2014 - A LANDMARK YEAR FOR GLOBAL ISLAMIC FINANCE INDUSTRY

The global Islamic finance industry has seen some key developments in 2014, as the industry achieved several milestones and continues to move towards greater sustainability and providing a wider range of financial services. By end of year, the total assets of the Islamic finance industry are expected to surpass USD2tln. Substantial debut sukuk issuances, from several non-OIC countries, saw the feasibility of sukuk outside the Muslim world. A number of landmark regulatory advances were made, and continued innovation, including Basel III compliant sukuk, sukuk for social causes and more cross-border sukuk activity have added further substance and sophistication for a deeper and more sustainable ecosystem.

MALAYSIA
WORLD'S ISLAMIC FINANCE MARKETPLACE

26 December 2014

2014 - A LANDMARK YEAR FOR GLOBAL ISLAMIC FINANCE INDUSTRY

MALAYSIA
WORLD'S ISLAMIC FINANCE MARKETPLACE

Islamic finance is gearing up to more sustainable growth trajectory amid more sophisticated regulatory framework and innovative products.

The year 2014 was an important one for Islamic finance, as the industry achieved several milestones and continues to move towards greater sustainability and providing a wider range of financial services. As of end-2014, the total assets of the Islamic finance industry is expected to surpass USD2tln[1] (compounded average growth rate, CAGR 2010-2014: 17.3%).

Throughout the year, the sukuk market generate excitement following monumental issuances by sovereign entities making their debut in the market. From a regulatory standpoint, several landmark regulatory advances were made, including the Islamic Financial Services Board's guidelines on core principles for Islamic finance regulation, and the launch of the "Sustainable and Responsible Investment (SRI) Sukuk" in Malaysia. Elsewhere in Qatar, the financial regulatory authority has announced the establishment of a deposit insurance framework, including a Shariah-compliant variant, as part of the strategic plan to modernise the country's financial sector by 2016. Broadly, the expansion of Islamic finance in 2014 was supported by the robust demand for credit and capital market products; while the industry also remained vulnerable to volatilities arising from concerns on growth, unwinding of advanced economies' monetary policies, equity market sell- offs and low bond yields.

Global Developments and Economic Outlook

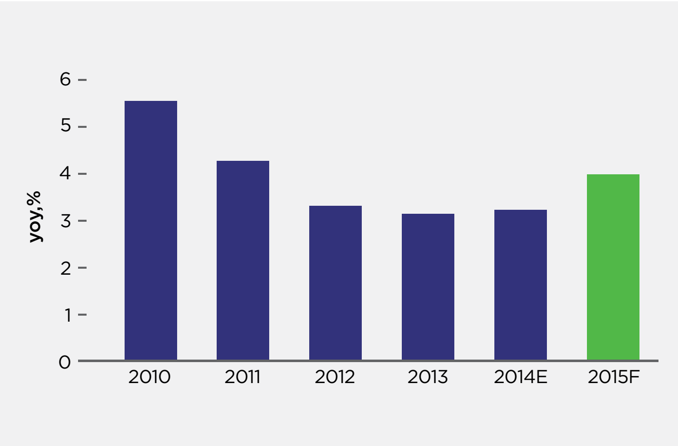
Five years after the financial crises, the global economic and financial system continue to operate in an environment of heightened uncertainty. World economic growth remains affected by the fragile recovery in the advanced economies. Emerging economies faced bouts of destabilising financial flows due to exogenous events such as the US quantitative easing taper plans and geopolitical crises. Amid these constraints, credit growth in emerging economies remained healthy[2], supported by domestic demand and accommodative monetary policies. Capital market activity was fairly buoyant, as equity markets recorded a general uptrend, prior to the sharp sell-off in November 2014 when oil prices declined; while bond yields faced downward pressure from low interest rates in advanced markets.

For the full-year 2014, the International Monetary Fund (IMF) estimates[3] that global GDP expanded at a sustained pace of 3.3% (2013: 3.3%), as the global economy continues its protracted recovery. The outlook for global growth is one of cautious optimism, as risk and uncertainty abound. Looking ahead, GDP growth is expected to improve to 3.8% by 2015 and to average at 4.1% between 2016 and 2019[4]. Importantly for Islamic finance, growth will be underpinned robust domestic demand in emerging economies, including in Asia Pacific and the Middle East. Furthermore global trade activity is expected

[1] KFH Research Ltd
[2] Bank Ownership and Credit Growth in Emerging Markets During and After the 2008-09 Financial Crisis-A Cross-Regional Comparison, Chen & Wu (2014), International Monetery Fund (IMF)
[3] October 2014
[4] IMF forecast

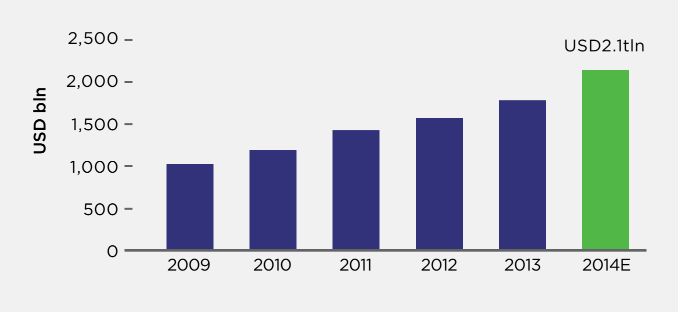
to accelerate from current levels, to support this demand (2014E: 3.7%; 2015F: 5%)[5]. Risks to these forecasts arise partly from financial channels, as sentiment remains vulnerable to exogenous events such as geopolitical crises, especially in the Middle East and Russia; as well as shocks to oil prices. Another key risk is the possible disorderly market adjustment to the expected normalisation of monetary conditions in the advanced economies.

