIFIG) was established, with the aim of identifying key global opportunities and challenges facing Islamic finance and using its knowledge and expertise to create a global Islamic finance market that supports growth and prosperity. The group includes ministers, central bank governors, regulators, and heads of major Islamic financial institutions. The GIFIG's inaugural meeting was held in London in March 2014 and most recently in Kuala Lumpur in February 2015.

> *Global Islamic Finance and Investment Group (GIFIG) serves as a platform to foster cross-border linkages between different time zones, which may lead to seamless flow of information to facilitate capital and financial flows, efficient price discovery process, enhance competitiveness and innovation, as well as maintain the vibrancy of the industry.*
>
> **United Kingdom Foreign and Commonwealth Office and Bank Negara Malaysia, February 2015**

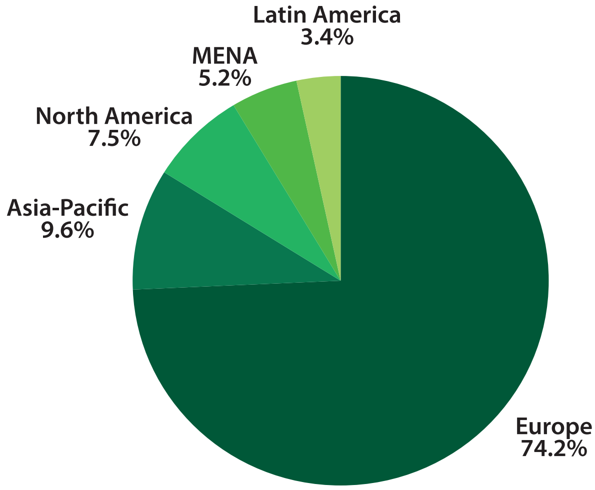
The structure of the EU single market system is capable of spurring the future expansion of Islamic finance businesses – ranging from Islamic fund managers and takaful companies to Islamic banks and Shariah-compliant wealth managers – across most of the continent. The union's common policies on trade augur well for the enlargement of the region's trade linkages with partners in Southeast Asia and the Middle East where the preference for Shariah-compliant financing solutions is most pronounced. The forthcoming issuances of sovereign sukuk out of Europe and the accompanying regulatory revisions should promote the uptake of Islamic capital market arrangements among corporate issuers.

Alternative Finance

A growing number of investors around the world – both Muslim and non-Muslim – are grativating progressively more toward Islamic asset management products and services given their roots in ethical finance and real economy and competitive return propositions vis-à-vis conventional alternatives. The European high-net-worth-individuals' (HNWI) wealth has been forecasted to reach a CAGR of 6.2% between 2012 and 2015 (North America: 5.7%), taking it to USD13.1tln[8]. What portends well for the Islamic funds sector is that, aside from the home region, European HNWIs invest the largest share of their investment dollars in Asia-Pacific (9.6%); the other region with substantive Islamic finance credentials, the Middle East, holds the third biggest extra-regional share.

[8] Capgemini

Europe: Geographical Wealth Allocation of European HNWIs



Source: Capgemini, KFH Research

The European professional investors' rising demand for socially responsible investment (SRI) avenues will also be creating greater prospects for Islamic funds in Europe. To fully benefit from these trends, Islamic fund managers – in Asia, primarily Malaysia, and the Middle East – are starting to incorporate positive or socially-conscious investment criteria into their screening processes to increase the appeal of Islamic schemes to a broader audience of investors. Also critically important is the enhancement of investor education and marketing campaigns on the topic of Shariah-compliant investments. In response to these trends, Scotland's fund industry is presently developing an action plan with regard to creating an ethical finance hub in Edinburgh – an initiative proposed by the Islamic Financial Council (IFC). Conversely, given Europe's long-standing asset management expertise, European wealth managers (including private banks and family offices) can benefit by establishing Shariah-compliant operations within Islamic finance jurisdictions; alternatively, Islamic customers could be drawn into cross-border management of funds.

