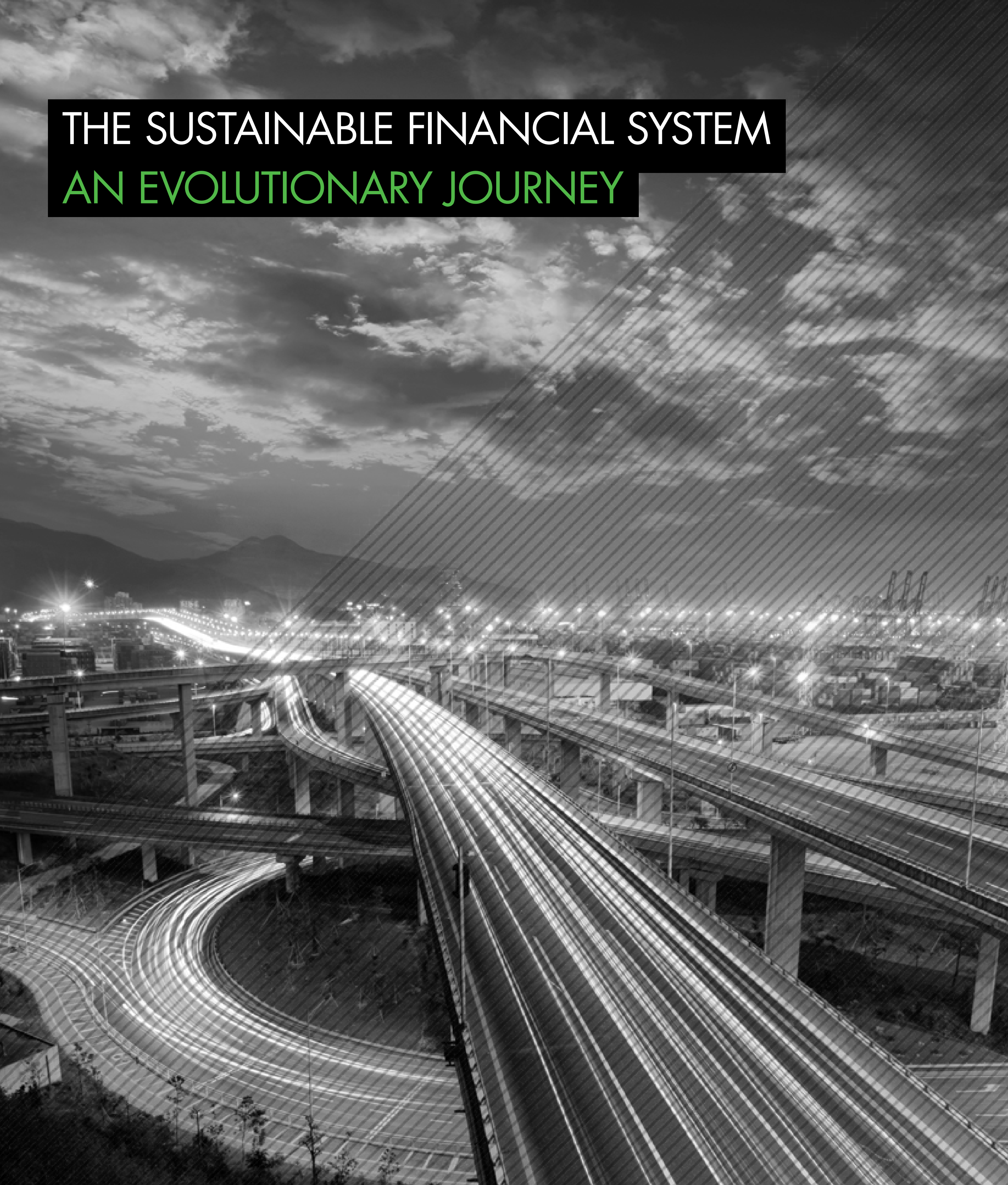
THE SUSTAINABLE FINANCIAL SYSTEM
AN EVOLUTIONARY JOURNEY



Having begun as a nascent sector in the 1970s that predominantly focused on Shariah-compliant banking, today Islamic finance is a complete financial system of its own, having evolved into a more cohesive and competitive global option, with a widening investor and issuer base, improving industry infrastructure and more cross-border activity. Today Islamic finance has some form of presence in 70 countries, through 600 financial institutions, and advanced economies such as the UK, Hong Kong, Singapore and Germany have seen increased activity. These development were supported by improvements in the industry's infrastructure, as regulatory developments continued to keep pace with industry and market demands, in pursuit of the overarching goal of Islamic finance as a more sustainable and equitable financial system. Having recorded double-digit growth rates in all four segments, the industry is expected to expand beyond the USD3tln mark by 2018 and continue to evolve as an increasingly significant part of the global financial system.

MALAYSIA
WORLD'S ISLAMIC FINANCE MARKETPLACE

29 April 2015

Islamic Finance: Transformation Journey and New Windows of Opportunity

In the past five years, the global Islamic finance industry has undergone solid growth, recording a 17.3% Compounded Annual Growth Rate (CAGR) between 2009 and 2014[1]. Today, total global financial assets of the Islamic financial industry is estimated to be more than USD2tln[2]. Beyond these headline numbers, the industry has experienced transformative changes, which supports the overarching