Global GDP Growth (2010-2015F)

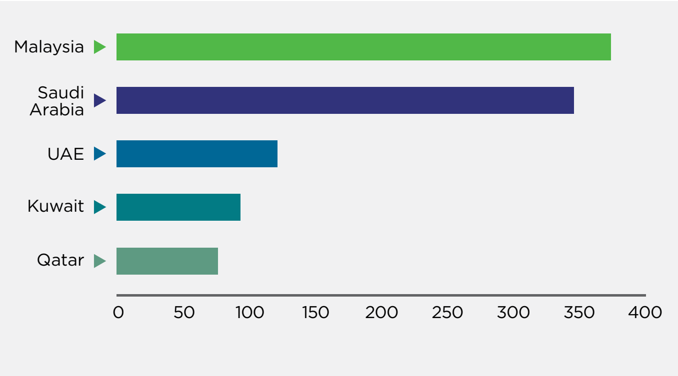


Source: IMF World Economic Outlook (October 2014, KFH Research)

Global Islamic Finance Assets (2009-2014E)



Islamic Finance Assets by Domicile (3Q2014)



Source: Various, KFH Research

2014 in Review: Defining Trends

Overall, the asset size of the global Islamic finance industry is estimated at USD2.1tln as of end-2014. The industry continued to chart encouraging growth; assets have grown at a compounded annual growth rate (CAGR) of 17.3% between 2009 and 2014. Islamic banking and sukuk sectors dominate the industry, with respective 80% and 15% shares in aggregate assets[6] . By country[7], Malaysia is the leading jurisdiction, followed by Saudi Arabia, UAE, Kuwait and Qatar.

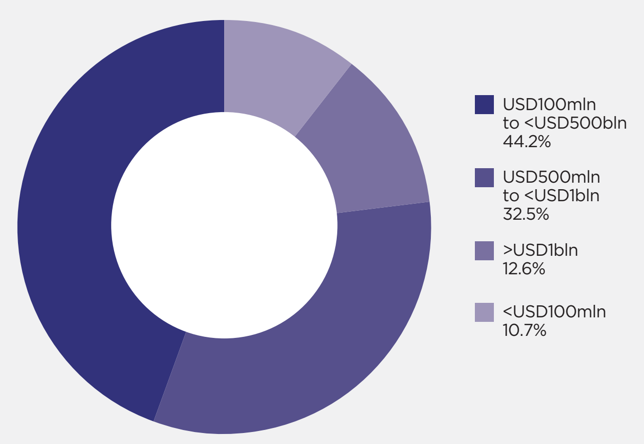
As Islamic finance continued to reach new heights, the expansion was complemented by trends which suggest that the industry is evolving into a deeper and more sustainable ecosystem. Key trends driving in the sphere of Islamic finance include landmark debut sukuk issuances by governments, and the expansion of Islamic finance into more countries in Africa and Europe. Meanwhile, the industry continued to innovate its products, supported in part by regulatory advancements in key jurisdictions such as Malaysia and the GCC. Advances made by multilateral agencies also supported the progress of Islamic finance in 2014.

5 IMF forecast
6 IMF forecast
7 Excluding Iran

Monumental Issuances in the Sukuk Market

Throughout the year, the sukuk market made headlines for various large issuances (both sovereign and corporate) as well debut issuances from the governments of the UK, Senegal, Hong Kong, South Africa and Luxembourg. Overall, the sukuk market recorded USD114.7bln issuances in January-November 2014 (11m13: USD105.6bln) spurred mainly by sovereign issuers which accounted for more than 70% of total issuances. The size of individual sukuk deal sizes for the year were substantial, issuances between USD100mln-USD500mln accounting for 44.2% of total issuances in 11M14. Major benchmark issuances of USD500mln and above have become commonplace in the sukuk market, accounting for 45.1% of total issuances in the same period. This compares favourably with historical figures; landmark sukuk issued back in the 1990s and early 2000s were well below the USD1bln mark[8].

Sukuk Issuances by Individual Deal Size (11m14)



Source: IFIS, Zawya, Bloomberg, KFHR

Of these major deals, the five sovereign sukuk generated much interest. The countries involved - UK, Senegal, Hong Kong, South Africa and Luxembourg – were non-OIC (Organisation of Islamic Cooperation) nations, a testament to the feasibility of sukuk outside the Muslim world. Furthermore, issuances by financial centres such as the UK and Hong Kong signalled that sukuk will be more widely accepted by mainstream finance. The UK government issued a USD339.50 sukuk in June, with a profit rate Of 2.036%. Senegal's debut issuance was also a first for Islamic capital markets in the sub-Saharan Africa region. Elsewhere, the Government of Hong Kong SAR issued a 5-year US Dollar deal worth USD1bln. The programme attracted substantial investor demand, with an order book of USD4.7bln. The Republic of South Africa debuted in the sovereign sukuk market with a deal worth USD500mln in September 2014. The sukuk, which was listed on the Luxembourg Stock Exchange, was oversubscribed by 4.4 times, with nearly 50% orders originating from the Middle East. Later in the year, the government of Luxembourg issued a USD271.72mln EUR-denominated sukuk. All five sukuk issuances utilised the Ijarah structure.

Amongst corporate issuers, a major American investment bank issued its USD500mln sukuk with a return of 2.844% in September 2014. Another landmark corporate sukuk was Al Hilal Bank's Murabahah sukuk, which was a perpetual sukuk and Basel III compliant. The world's first sukuk by a takaful operator was issued in May 2014, by a major player in the Malaysian market.

8 IFIS, Zawya, Bloomberg, KFH Research

Future Frontiers for Islamic finance in Africa and Europe

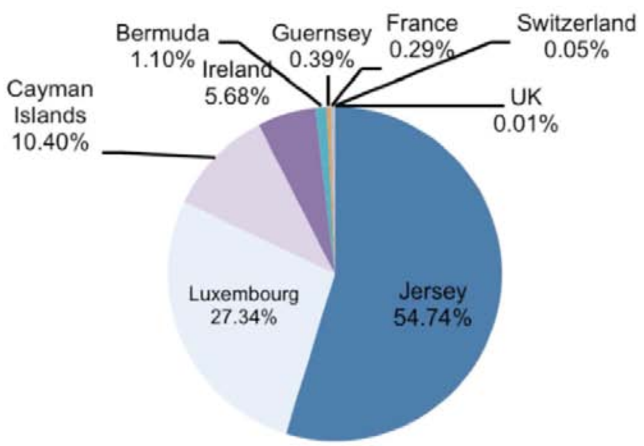
The geographical expansion of Islamic finance continued in 2014, as Africa and Europe witnessed advancements in Islamic banking and capital market, respectively; complementing the growth of Islamic finance domiciles in Asia and the GCC. These developments were consisted of both regulatory changes and increased Islamic finance activity on these two continents.

