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The solid growth potential in Asia represents one of the most important economic stories in the past decade. Between 2000 and 2013, emerging and developing Asia grew by an average of 7.9%, while growth in advanced economies averaged just 1.8%. While the region's economies vary in terms of structure, growth was broadly supported by increasing trade activity, as well as domestic consumption and investment.

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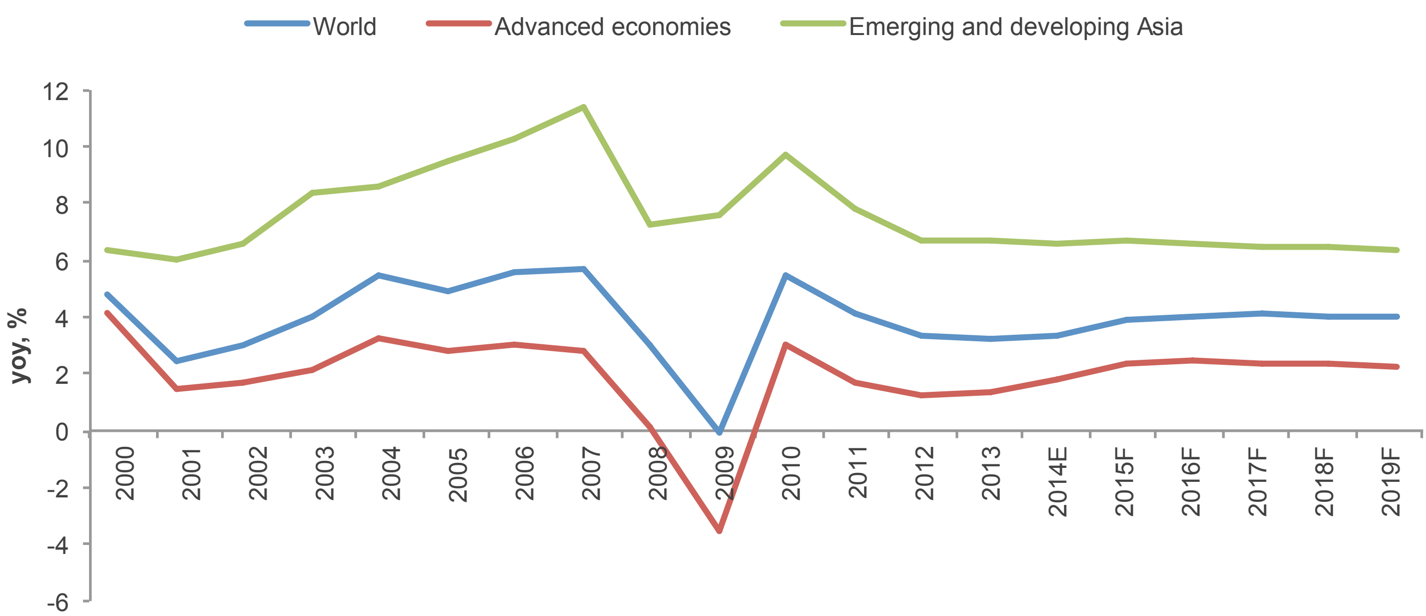
Growing potential in South East Asian economies supports expansion of Islamic finance

The solid growth potential in Asia represents one of the most important economic stories in the past decade. Between 2000 and 2013, emerging and developing Asia grew by an average of 7.9%, while growth in advanced economies averaged just 1.8%[1] . While the region's economies vary in terms of structure, growth was broadly supported by increasing trade activity, as well as domestic consumption and investment.

During the global financial crisis, Asian economies were adversely affected mainly through trade connections with advanced economies. Nevertheless, Asian economies remained structurally sound, and supported by relatively healthy corporate balance sheets and robust credit growth[2] . As such, the region's economic recovery was quicker and stronger than that of the advanced economies. Reflecting the sound fundamentals of the region's economy, Asian economies are expected to continue to bolster global economic growth in the future, with an average GDP growth forecast of 6.5%[3] in the next five years.