goal of Islamic finance as a more inclusive and equitable financial system. The evolution of regulations related to Islamic finance and the ensuing product innovation have boosted Islamic financial institutions' (IFIs) ability to serve the economy through Shariah-compliant instruments.

Several key themes that have emerged at global level aspire greater drive for the industry to expand its frontiers and tap into new business and geographical horizons. Of importance, the growth in Islamic finance has attracted the attention of the conventional banking industry and non-OIC countries to tap into this growing market. The interest of conventional institutions in Islamic finance is part of its testament on its universal appeal and propositions, especially to tap wider investor and consumer base. Furthermore, ongoing efforts are being intensified at improving and harmonising standards on regulatory, prudential, accounting, legal and human capital matters - setting the stage for a more cohesive and sustainable Islamic financial industry in the future.

[1] KFH Research , February 2015
[2] KFH Research, February 2015

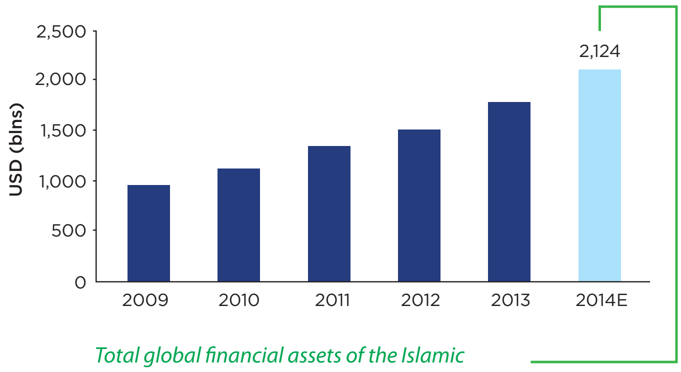
Market breadth and depth: Evolution and performance

These IFIs were mainly home-grown and were supported by localised demand for Islamic finance, and mostly regulated under laws which had been designed for the conventional finance industry. Meanwhile, regulations governing the IFIs were conducted on needed basis, and geared towards domestic institutions only; most institutions dealing with cross-border or global Islamic finance standards only started to gain traction in the late 1990s onwards.