To date, Islamic finance has made inroads into Africa, for example in Nigeria, South Africa and Kenya, mainly via Islamic banking and a few takaful firms. Regulatory challenges abound, and these are being addressed gradually. In Kenya, the Capital Markets Authority (CMA) submitted a proposal in 2014 for a separate regulatory framework for Islamic finance to the National Treasury. The proposed framework is expected to increase the appeal of the Kenyan capital market to international investors by facilitating Islamic debt structures. In Burkina Faso, Coris Bank International (CBI) announced its decision to launch a Shariah-compliant window early next year, paving the way for the republic to join the likes of Nigeria, Guinea, Senegal and Ghana in offering Islamic banking services.

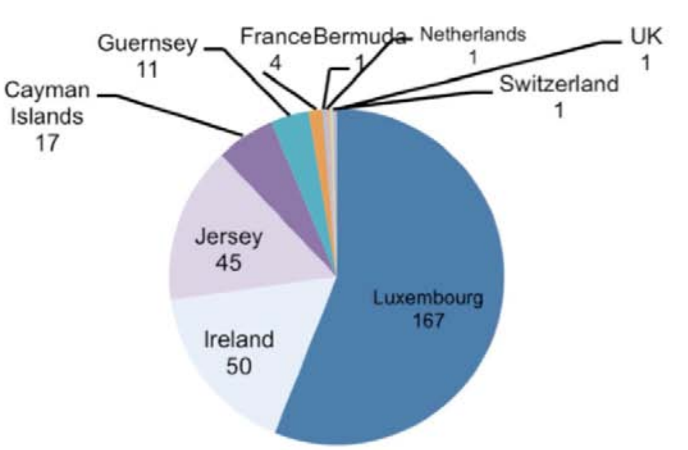
Meanwhile, Islamic finance expanded its presence in Europe, mainly via capital markets. Reflecting the region's importance as a centre for global financial activity, Islamic funds continued to expand, while sukuk listings by foreign issuers on European stock exchanges also increased[11].

Islamic funds domiciled in Europe held approximately USD11.9bln in assets under management (AuM) as at 17 September 2014, accounting for sizeable 16.3% of the global aggregate Shariah-compliant AuM, up from an 11.8% share as at end-2012. Apart from the offshore centre in Jersey, other key European players in the Islamic funds market are located in Luxembourg and Ireland. These funds invest mainly in global markets, as well as the Middle East and North Africa (MENA) region. Following the sukuk issuances by the UK and Luxembourg, UK's Gatehouse Bank is expected to issue a sukuk in 2017.

European Islamic Fund Assets by Domicile (17 September 2014)



Number of European Islamic Fund Assets by Domicile (17 September 2014)



Source: Zawya, Bloomberg, Eurekahedge, KFH Research

9 Kenya's market overhaul eyes Islamic finance framework", Reuters (March 2014)
10 "Burkina Faso's bank to introduce Islamic banking", StarAfrica news (October 2014)
11 IFIS, KFH Research

Innovation in Product Design

Continuous innovation is imperative to support the sustainability of Islamic finance. The industry witnessed advancements in product design in 2014, mainly in the sukuk market. These included more issuances of Basel III compliant sukuk, sukuk for social causes and more cross-border sukuk activity. Notably, the growth of Basel III-compliant sukuk necessitated by new capital requirements, which Islamic banks needs to address via Shariah-compliant instruments. Since the issuance of the world's first Basel III compliant sukuk in November 2012, Islamic banks in countries including the United Arab Emirates (UAE), Saudi Arabia and Malaysia have issued such innovative sukuk instruments. To date, a total of nine Basel III compliant sukuks have been issued to date raising USD5.09bln in proceeds for eight different issuing banks.

In December 2014, the International Finance Facility for Immunisation Company issued a USD500mln sukuk to support a major vaccination programme. The utilisation of sukuk as a mechanism to finance social causes as well as "green sukuk" has been in progress for a few years; for example, the Dubai Supreme Council of Energy (DSCE) and the World Bank have an ongoing collaboration since 2010 to finance substantial energy investments via green sukuk or bonds. Elsewhere in Malaysia, the Securities Commission announced the framework for socially responsible sukuk, referred to as the "Sustainable and Responsible Investment (SRI) Sukuk" framework in September 2014. The SRI sukuk framework is expected to support demand from both retail and sophisticated investors for access to a wider range of investment products and to facilitate greater participation in the sukuk market.

Continued progress has been made on cross-border sukuk issuances, where obligors issue sukuk in other domiciles, utilising the domiciles' local or other currencies. In this regard, Malaysia has been home to issuances by foreign multilaterals, sovereigns and corporates; issuing both Ringgit-denominated and foreign currency sukuk. In 2014, a financial institution issued the world's first first JPY-denominated sukuk in Malaysia. In addition, a Turkish Islamic bank and two Singapore-listed plantations had issued ringgit-denominated sukuk in Malaysia during the year. Going forward, Turkey Finans has announced plans to issue another Ringgit sukuk in the near future. Issuances by foreign entities are generally supported by Malaysia's deep and liquid Islamic capital markets.

Key Regulatory and Multilateral Advancements

Since inception in the early 1960s, regulatory advancement and adaptation have been instrumental in supporting the growth of Islamic finance. Much of the innovation in Islamic finance occurs within the boundaries of Shariah, as well as regulatory boundaries. In this regard, regulatory clarity is important to support innovation.

In support to drive for greater product innovation, Bank Negara Malaysia (BNM) issued new and enhanced Shariah standards for key Shariah contracts. Following the issuance of Murabahah standard, more Shariah standards are likely to be issued soon for the other five key Islamic contracts of Mudharabah, Musharakah, Ijarah, Wadiah and Istisna, upon consultation with the industry. Other contracts that are awaiting feedback from the public and industry on the exposure drafts of the Shariah requirements and optional practices include: Hibah, Bai Inah, Kafalah; Wakalah; Wadi'ah; Wa'd; and Tawarruq. The gradual roll-out of standards for important contracts will support further product innovation, as well as enhance and streamline practices in the industry.