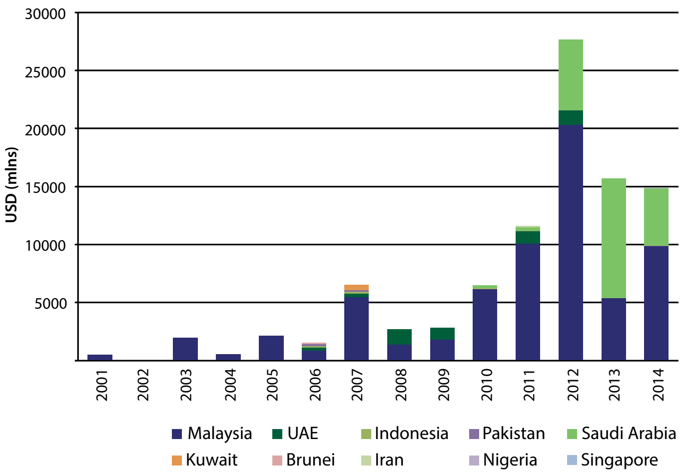
Liquidity and Infrastructure Funding

It has been estimated that the EU's infrastructure investment needs to meet the Europe 2020 objectives could reach as much as EUR2tln in the sectors of transport, energy and information technology[9]. In order to maintain the region's competitive position globally and to meet the future demand for infrastructure, European states are actively looking for alternative funding sources. Increasingly, the focus is shifting toward public private partnerships (PPPs) and institutional investor driven fundraising. In this regard, Islamic finance presents yet another avenue for raising funds for infrastructure projects in Europe. Sukuk could be used to supplement the Europe 2020 Project Bond Initiative which is intended to enable the issuance of long-term bonds by project companies.

Sukuk instruments have played a crucial role in financing the infrastructure sector with proceeds raised from issuances being utilised for both public and private projects in Asia and the GCC. Between 2001 and 2014, a total of USD99.8bln worth of infrastructure sukuks have been issued by 10 different countries, including Malaysia, Saudi Arabia, the United Arab Emirates, Indonesia, Pakistan, Kuwait, and Brunei. Notably, Malaysia alone accounted for 66.8% of this issuance volume[10]. For example, the largest sukuk in terms of issue size in 2013 was an infrastructure sukuk issued by the General Authority of Civil Aviation (GACA) in Saudi Arabia worth USD4.06bln to finance expansion projects of King Abdul Aziz International Airport (KAIA) in Jeddah and King Khalid International Airport (KKIA) in Riyadh. In recent years, several African countries, such as Sudan and Nigeria, have tapped the sukuk market to support its infrastructure funding needs.

[9] European Investment Bank
[10] KFH Research

Infrastructure Sukuk Issuances Trend (2001-2014)



Source: IFIS, Zawya, Bloomberg, KFH Research

Passportability of Funds

Islamic funds have several options for geographical expansion or diversification in terms of domicile registration and/or focus. In the EU, the Undertakings for Collective Investment in Transferable Securities (UCITS) directive represents a significant window of opportunity for Islamic fund managers to sell to European investors and to add scale. The global success of UCITS funds and the robust regulation associated with them makes obtaining a UCITS status certainly worth the effort for Islamic fund managers, given the European investor community's being largely unaware of Shariah-compliant propositions. However, at present, only a handful of Islamic fund managers have domiciled UCITS funds in European jurisdictions (estimatedly, 26 in Luxembourg and Ireland), primarily due to the perceived complexity of registering new funds as UCITS compliant or transferring existing structures onto the UCITS platform. Nonetheless, we expect to see the emergence of a greater number of Shariah-compliant UCITS funds in the near future, in view of supportive cross-border regulatory partnerships. A case in point is the supervisory cooperation arrangements entered by the SC and authorities from Luxembourg and Ireland to facilitate cross-border opportunities for the fund management industry.

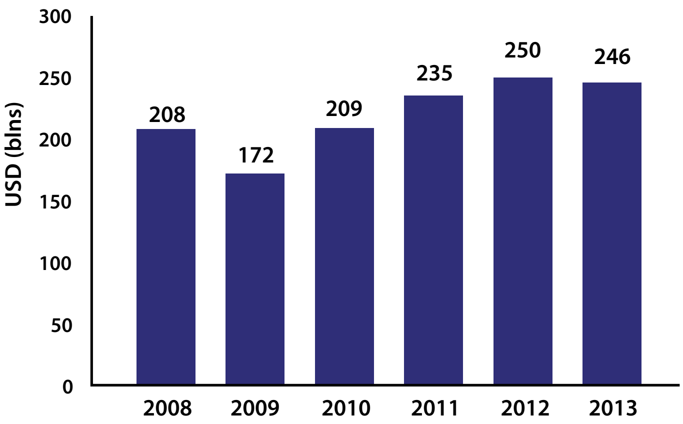
Trade Ties

A critical driver of the future growth of Islamic finance in Europe is trade: the region's many established trading centres in both core and peripheral economies hold a large business potential for providers of Islamic trade facilities. Ranging from Islamic banker's acceptances to Islamic factoring services, Shariah-compliant trade instruments are fast becoming preferable modes of financing for a growing number of trading companies across Southeast Asia and the Middle East. This development is of particular significance to Europe whose trade linkages with the two regions are set to strengthen on the back of worldwide economic reinvigoration and supportive regional geopolitical factors.