Regional GDP Growth (2000-2019F)



Source: International Monetary Fund (IMF) October 2014 forecasts, KFHR

1 IMF (October 2014), KFHR
2 "Asia, the Financial Crisis, and Global Economic Governance", IMF (October 2009)
3 IMF (October 2014), KFHR

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Discussions on Asia's growth prospects typically centre around large and populous economies such as China and India, as well as dynamic hotspots such as Japan, Hong Kong and Singapore. Looking ahead, the South East Asian economies will become an increasingly important part of this discussion, on account of its favourable demographics and growth potential. The 10-country region is home to economies which vary terms of size, stages of development and economic structure; and encompassing fast-advancing economies such as Malaysia and Indonesia, as well as new frontiers such as Vietnam and Myanmar. These economies which have extensive historical and cultural connections, as well as increasingly linked by business and trade connections.

Collectively, the South East Asian countries would rank as the world's seventh-largest economy[4] . The region's GDP is expected to reach USD3tln by 2017[5] , three times its size in the last decade. Global trade is an important part of economic success in South East Asia - total exports from these economies combined ranked as the fourth largest globally in 2013[6] . Recognising their collective economic potential, these countries, via the Association of South East Asian Nations (ASEAN), have continuously pursued regional and economic integration; which would unite the region and allow investors to expand their reach to a total of 600 million[7] strong population.

Dynamics of ASEAN

Demographics	Economic growth	Infrastructure	International trade
81 million households with solid spending power (2030: 163 million)	Collectively, South East Asia is the 7th largest economy globally	USD7tln needed between 2015 to 2030 for infrastructure and real estate	Third largest exporter globally in 2013

Source: McKinsey Global Institute, Asian Development Bank, Economist Intelligence Unit, KFHR

4 "ASEAN Economic Community: 12 Things to Know", Asian Development Bank (August 2014)
5 "ASEAN's rapid economic growth and future potential", opening address of ASEAN Fixed Income Summit (September 2014)
6 Economist Intelligence Unit (2014)
7 Invest in ASEAN website

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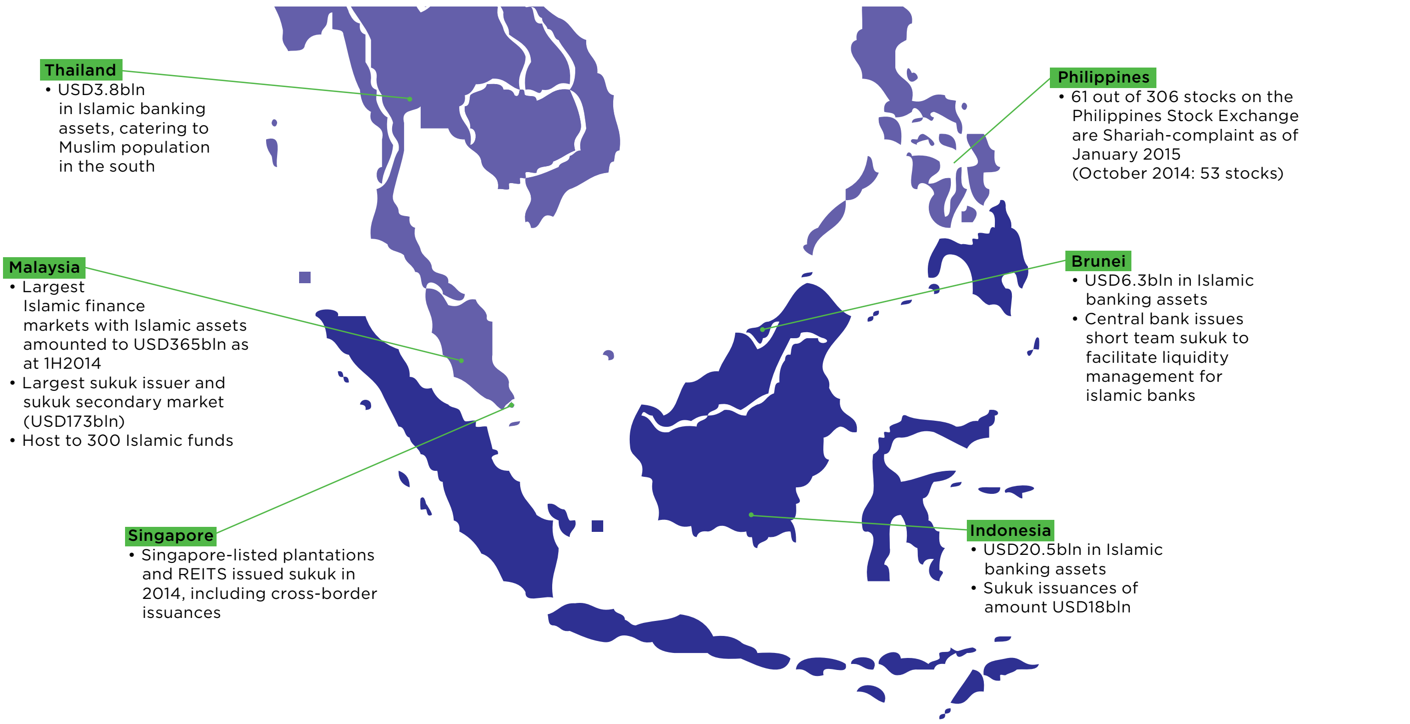
Financial integration in Asia and ASEAN markets set to create opportunities for Islamic finance