Elsewhere in South Asia, the State Bank of Pakistan announced in October 2014 that it would start conducting open market operations to facilitate more efficient short-term liquidity management for Islamic financial institutions. The decision by the central bank follows the initial issuance of short-term Ijarah sukuk since 2008 for liquidity management. Meanwhile, the Reserve Bank of India has begun a review of regulations on Islamic banking in India[12]. In July, the central bank was reported to have established an internal committee consisting of senior RBI officials responsible for the task.

While enhancing domestic regulatory sophistication is imperative, efforts by multilateral entities to elevate standards and practices in Islamic finance should be given due recognition as well. Ongoing efforts by the Islamic Financial Service Board (IFSB) on the Core Principles for Islamic Finance Regulation, as well as the Guidance Note on Liquidity Risk Management are expected to further streamline Islamic finance operations globally[13]. The core principles will serve as a basis for assessing the strength and effectiveness of regulation and supervision; the assessment may be conducted by domestic authorities or by external parties such as the International Monetary Fund and World Bank. These principles take into account the unique properties of Islamic banking and is expected to be used as benchmark by Islamic finance jurisdictions in safeguarding the stability of their financial systems. On the other hand, this effort is pertinent to complement global liquidity standards and to promote the sound management of liquidity risk.

On another note, further progress has been made on the Ten-Year Framework and Strategies for Islamic

Selected Basel III Compliant Sukuk Issuances (2014)

Sukuk	Structure	Country	Issue Date	Tenure (Years)	Size	Type of Capital
NCB Tier 2 Sukuk	Mudarabah	Saudi Arabia	20th Feb 2014	10 years (Callable 5-years)	SAR5bln	T2
Maybank Islamic	Mudarabah	Malaysia	7th Apr 2014	10 years (Callable 5-years)	MYR1.5bln	T2
Saudi Investment Bank	Combination	Saudi Arabia	5th June 2014	10 years (Callable 5-years)	SAR2bln	T2
Public Islamic	Mudarabah	Malaysia	9th June 2014	10 years (Callable 5-years)	MYR500mln	T2
Hong Leong Islamic	Ijarah	Malaysia	17th June 2014	10 years (Callable 5-years)	MYR400mln	T2
Banque Saudi Fransi	Combination	Saudi Arabia	18th June 2014	10 years (Callable 5-years)	SAR2bln	T2
Al Hilal Bank	Mudarabah	United Arab Emirates	30th June 2014	10 years (Callable 5-years)	USD500mln	AT1

Source: IFIS, KFHR Research

Financial Services Industry (IFSI) Development. In 2014, a mid-term review was documented and jointly published by the IFSB and the Islamic Research and Training Institute (IRTI). The ten-year plan is a general framework that national authorities may refer to for Islamic finance development initiatives. The review was released five years after the initial document, to assess the progress made by the industry in implementing the recommendations, incorporate the new developments taking place in the global financial system and the challenges faced.

Meanwhile, the key multilateral entity for liquidity management, the International Islamic Liquidity Management Corporation (IILM) remains dedicated to supporting the short-term financial needs of Islamic financial institutions. The IILM has increased the frequency and size of its sukuk issuances in 2014, issuing a total of USD5.8bln of sukuk as of November 2014 (2013: USD980mln). These sukuk satisfy the Basel III requirements on the liquidity coverage ratio and thus, have attracted strong demand. Going forward, the IILM aims to increase its issuance size.

International Islamic Liquidity Management Corporation Sukuk Issuances

	2013		2014								
	Aug	Nov	Jan	Feb	Apr	May	Jul	Aug	Aug	Oct	Nov
USD (mln)	490	490	860	490	860	490	860	400	390	860	590
Tenure (month)	3	3	3	3	3	3	3	6	3	3	3

Source: IFIS, KFH Research

12 "After opening doors to differentiated banks, RBI now reviews Islamic banking norms", Firstpost news (July 2014)
13 The IFSB released these exposure drafts on 31 October 2013

2014 - A LANDMARK YEAR FOR GLOBAL ISLAMIC FINANCE INDUSTRY

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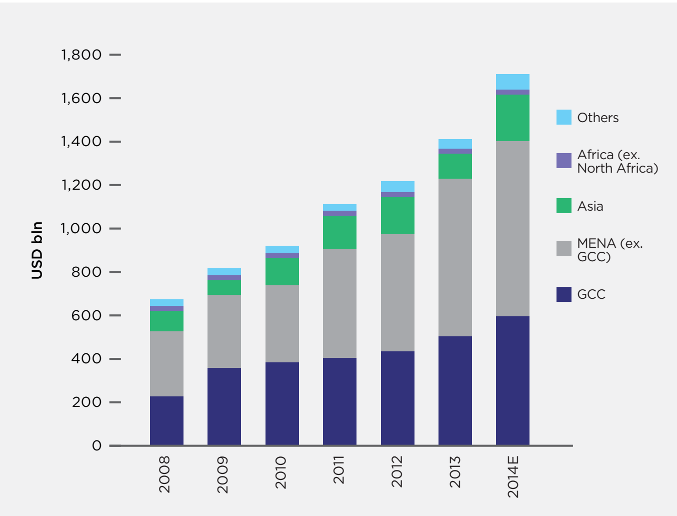
2014 in Review: Snapshot of Growth by Segment

Islamic Banking

- Total Islamic banking assets is expected to increase to USD1.7tln in end-2014, having recorded a CAGR of 14.1% between 2009 and 2014. The largest Islamic banking markets are in the Middle East and North Africa (MENA) excluding the GCC; this region accounted for 45% of total Islamic banking assets worldwide. The GCC accounted for a 37% share, while Asian jurisdictions cumulatively made up 12%. Africa's Islamic banking assets, while comprising just 1% of total, have grown faster than the other regions.