Within the Middle East, the GCC is becoming an increasingly important trading partner for the EU. The GCC is the fifth largest export market with a total of EUR95bln of exports in 2013 and the EU is the GCC's biggest trade partner, with total trade flows totalling EUR152bln or 13% of the GCC's global trade[11]. Throughout the decade, the trade patterns between two regions have been stable, revealing that GCC exports to the EU are largely composed of petrochemical products, while the EU imports to the GCC are made up to a great extent of knowledge-intensive manufactured products.

[11] European Commission

EU-ASEAN Trade Volume (2008-2013)



Source: Eurostat, KFH Research

Within Southeast Asia, the ASEAN bloc is Europe's third largest trading partner, with the total ASEAN-EU trade growing slightly by 1.5% in 2013 amounting to USD246.bln (EUR240.3bln)[12]. Inversely, ASEAN as a whole is the EU's third largest trading partner outside Europe after the US and China. Higher extra-regional trade volume between ASEAN and the EU promises to give a boost to Shariah-compliant trade financing business in Europe, given the strong footing of Islamic finance in some of ASEAN's key economies (particularly, in Indonesia and Malaysia).

Growing Islamic Financial Linkages between Malaysia and the UK

Malaysia and the UK are connected by ties of special affinity with an established bond in the areas of trade, investment, education and finance. Most recently, Islamic finance is opening a number of collaborative opportunities for the two jurisdictions, and this promises to advance Islamic finance in these markets further as well as directly support their economic growth.

Islamic finance in the UK is developing on multiple fronts, owing to the government's continual commitment to the development of the nascent industry. According to the UK Trade and Investment (UKTI), Islamic finance is worth around USD18bln a year to the country. Having recognised its growth potential, the newly created Financial Services Trade and Investment Board (FSTIB) has placed Islamic finance as one of its developmental priorities since mid-2014. Positive advances are taking place in the area of Shariah-compliant financing, in particular with regard to start-up and student loans. Presently, the Bank of England is studying the option of allowing Islamic banks to hold a wider range of liquid asset buffers (LAB). The Treasury issued the country's sovereign sukuk in June last year.

Gradual Emergence of Islamic Finance Players in the UK

1982
Albaraka International Bank (Islamic mortgages)

1996
United Bank of Kuwait (Islamic mortgages)

2003
HSBC Amanah (Islamic mortgages, treasury, private banking)

2004
ABC International Bank
Islamic Bank of Britain
Bank of Ireland

2005
European Islamic Investment Bank, Lloyds TBS, Children's Mutual

2007
Bank of London and the Middle East (wholesale Islamic)

2008
QIB UK
Gatehouse Bank
British Islamic Insurance

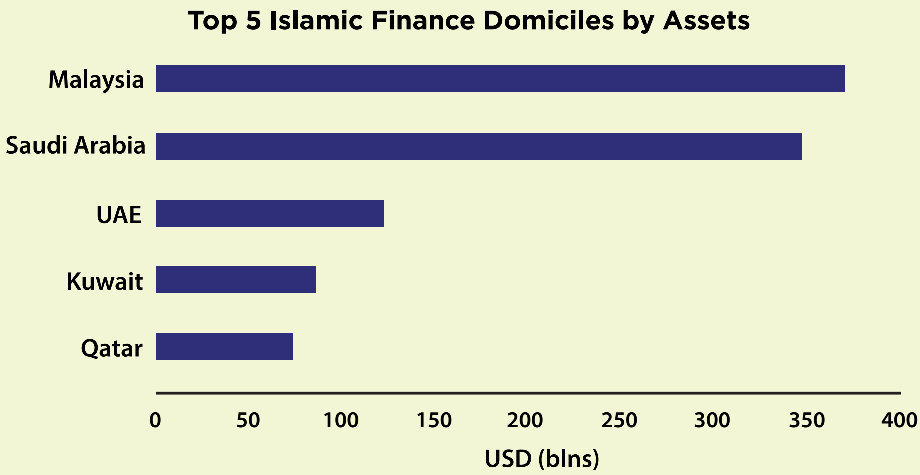
2013
Abu Dhabi Islamic Bank
Cobalt Underwriting