Going forward, regional integration will an important theme for ASEAN economies and corporations. With regard to the financial sector, the pace of regional integration is expected to be gradual, as governments need to prioritise financial stability. Over the past two decades since the Asian financial crisis, ASEAN countries have made great strides in improving the efficiency and soundness of their financial institutions and in developing money and capital markets. Nevertheless, greater cooperation is needed to support the development and scale of the region's banking sector. In this regard, the region has endorsed and is in the process of formulating the ASEAN Banking Integration Framework, which aims to liberalise the banking sector by 2020. The benefits from financial integration include greater scale and more competition, which would ultimately benefit the region's 600 million population; and to improve resilience to external shocks. For the year 2015, Malaysia has assumed the chairmanship of the 10-member bloc. Amongst the key tasks ahead include formulating a post-2015 plan for ASEAN's economic integration efforts.

To date, Islamic finance is fairly entrenched in Muslim-majority countries such as Malaysia, Indonesia and Brunei; with strong growth potential in banking, takaful and Islamic funds to support growing economic activity. Meanwhile, the region's demand for infrastructure investment is likely to spur more sukuk issuances by sovereign and government-related entities. Corporate issuers have also tapped the sukuk market to raise funds for the plantation and real estate sector. In addition, Islamic finance has a growing presence in countries such as Thailand and the Phiippines, particularly in areas where the minority Muslim population demands Shariah-compliant financial services.

Islamic Finance in South East Asia (2014*)



*The cut-off dates for the data vary by segment, as follows: Banking (1H2014), Sukuk (2014), Funds (3Q2014).
Source: IFIS, Zawya, Bloomberg, Eurekahedge, World Islamic Insurance Directory, KFHR

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Against the backdrop of these efforts to support regional integration, the growth story of South East Asia is expected to continue going forward. By 2020, the ten-nation region is estimated to contribute to more than half of the total global middle class population, representing more than USD2tln of new consumption within the region[8]. Importantly, the region will need to mobilise its savings; the savings rate in South East Asia is one of the highest in the world at around 30%[9].

Islamic finance activity in South East Asia has accelerated in the past decade, and the outlook for future demand remains bright. Broadly, there are four key economic and financial trends which are expected to further intensify demand for Islamic finance in the region. In terms of size, the infrastructure sector (including real estate) is expected to utilise USD7tln worth of funds in the next 15 years; some of which may be generated through sukuk issuances. By economic sector of individual countries, South East Asia is a producer of several key commodities in the agricultural sector, while moving towards expansion of manufacturing activity; thus creating potential for Islamic financing to support investment and working capital needs of these key sectors.