Global Islamic Bnking Assets by Region

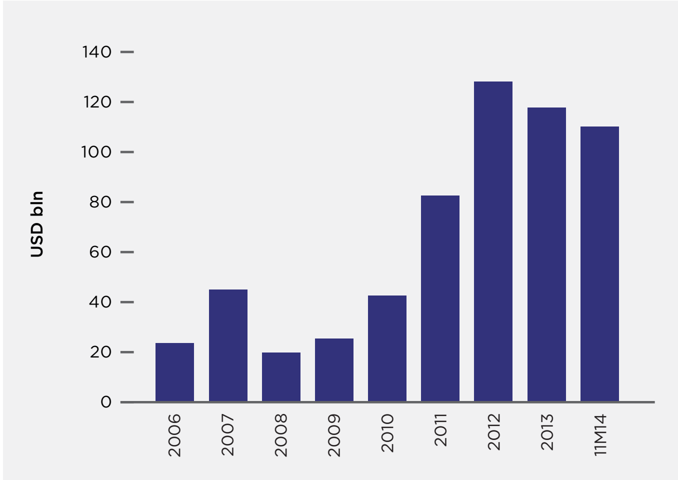


Source: Various, KFH Research Database

Sukuk

- Sukuk issuances rose to USD114.7bln in 11M14 (Jan-Nov 2014), a sizeable 8.6% increase from the USD105.6bln volume recorded during 11M13. Sovereign issuances accounted for almost 80% of total issuances, including first time sovereign obligors such as the United Kingdom, Senegal, the Emirate of Sharjah, Hong Kong, South Africa, Luxembourg and Pakistan. Amongst corporates, issuers from the financial services sector from Malaysia, Saudi Arabia, the UAE and Turkey were fairly active.

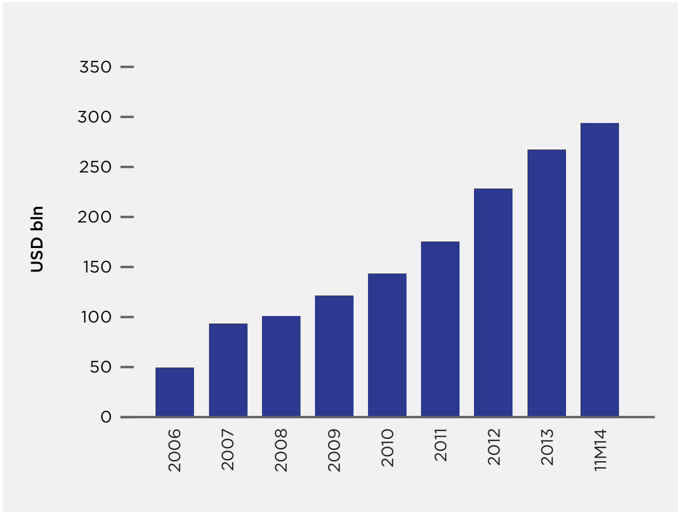
Global Sukuk Issuances



Source: Various, KFH Research Database

- Global sukuk outstanding increased to a record of USD300bln as of 11M14, an 11.4% rise from USD269.4bln at end-2013. By domicile, Malaysia's secondary sukuk market is was valued at USD173.4bln, a 9.6% increase year-on-year (y-o-y). Meanwhile, the total GCC sukuk outstanding portfolio grew by 6.4% to USD90.8bln, as compared to USD85.3bln outstanding at end-2013.

Global Sukuk Outstanding Trend



Source: Various, KFH Research Database

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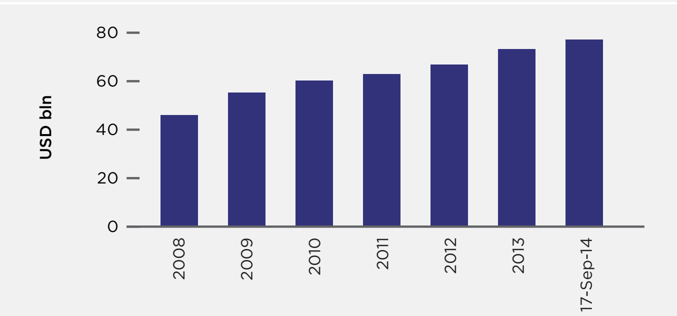
Islamic funds

- The global Islamic fund sector amassed USD75.8bln in assets under management (AuM) as of 17 September 2014, with 1,161 active funds. The market is led by Saudi Arabia and Malaysia, which together hold 65% of Shariah-compliant AuM. European jurisdictions continue to attract fund managers with Islamic offerings. In Asia, a substantial more funds are emerging from Indonesia and Pakistan.

Global Islamic Fund Assets Trend

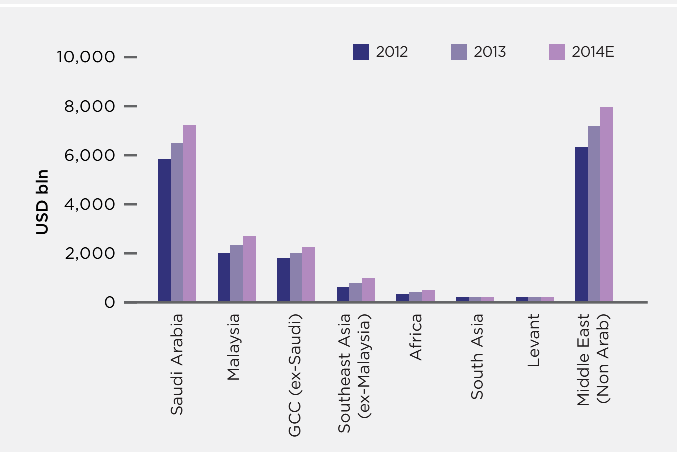


Source: Zawya, Bloomberg, Eurekahedge, KFH Research Database

Takaful

- Global gross takaful contributions are estimated to have amounted to USD26bln as at end-2014. Saudi Arabia and Malaysia are the largest takaful markets by gross contributions. Saudi Arabia generated an estimated USD7.2bln in gross takaful contributions in 2014, while Malaysia gathered about USD2.7bln.