Having begun as a nascent sector in the 1970s that predominantly focused on Shariah-compliant banking systems, today Islamic finance is a complete financial system of its own that includes capital market products and services such as Islamic securitised assets (sukuk), Islamic equities, Islamic investment funds, and also Islamic insurance services (takaful). Islamic finance now has form of presence in more than 70 countries, through 600 financial institutions. Apart from existing key Islamic financial markets in the likes of Malaysia and the GCC, the industry's growth gained stronger footing in parts of Asia such as Turkey, Pakistan and Bangladesh; and African countries namely Kenya, South Africa and Nigeria. Furthermore, advanced economies such as the UK, Hong Kong, Singapore and Germany have seen increased activity in Islamic finance in recent years. At present, the top Islamic finance jurisdictions by assets are Malaysia and Saudi Arabia. Other important markets include the UAE, Kuwait and Qatar, as well as the highly-populous domicile of Indonesia. In Islamic funds, key financial centres such Jersey, Luxembourg and the US are home to a significant share of funds.

More recently, the industry has transformed into a more cohesive and competitive system. Of significance, the rapid growth of Islamic finance between 2009 and 2014 (post crisis period) has been characterized by a deeper and more comprehensive industry, a widening investor and issuer base, improving industry infrastructure (including regulatory developments) and more cross-border activity. The global Islamic finance industry is gradually emerging as an important component supporting international

Total Islamic Finance Assets (2009-2018F)



Total global financial assets of the Islamic financial industry is estimated to be more than USD2tln and characterized by:

i. Deeper and more comprehensive industry;
ii. Widening investor and issuer base;
iii. Increased cross-border activity; and
iv. Improving industry infrastructure (including regulatory developments).

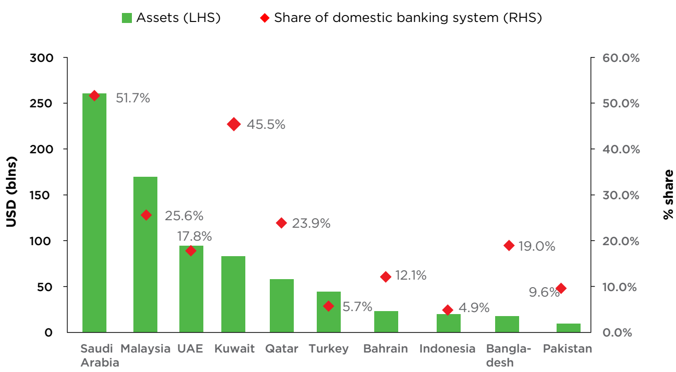
Source: KFH Research database

economic and financial linkages. Islamic financing facilities are increasingly being used to fund various transactions including cross-border trade financing, national infrastructural and developmental projects, supporting the international halal trade industry and also facilitating foreign direct and portfolio investments.

A deeper and more comprehensive industry

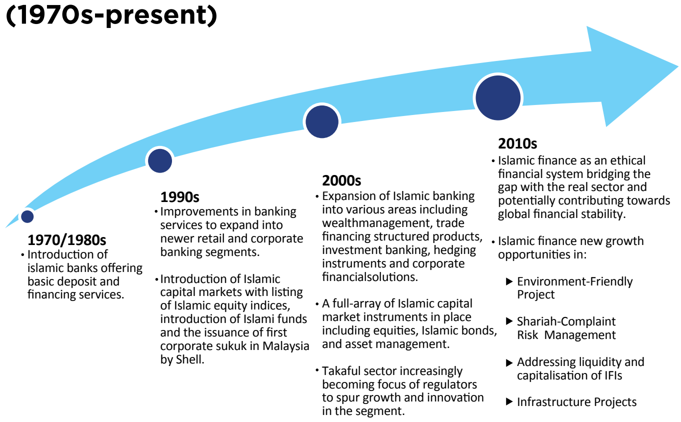
The Islamic banking market has reached greater depth, as evidenced by rapidly growing market share vis-à-vis conventional institutions. In some of the more advanced Islamic finance jurisdictions, Islamic banking is set to gradually take the lead as the main banking sector such as Saudi Arabia (where it represents 52% of the domestic system's banking assets) and Kuwait (45%). Similarly, Islamic banking is rapidly gaining market share Bangladesh, Malaysia and Qatar (17%, 22% and 25% respectively). These figures are encouraging, and suggest that in countries with a large Muslim population, solid Islamic finance infrastructure and intensifying competition amongst IFIs, Islamic finance is likely to increase its market share in the domestic financial system. In countries with predominantly non-Muslim populations, Islamic finance offers opportunities for corporates and SMEs, in part due to its ethical value propositions.