Meanwhile, cross-border activity in trade and finance is expected to increase; of late, this trend has also been apparent in Islamic finance, for example in terms of cross-border sukuk issuances. Key sukuk markets in South East Asia with strong investor bases are likely to attract more issuances from neighbouring countries, in search of more competitive and diverse financing costs. On another note, the mobilisation of funds in the region may benefit from unique mechanisms such as Waqf, which has already taken root in the region.

How Islamic Finance Can Support the Mobilisation of Funds in South East Asia

- **Sizeable infrastructure funding needs**
- **Financing for key economic sectors**
- **Cross-border financing deals, including sukuk issuances**
- **Utilisation of unique mechanisms in Islamic finance (Waqf)**

Source: KFHR

[8] "Roadmap of financial integration for Malaysia and ASEAN - what can business expect?", speech by Governor Tan Sri Dr Zeti Akhtar Aziz (December 2014)

[9] World Bank data (2013)

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Supporting the region's sizeable infrastructure (including real estate) financing needs

The region's economic prospects and rapidly growing population necessitate continued spending on infrastructure such as transportation, telecommunication and power and utilities. On a per capita basis, South East Asian nations broadly lag behind the OECD nations in terms of the roads and railways infrastructure, as well as electricity and clean water coverage[10] . Recognising these facilities as a key enabler for economic activity and well-being, South East Asian governments plan to invest heavily in infrastructure building and maintenance in the medium-term. In this regard, increasing and diversifying sources of funding will be an important exercise for the respective governments. While there have been concerted efforts such as the ASEAN Infrastructure Fund founded by the Asian Development Bank (ADB), much of the funding needs will need to be channelled from the financial and capital markets.

On the role of Islamic finance, sukuk is likely to gain further prominence as a source of infrastructure financing for South East Asia, partly due to its attractiveness to highly-liquid Middle Eastern investors. To date, Malaysia has been a major issuer of infrastructure sukuk, issuing more than USD10bln of sukuk for infrastructure projects in 2014 (2013: USD5.4bln). Issuers include both government-related entities, as well as construction and real estate players for the purpose of building highways, public transportation structures, offices, hospitals and universities. Meanwhile, a telecommunications provider from Indonesia also issued a three-tranche sukuk in December 2014. Elsewhere in Singapore, real estate operators have tapped into both the sukuk market and Islamic financing facilities such as commodity Murabahah. Beyond these established Islamic finance jurisdictions, potential lies in the new frontier economies such as Vietnam and Myanmar, which will likely attract cross-border investment for their large infrastructure needs.

Financing for activity in key economic sectors

A distinctive theme across South East Asian countries is the ongoing move towards industrialisation, to varying degrees. These include both resource-based manufacturing, as well has higher value-added manufacturing of electronics and pharmaceuticals. For the region's exports especially, the manufacturing sector accounts for a significant share. Key sub-sectors such as electrical and electronic goods, machinery, vehicles and plastic and plastic products accounted for 44.5% of total South East Asian exports in 2013[11] . These sectors represent relatively untapped potential for Islamic finance, including financing for capital expenditure, working capital and trade financing.

On the agricultural sector, South East Asia is the world's largest producer of key commodities such as palm oil and rubber[12]. Both these commodities are typically processed and traded within the region; other key trading partners include China and India. As such, the potential for growth remains solid, and will also require financing for expansion. To date, Singapore-listed oil palm companies have actively tapped the sukuk market for financing. In 2014 alone, First Resources Limited and Bumitama Agri issued four and two ringgit sukuk, respectively, to diversify funding sources and to finance working capital needs.

[10] "Facts and Data about ASEAN Infrastructure", Asian Development Bank (May 2012)
[11] BDG Asia estimate
[12] Economist Intelligence Unit (2014)

Cross-border financing deals, including sukuk issuances

An emerging trend in the sukuk market is the increase in cross-border issuances in Asia, including in South East Asia. Indeed, the region's significant financing needs amid growing intra-regional ties have created ample opportunities for cross-border financial activity. To date, Asian sukuk issuers have ventured outside of their own domestic markets to issue sukuk due to the large pool of Shariah-compliant investors in other parts of the region. For example, in January 2013 a major conglomerate from Hong Kong issued a 3-year Murabahah sukuk in Malaysia. More recently in 2014, Singapore-listed plantations such as First Resources Limited and Bumitama Agri issued ringgit-denominated sukuk. Elsewhere, financial institutions from Turkey have also tapped the South East Asian sukuk market in search of more diversified sources of funding, and have expressed interest to issue more sukuk in the region in 2015.