Global Islamic Fund Assets Trend

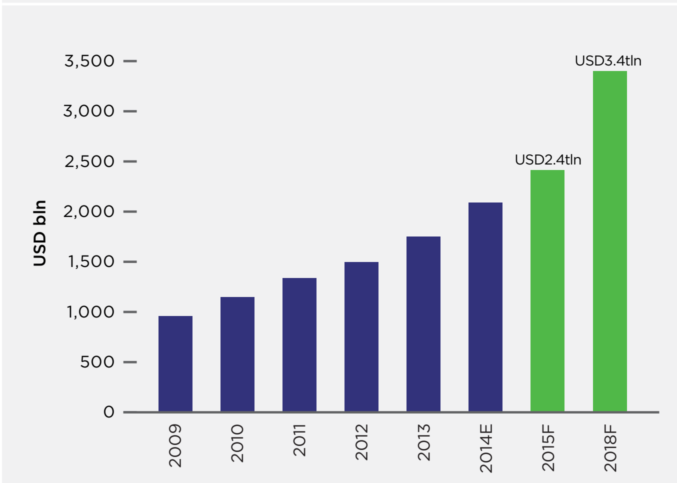


Source: Various, KFH Research Database

2015-2018 Outlook: Islamic Finance to Reach New Heights amid Global Uncertainties

The growth of Islamic finance will be supported by the on-going recovery in the global economy, with firmer global growth forecasted at 3.8% next year[14], an uptrend compared to 3.3% growth in 2013 and 2014 estimates. Underpinning this growth is robust domestic demand in emerging economies, including in Asia Pacific and the Middle East, amid stronger global trade activity (2014E: 3.7%; 2015F: 5%). Nevertheless, financial market sentiment remains vulnerable to exogenous events such as geopolitical crises, especially in the Middle East and Russia; as well as shocks to oil prices. Another key concern for investors will be timing of the unwinding of easy monetary policies in the advanced economies, especially the Federal Reserve's quantitative easing programme. In the past, announcements on the Fed taper had led to volatility in financial market yields, especially in emerging economies.

Global Islamic Fund Assets Trend



Source: Various, KFH Research Database

Nevertheless, Islamic finance remains supported by structural and demographic factors, as well as the generally better economic sentiment in emerging economies. Next year, the industry's total assets is expected to increase to USD2.4bln and to expand further to above USD4bln by 2020 (CAGR 2014-2020: 12.5%). Growth will be spurred mainly by the

14 International Monetary Fund (IMF) forecasts for economic data (October 2014)

leading domiciles of Malaysia, Saudi Arabia, the UAE, Qatar and Kuwait; new frontiers such as Indonesia and Turkey; as well as the expected entry into nascent markets in Africa and Central Asia. In these countries, retail and corporate financing are likely to be the main sources of business for Islamic finance, driven by private consumption and investment. Meanwhile, the desire to tap into Middle Eastern wealth will continue to support the sukuk market; in addition to the demand for infrastructure financing. On the supply side, Islamic finance remains well-supported by multilateral agencies and domestic regulators.

Key Growth Drivers for Islamic Finance (2015-2020)

Source: Various, KFH Research Database

Islamic Banking

Moving forward, overall growth is projected to maintain high growth rates (2008-2013 CAGR: 17.4%)[15] as the Islamic banking sector in some major markets, such as Saudi Arabia, Kuwait, Qatar, Malaysia, and the UAE continue to expand in wider economic sectors. In these jurisdictions, as focus will increasingly be on regulatory sophistication and prudential supervision; market participants are likely to turn more innovative in product structuring and customer service strategies amid heightened competition. In Malaysia, the IFSA 2013 has been in force since end-June 2014 and facilitates a contract-based regulatory framework. Qatar is planning to introduce a Shariah-compliant variation of its recently established deposit insurance framework. The UAE opened a credit bureau in June to safeguard bank lending.

Niche players – where Islamic banking assets account for less than 10% of total banking system assets – are also gradually strengthening their positions. For example, Turkey is adding to the number of players on the domestic banking scene by encouraging state-run banks to open Shariah-compliant units. The State Bank of Pakistan's five-year strategic plan is expected to drive strong asset growth in the Islamic banking sector, with the stated objective of taking a 15% in the domestic market by 2018[16]. Meanwhile, Indonesia's new roadmap envisions the establishment of separate legal policies, infrastructure and market incentives for the Islamic banking sector[17].

Nascent Islamic banking jurisdictions, including Morocco and Tunisia in North Africa and Azerbaijan and Tajikistan in Asia. The Moroccan parliament voted in the Islamic banking bill in November 2014[18], allowing both local and foreign players to set up participative banks. The regulatory authority in Tunisia has approved the establishment of the country's third fully-fledged Islamic bank[19]. Azerbaijan is preparing

15 KFH Research
16 "Moody's: Pakistani regulator's plan will drive asset growth in Islamic banking" (August 2014)
17 Indonesia eyes consolidation, new laws in roadmap for Islamic finance", Reuters (November 2014)
18 "Moroccan parliament approves Islamic finance legislation", Reuters (November 2014)
19 "Private sector moves keep Tunisia's Islamic finance hopes alive", Gulf Times (December 2014)

to pass an Islamic banking law in second quarter of 2015[20] and may have its first standalone Islamic bank unit soon. In Tajikistan, the Islamic banking law, approved in 2012[21], came into force in August 2014[21]. Among prospective entrants to the Islamic banking business is Burkina Faso which expects to see its first Shariah-compliant window early in 2015.

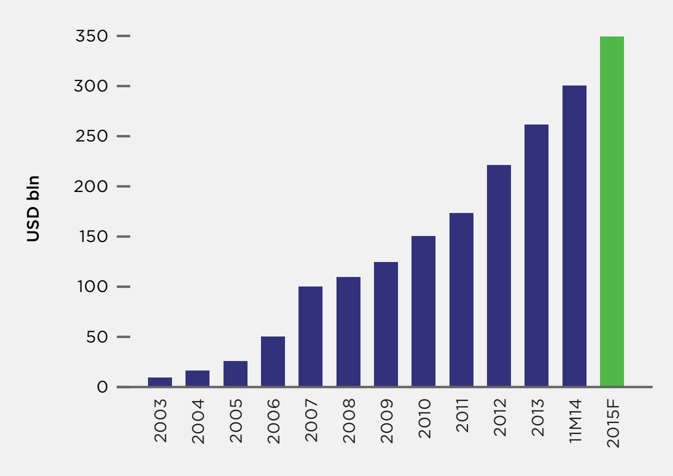
A notable trend in development in Islamic banking is proliferation of centralised Shariah supervision. In October 2014, the Central Bank of Oman set up a five-member Shariah board which has been awarded with direct oversight of Islamic banking institutions. Later in December, the Central Bank of Bahrain announced its introducing enhanced Shariah governance standards for the Islamic banking sector and its forming a central Shariah body tasked with approving Islamic products. Similarly, Da Bank Afghanistan is also moving toward a centralised Shariah board.