Top Islamic Banking Jurisdictions: Assets* (LHS) and Market Share (RHS) (end-2013)



Source: Central banks, annual reports, KFH Research
*DFI assets are included for Malaysia's Islamic banking share

Islamic Finance Innovations and Developments (1970s-present)



Source: MIFC Insights on "Innovations Drive Expansion of Global Islamic Finance Industry"

Product innovation in Islamic banking has been steadily progressing since the 1970s. In the early days, the Shariah-compliant banking sector offered mainly "plain vanilla" products such as basic deposit and financing services for retail clients. In the 1990s, Islamic banking expanded into more retail products while serving the corporate sector as well. The turning point for Islamic banking occurred sometime in the 2000s, when the existence of bigger banks and clearer regulations supported its expansion into wealth management, trade financing, structured products, and many other new products. Similarly, other key Islamic finance segments such as sukuk, funds and takaful had also expanded significantly in this decade. In recent years, Islamic finance, including banking, has played a greater role in the mobilization of funds for environment-friendly projects and infrastructure projects; while addressing industry needs for better liquidity management and capitalization of IFIs.

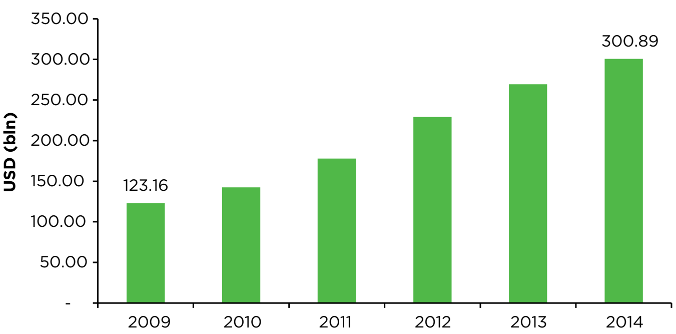
The global primary sukuk market has witnessed several new and innovative sukuk in recent times. Amongst these are sukuk with perpetual tenures and Basel III-compliant sukuk. The increasing popularity of perpetual sukuk reflects confidence in the sukuk market as a long-term source of funds for key economic projects; to date, sukuk with indefinite tenures have been issued by the financial sector in the UAE, and the transportation and real estate sectors in Malaysia. On another note, more Islamic banks are turning towards issuing Basel III compliant sukuk instruments in order to satisfy the revised capital standards. 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. Overall, the global sukuk market is rapidly expanding its horizons, and sukuk are increasingly becoming an attractive source of alternative fund raising instruments. To date, a total of 30 jurisdictions have issued sukuk instruments (excluding offshore jurisdictions), and this number is expected to grow further based on recent success in new markets including South Africa, Senegal, Hong Kong and Luxembourg.

Meanwhile, the size of the global sukuk outstanding in the market has more than doubled in the past five years, from USD123.2bln in 2009 to USD300.9bln as at end-2014[3]. A robust secondary market enables more trading activity for secondary sukuk; and the greater tradability of sukuk will further improve the cost competitiveness of the instrument as a means to raise financing. Malaysia continued to lead the secondary sukuk market, with USD172.8bln outstanding amount as at end-2014,