2014
Umex Securities
Al Rayan Bank

Source: UKTI, KFH Research

[12] European Commission

Meanwhile, Malaysia continues to lead the Islamic finance world in terms of industry asset size and activity in the market, especially in the sukuk segment. Islamic finance assets in Malaysia amounted to USD365bln as at 1H2014, ahead of Saudi Arabia, the UAE, Kuwait and Qatar. The industry of Islamic finance in Malaysia is supported by: (1) robust economic growth driven by private consumption and investment. GDP for the full year of 2014 is estimated to have grown at 5.6%, faster than 4.7% for 2013; (2) regional expansion of domestic Islamic financial institutions; (3) continued efforts by regulators to ensure that industry practices evolve to further support real economic activity; as well as (4) financial markets' advancement. The sustained healthy progression of Islamic finance in Malaysia promises to support the country's economic relations with interested international counterparties, including the UK.



Source: Various, KFH Research

Notes: Excluding Iran; Malaysia with Islamic banking assets of Development Finance Institutions

Interregionally, Malaysia is one of the UK's most strategic economic partners in Asia. Their relationship, which goes back in time, has been strengthening of the past few years, on the back of their mutual interest in bilateral trade, investment and most lately Islamic finance. Key developments concerning Malaysia and the UK over the past few years are evident of the growing mutual interest in both regulators and private entities. In February 2009, Bank Negara Malaysia (BNM) signed a Memorandum of Understanding (MoU) with the UK Trade and Investment (UKTI) to establish a collaborative framework to promote mutual co-operation in the area of Islamic finance. This MoU has paved the way for Malaysia and the UK to strengthen co-operation in the development of talent, expertise and business linkages in Islamic finance. The signing of this MoU reflected the commitment to further develop the Islamic finance industry in the two countries. In May 2013, Gatehouse Bank, one of the UK's six full-fledged Islamic banks, commenced operations in Malaysia via a representative office to tap opportunities and to ensure its proximity with its key clients, regulators and stakeholders in the region. This followed the GBP165mln acquisition of the law firm SJ Berwin's offices in London, in collaboration with Khazanah Nasional in September 2012.

Malaysian investment in the UK has been on the increase with companies, including government-linked firms, looking at investing in real estate and purchasing buildings in London. For example, in 2012, Malaysian companies invested close to GBP1.4bln in London, more than any other Asian state. As at December 2014, Malaysian funds had investments overseas totalling GBP4.91bln (MYR27bln).

These were mostly from the Employees Provident Fund (EPF), the Retirement Fund (KWAP) and Permodalan Nasional Bhd (PNB). The EPF has been especially active in the overseas investment market. In 2014, for example, EPF purchased stakes in Arena Unit Trust, which owns three Tesco-anchored retail parks. The previous year, EPF via a Malaysian consortium, was involved in the London Battersea Power Station investment. The Battersea site was bought in July 2012 for GBP400mln by a three-member consortium from Malaysia, believed to be worth GBP8bln by the time it is completed in 2024. Most importantly, the financing of the project was partially funded through a Shariah-compliant syndicated financing.

Malaysia is the largest issuer of infrastructure sukuk, accounting for 66.8% of the volume in 2014. Therefore, the UK's investment linkages with Malaysia may also create encouraging opportunities for the former to fulfil its infrastructure financing needs. Recently, the UK's National Infrastructure Plan 2014 has peeked the interest of foreign investors by revealing a refreshed infrastructure pipeline of over GBP460bln of planned investments in both public and private sectors, including the upstream oil and gas objects for the first time. Aside from regional investments which hold a 38% in the total, there are cross-regional and UK-wide projects such as the roll-out of superfast broadband (worth GBP1.7bln), the GBP20bln of works maintaining the country's gas and electricity networks, and major multi-regional projects such as HS2.

Moving forward, fast developing Islamic finance ties between the countries are expected to have a significant positive effect on two fronts: by reinforcing their existing economic ties and by buttressing the development of the industry of Islamic finance in the UK and, in the whole of Europe.

Conclusion

The rapid development of Islamic finance in various parts of the world has proven the practicality of Islamic financial solutions. In Europe, Islamic finance offers a unique proposition through alternative ethically driven products and services. These are capable of further enhancing trade and financial linkages between the EU and various OIC countries where Islamic finance has deep presence, including Malaysia.

Islamic finance ties between Malaysia and the UK are expected to significantly complement their existing economic and financial linkages while facilitating greater volume of business transactions through Shariah-compliant means. Additionally, Malaysia's established relationship with the UK adds to the Islamic finance business in Europe in general and in the UK specifically, through collaborations on various levels as well as exchange of knowledge and experience.