General trends in the banking industry worldwide, from leveraging on mobile technology to tighter capital adequacy and liquidity rules, will affect Islamic banking institutions progressively more with the passage of time. Cross-border, the Islamic banking sector is becoming more integrated and more standardised. The efforts of the Islamic finance industry's own multilateral organisations such as the Islamic Financial Services Board (which mostly recently released a draft guidance on liquidity risk management and a new standard for regulatory supervision of Islamic banks), the International Islamic Financial Market (which mostly recently released a standard documentation for a collateralised Murabahah agreement) and the Accounting and Auditing Organisation for Islamic Financial Institutions (which mostly recently issued a standard for down payments and another on conditional termination of contracts) are amongst key initiatives that will facilitate the advancement of the industry at global level.

Sukuk

Sukuk outstanding is expected to grow at the average pace of the past five years (around 16% per annum), to USD350-360bln in 2015 (2020F: USD630-640bln)[22]. A key supporting factor for the sukuk sector is the infrastructure needs of leading sukuk domiciles, as well as countries new to the sukuk market in South Asia and Africa. Between 2015 and 2020, growth rates may moderate from the high average growth in the past, given that the infrastructure projects in Malaysia and several GCC economies would be well underway; many of these plans are targeted for completion before 2020. At the global level, the sukuk market is likely to see more cross-border and foreign currency issuances.

Global Sukuk Outstanding (2006-2015F)



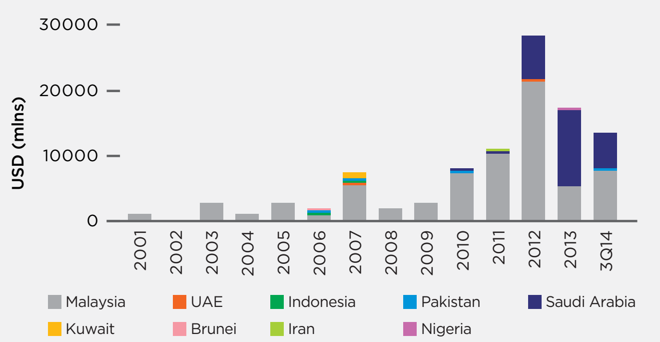
Source: IFIS, Zawya, Bloomberg, KFH Research

Sukuk has played a pivotal role in infrastructure financing and has been utilised for both public and private projects. Between 2001 and 3Q2014, a total of USD97.4bln worth of infrastructure sukuk have been issued by more than 10 different countries. The market for infrastructure sukuk has generally been dominated by issuances from Malaysia, followed by Saudi Arabia and the UAE. Going forward, Amongst key sukuk jurisdictions, Malaysia is on the last leg of its Economic Transformation Programme (ETP), and is expected to accelerate spending plans to meet the various economic and socio-economic targets by 2020. In the medium-term, GCC infrastructure and

20 "Azerbaijan's top bank to drive Islamic banking in Russia", Azer News (December 2014)
21 "Law on Islamic banking in Tajikistan comes into force", Asia-Plus (August 2014)
22 KFH Research

real estate projects are forecasted to value almost USD3tln, including sectors such as power and utilities and transport. In the event of a prolonged period of weak oil prices, some of these projects may face delays; but overall, most projects are expected to continue given the region's immediate infrastructure needs.

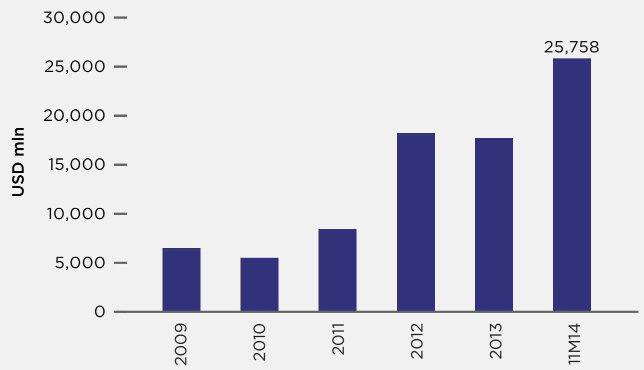
Infrastructure Sukuk Issuances Trend (2001-3Q2014)



Source: IFIS, Zawya, Bloomberg KFHR

In line with recent trends[23], the sukuk market will continue to attract cross-border and foreign currency transactions (11M14: USD25.7bln issuances) , leveraging on the attractiveness of key jurisdictions such as Malaysia. In addition, the growth of USD-denominated sukuk is expected to persist, due to the tradability of the currency. Within the GCC, as well as Indonesia and Turkey, USD will continue to be the main foreign currency. Meanwhile, Malaysia is likely to attract more foreign issuers to issue ringgit sukuks; currently ringgit sukuks have been issued by multilaterals and regional corporations such as Singapore-listed plantations. In 2014, the first JPY-denominated sukuk in Malaysia was issued by a conventional financial institution; other regional currencies may follow in the future. The Malaysian market is further supported by ample Shariah-compliant investors, including cash-rich institutional investors.

Total Foreign Currency-denominayed Sukuk Issuances (2009-11M14)



Source: IFIS, KFHR

Overall, the sukuk market is expected to reach greater heights, and importantly, greater depth in terms of the rising popularity of foreign-currency sukuk and cross border transactions. The debut sovereign issuances in 2014 are likely to draw more interest into sukuk by other potential issuers in these countries. Nevertheless, investors and issuers alike are likely to be cautious in the immediate term, due to the expected gradual end of easy monetary policies and the ensuing temporary volatility.