[3] KFH Research, February 2015

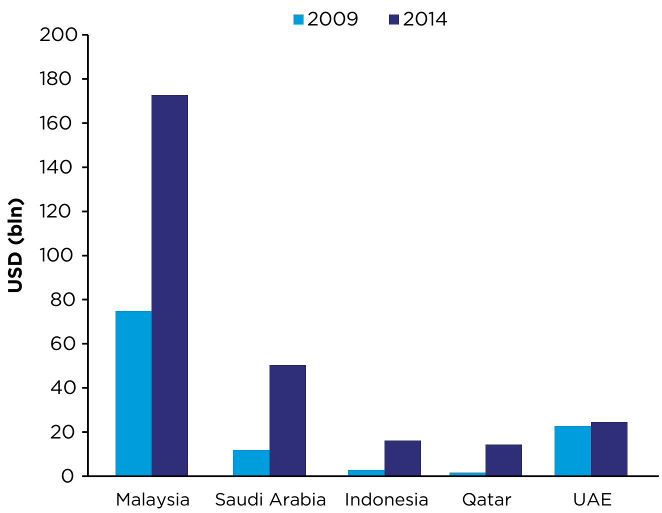
followed by Saudi Arabia at USD50.4bln. In terms of growth, Qatar and Indonesia recorded CAGRs of 55.6% and 41.2% (from a relatively modest base) in sukuk outstanding in the past five years[4], supported mainly sovereign issuers and issuances of infrastructure-related sukuk.

Global Sukuk Outstanding (2009-2014)



Source: IFIS, Zawya, Bloomberg, KFH Research

Sukuk Outstanding in Seleted Jurisdictions (2009 and 2014)



Source: IFIS, Zawya, Bloomberg, KFH Research

In the Islamic fund management industry, an ongoing innovation include mechanism to improve returns through the introduction of Shariah-compliant "Smart Beta" strategies. The Smart Beta strategy became popular in the past three years, spurred by a desire to diversify investment strategies in a challenging post-crisis environment. Broadly, it involves weighting the investment portfolio against fundamental business metrics such as sales, earning, book value and other indicators, as opposed to weights based on market capitalization[5]. These performance-based weights are seen as a better gauge of returns, and is in line with one of the main tenets of Islamic finance – which is to support real activity. For investors, the diversification of investment strategies is likely to support better returns.

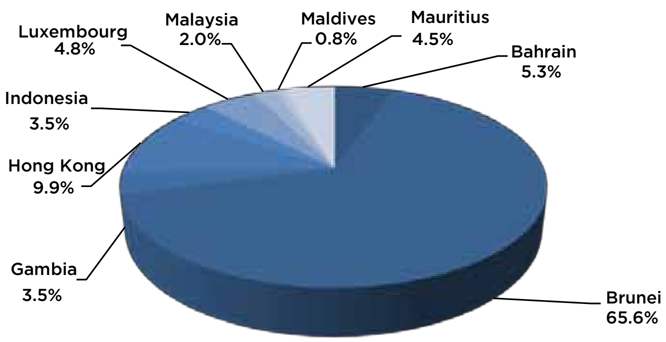
Meanwhile, total gross takaful contributions are expected to increase around USD26bln at end-2015[6]. In the takaful sector, Waqf-based takaful models have become more commonplace, involving the utilization of a redistributive instrument to operate a profit-sharing entity. This model is a workable example that may resolve certain Shariah issues in pure Mudharabah and Wakalah arrangements (for example, those concerning ownership); and has been applied successfully in Malaysia, Pakistan and South Africa[7]. In Pakistan, for example, all takaful companies operate on the basis of a Wakalah-Waqf hybrid model. Participants' contributions to the Waqf fund are invested in safe Shariah-compliant investments and returns are used for the benefit of the participants.

[4] KFH Research, February 2015
[5] Towers Watson
[6] Source: KFH Research, February 2015
[7] Swiss Re, KFH Research, February 2015

A widening issuer and investor base

The growth of Islamic finance activity has been supported by increasing participation from a wide range of investors. This is particularly evident in the sukuk market, where sukuk issuances in 2014 were from 19 different countries. This represents a doubling of the sukuk issuer base by country, as only 10 countries had issued sukuk in 2009. New entrants to the sukuk market in the past five years include the UK, Hong Kong, Senegal, Luxembourg, South Africa, Nigeria, Turkey and Maldives. The debut issuances by these domiciles are mainly from sovereign issuers, who set a benchmark to pave the way for future issuers from government-related entities and the private sector.