This trend is expected to continue, in light of financial integration efforts in the region. On another note, there will be more opportunities for cross-border investment in funds; in August 2014, the ASEAN Capital Markets Forum (ACMF) launched the ASEAN Framework for cross-border offerings of collective investment schemes (CIS), which would ease regulatory restrictions on cross-border investments between Malaysia, Singapore, and Thailand.

Utilisation of unique mechanisms in Islamic finance such as Waqf

Notably, developments in niche Islamic finance segments such as Waqf have also taken place in South East Asia, especially in Malaysia and Singapore. Untapping the potential in these unique mechanisms will create more opportunities for Islamic finance to mobilise funds in the region. In Malaysia, a large takaful operator utilises the Waqf model to manage its funds. Meanwhile in financing of Waqf properties, an Islamic development foundation has regularly issued Waqf shares, and enables contributors to donate through the implementation of a salary deduction scheme and a corporate project scheme. Elsewhere in Singapore, a sukuk by Majlis Ugama Islam Singapura (MUIS) in 2001 involved the utilisation of waqf properties under a Musharakah structure. MUIS, via an SPV, entered into a Musharakah partnership with the investors, to purchase and develop several prime properties, which would eventually become waqf properties. These properties were leased out, and the lease rentals (which are essentially profits) were shared between the MUIS and the sukuk holders. In 2009, MUIS tapped the Islamic capital market again to augment its waqf fund via an Ijarah sukuk.

Islamic finance developments and outlook in South East Asia

In Asia as a whole, Islamic finance has expanded and served the economy through banking and capital markets. As at end-2013 the region's Islamic finance assets totalled about USD391.2bln[13], equalling 22% of Islamic finance assets worldwide. Asia's Islamic finance asset composition is balanced – in particular, among Islamic banking and sukuk sectors – with Islamic banking accounting for 49% of aggregate Islamic finance assets in Asia, followed by sukuk (45%), Islamic funds (5%) and takaful (1%). Going forward, the industry is expected to grow at a fairly sustained pace, and amount to USD770bln by 2018.

Future prospects for Islamic finance in South East Asia will be supported by recent regulatory efforts in the region. In 2014, several key developments have taken place in both established and new Islamic finance markets in ASEAN. These developments are expected to support further expansion of the industry in this economically-important region. Many of these developments are centred in Malaysia, in line with its status as a leading Islamic finance destination. The country's Islamic Financial Services Act 2013 (IFSA 2013), which went into effect in June 2014, has focused on

[13] KFHR

strengthening the development of Shariah matters in the industry. Amongst many important changes, the Act differentiates between investment and deposit accounts in Islamic banks.

Elsewhere in Indonesia, its financial services authority Otoritas Jasa Keuangan (OJK) announced in August 2014 that it was working on a five-year blueprint to develop Islamic finance. Amongst others, the blueprint is expected to address pertinent issues such as the lack of scale in the industry, sector consolidation and the role of foreign ownership. In November 2014, the country's capital markets authority signed an agreement with the national Shariah board to move towards the centralisation of Shariah matters related to Islamic finance. The streamlining of Shariah standards at the national level is expected to support innovation in Shariah-compliant products and to develop a wider pool of Shariah scholars.

Amidst these regulatory and market developments, the Islamic finance industry in South East Asia is well-positioned to benefit from the region's robust growth prospects and increasingly wealthy consumers. To date, the industry has successfully mobilised funds via the Islamic banking and sukuk markets. In the future, demand will be supported by demand for financing from the sizeable infrastructure sector, as well as other key real economic activity in the manufacturing and agriculture sectors. Notably, the region's efforts towards greater integration, including financial integration, augurs well for Islamic capital markets; cross-border investments in sukuk and Islamic funds would support a vibrant Islamic finance industry.