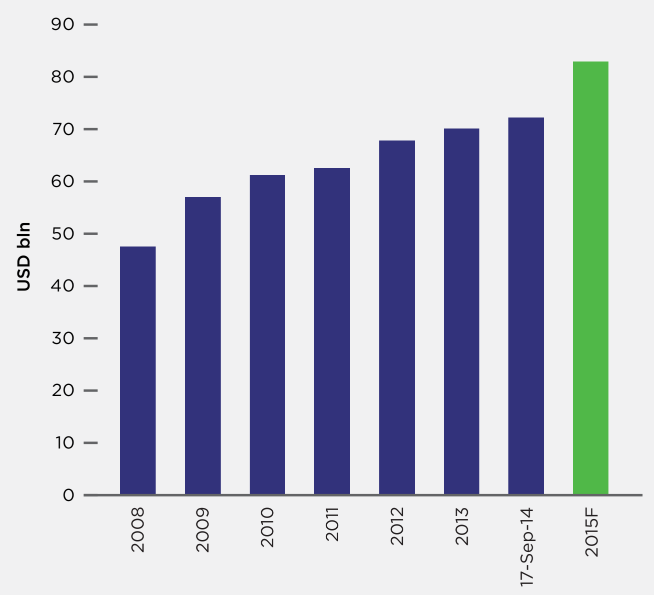
Islamic funds

Assets under management gathered by Islamic funds are forecasted to surpass USD100bln by 2018 (2020F: USD113bln). From 2008 to 2013, the sector grew at a CAGR of 9.1% and was valued at USD75.8bln as of 17 September 2014[24].

In the near term, the runaway leaders, Malaysia and Saudi Arabia, will hold their ground. Malaysia continues to develop comprehensively, enhancing its Islamic finance related regulation and leading in terms of market innovation. In August, Malaysia, Singapore and Thailand signed a framework streamlining the authorisation and distribution

23 KFH Research
24 Zawya, Bloomberg, Eurekahedge, KFH Research

Global Islamic Fund Assets: Growth Trend



Source: Zawya, Bloomberg, Eurekahedge, KFH Research

processes for fund managers across their borders[25]. Saudi Arabia has started implementing capital market reforms, as part of which it plans to open the domestic equity market – the largest in MENA – to foreign institutional investors sometime in the first half of 2015[26].

Fast growing Islamic finance jurisdictions of Indonesia, Pakistan, the UAE and Turkey are to feature more prominently. Pakistan, for example, will obtain its first Islamic gold fund in 2015[27]. Turkey launched two new participation indexes in August 2014, aiming to satisfy the demand from both local and foreign Islamic investors[28]. In the same month, the Dubai Financial Services Authority said it was creating a new class of funds targeting qualified investors with less stringent regulation and thus lowers costs[29].

European jurisdictions, including offshore destinations, will remain relevant, attracting Islamic fund managers with regulatory clarity and passporting schemes. In November, a maiden Shariah-compliant Seed Enterprise Investment Scheme fund was introduced in the UK which allows UK-based investors to invest in start-up and early stage businesses[30]. International financial centres in Asia (e.g., Singapore and Hong Kong) and the GCC (e.g., Dubai and Qatar) may hold a larger proportion of Islamic fund assets, as they rush to improve their offerings to Islamic investors. In June 2014, Hong Kong received its first Islamic fund launched by a Malaysian entity; in November, a tie-up was announced between another Malaysian fund manager and a Hong Kong counterpart for joint marketing of Islamic investment products in mainland China[31].

Among new markets, there is Australia that registered its first Islamic property trust in July 2014. Liechtenstein in Europe plans to concentrate on Islamic wealth management, with the financial regulator presently exploring tax and legal amendments to facilitate this segment. In Africa, the Nigerian Stock Exchange listed a Shariah-compliant equity exchange traded fund in November. The government-owned State Bank of India is launching an Islamic mutual fund in December, following an approval from the Reserve Bank of India.

The performance of Islamic funds will, as always, depend to a large extent on overall conditions in global financial markets as well as idiosyncratic risks in focus countries. Slightly lower and more divergent returns by asset class may emerge as new trends, as uncertainty hovers over the medium-term investment outlook for some asset categories (such as fixed income and commodities).

25 "Investors in 3 Asean markets get wider range of options", Asia One Business (August 2014)
26 "Saudi Arabia prepares to open USD530bln bourse to foreigners", Zawya (July 2014)
27 "Pakistan to welcome maiden Islamic gold fund next year", IFN (December 2014)
28 "Turkey launches two new participation indexes", IFN (August 2014)
29 "Dubai changing rules to attract asset managers", Trade Arabia (August 2014)
30 "UK's first Shariah-compliant Seed Enterprise Investment Scheme", CPI Financial (November 2014)
31 "Malaysia-Hong Kong tie-up to market Islamic funds in mainland China", Legal Business Online (November 2014)

Takaful

Developments in takaful are likely to accelerate in key domiciles such as the key GCC countries and Malaysia, as well as highly populated Muslim countries where takaful is gaining popularity such as Indonesia and Pakistan. In Pakistan, for example, a recent change to regulations will now allow conventional players to establish takaful windows, which should spur greater competition and innovation in the jurisdiction's nascent takaful market. Meanwhile, new entrants to the takaful market are likely to orginate from African countries (Kenya, South Africa, Morocco, Nigeria) and Asia (Afghanistan, Kazakhstan, Thailand, Sri Lanka); these countries are currently either at exploration stage or have a handful of takaful players in the market. Total gross takaful contributions are expected increase to around USD26bln at end-2015 and USD42bln by 2020 (2014E: USD23bln)[32].

Notably, even the key takaful markets have relatively low rates of takaful and insurance penetration, suggesting ample room for growth. In Saudi Arabia, the newly enforced 2012 Mortgage Law is expected to boost demand for home financing and thus, support growth of housing-related protection products such as Coverage for building materials and fixtures and fire risk; as well as life takaful. In other GCC markets such as the UAE and Qatar, takaful operators may leverage on recent legislations mandating health insurance for the population. Meanwhile, the Malaysian takaful market could undergo changes in operating flexibility, product disclosure and delivery channels to market practices, as mentioned in the concept paper for BNM's Life Insurance and Family Takaful for Everyone (LIFE) framework Generally, the four main Islamic finance segments – Islamic banking, sukuk, funds and takaful – are expected to grow further, albeit at more moderate rates compared to the recent surge. These growth rates reflect a more sustainable path for the industry, especially in key jurisdictions where regulatory enhancements are expected to improve the quality of Islamic financial products and services; improve the resilience of the industry to external shocks, and; support consumer confidence in the industry. Overall, these developments are positive for the Islamic finance sector in the longer-term, as a provider of competitive and safe financial services to the economy.

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