Sukuk Issuance by Country (2014)



Source: IFIS, Zawya, Bloomberg, KFH Research

Apart from a more diversified country base, the sukuk market has seen more issuers from different sectors, especially in the leading markets of Malaysia and Saudi Arabia. Globally, the main issuer of sukuk are sovereigns as well as large infrastructure-building companies in power and utilities, telecommunications and transportation. The Malaysian market has also attracted issuers from smaller but important sectors such as healthcare and education. In Saudi Arabia, a USD133.3mln sukuk issued by retail conglomerate Fawaz Alhokair Group marked a significant foray by the sector into the sukuk market. Similarly, halal food producer Al Marai of Saudi Arabi has also been active in the sukuk market – the halal market represents a relatively untapped opportunity as sukuk issuances would support end-to-end Shariah compliance of the budding industry's operations.

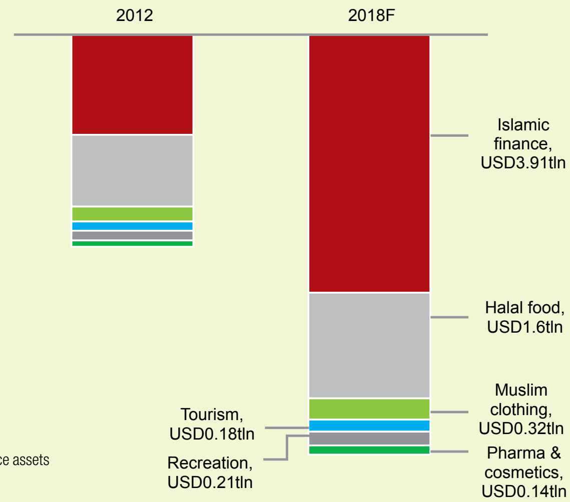
On another note, the sukuk market has attracted a wider investor base for key sukuk issuances, especially for those denominated in key global currencies such as the USD, and for sukuk issued by established and highly-rated entities which are new to the sukuk market such as the debut sukuk by Hong Kong. GCC issuers tend to issue large infrastructure-related sukuk in USD, listed in major financial exchanges such as in London, Ireland and Luxembourg – allowing greater access to international investors. Elsewhere, the Hong Kong sukuk had attracted almost 20% of investors from the US and Europe.

Global Halal Economy and Islamic Finance

Over the years, there is a growing awareness on the need for utilising Shariah-compliant financial services by the suppliers of halal products and services aimed at ensuring an end-to-end Shariah compliance in the suppliers' operations. In this regard, the Islamic financial institutions have abundant opportunities to unlock new business potential by catering to the financial needs of the halal industry stakeholders. Recent progress and efforts to support the halal industry have included provision of Shariah-compliant trade financing solutions, working capital, raw materials and asset financing products, as well as raising capital to fund expenditure through for e.g. sukuk in the Islamic capital markets.

The global halal economy was valued at approximately USD3.2tln in 2012 and this sector is forecasted to double to USD6.4tln by the year 2018[8]. Driving this tremendous growth is a combination of demand and supply factors that are spearheading the market expansion of the halal products and services. The halal industry operates across a number of sectors including food, clothing, finance and tourism. The industry's footprint extends beyond the Organisation of Islamic Cooperation (OIC) countries and has a sizeable presence in other jurisdictions such as the United Kingdom, Brazil, the United States of America and Thailand.

Global Halal Economy by Sectors (2012 and 2018F)



*Based on totals of expenditure of Muslim consumers & Islamic finance assets
Source: Thomson-Reuters (2013), KFH Research (2014)

As a way forward, integration between the world halal industry and the global Islamic finance system is a huge developmental potential for the growth and expansion of Islamic economics in the world markets. The combined two sectors worth several USD trillions are natural complements under the common guiding principles of Shariah and have the prospects to collectively emerge as one of the most important sectors of the world markets. The halal industries are fast gaining ground on the back of rising demand from burgeoning Muslim communities, economic standing of OIC countries and their active trade relations internally and with the rest of the world. Alongside, Islamic finance is progressing robustly, making a mark in numerous traditionally Muslim and non-Muslim countries alike. Islamic finance and its component sectors offer a comprehensive range of products and services that are capable of supporting the financing needs of halal industry companies, regardless of size and maturity.

[8] Thomson Reuter (2013), KFH Research (2014)

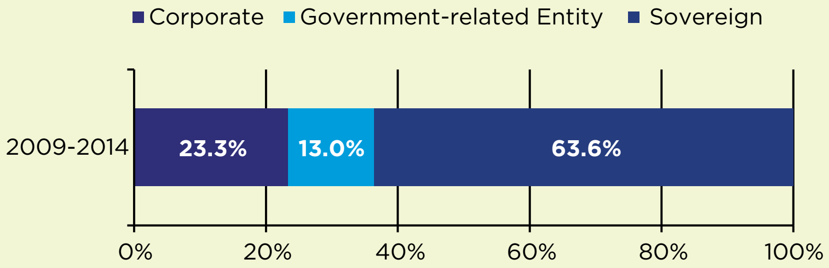
Islamic Finance for Large and Multinational Companies

In the few years after the global financial crisis, Islamic finance has increased its appeal to non-traditional domiciles such as the US, Europe and East Asia; as evidenced mainly by recent sukuk issuances and financing deals in these important regions. In addition, corporations in key Islamic finance domains have been involved in increasingly bigger Shariah-compliant financial transactions, including syndicated Islamic financing and cross-border deals. An added appeal of Islamic finance to global companies is the need to diversify sources of funding, and to leverage on highly-liquid investors from the Middle East and part of Asia. The growing interest of Islamic finance in non-traditional domiciles, coupled with proliferation of larger and more competitive Islamic financing deals are expected to increase the appeal of Islamic finance amongst global and multinational corporations, including the Fortune 500 companies.

Between 2009 to 2014, sukuk issuances by corporate entities accounted for 23% of total issuances[9]. In part, this smaller share compared to sovereign issuers partly reflects different funding size needs. By sector, corporate issuers encompass a wide range of sectors including power and utilities, oil and gas, transportation, telecommunications, construction, real estate, healthcare, education and retail. Notably, US participation in the corporate sukuk market has been entirely through the private sector, with a USD500mln issuance by Goldman Sachs in 2014. The Goldman Sachs sukuk attracted strong demand, which led to a competitive profit rate of 2.844%, a small premium to its conventional 2019 bonds, with a 2.625% yield[10].

The rising popularity of sukuk amongst sovereigns and large corporates has also witnessed significant increase in deal sizes. Landmark sukuk issued back in the 1990s and early 2000s were well below the USD1bln mark. For example, the corporate sukuk Ijarah issued in Malaysia amounted to USD150mln, while the first sovereign sukuk Ijarah raised USD600mln. Today, issuances of around USD1bln are fairly common. In 2014 alone, there were more than 15 issuances of USD1bln or above[11].

Sukuk Issuance by Type of Issuer (2009-2014)



Source: IFIS, Zawya, Bloomberg, KFH Research

[9] KFH Research, February 2015
[10] Thomson Reuters
[11] KFH Research, February 2015

Meanwhile, Islamic financing has also been well-utilised to fund corporate firms and projects, particularly in key Islamic finance domains. In December 2014, Marafiq, a utility services provider to two industrial cities in Saudi Arabia, secured a SAR2.5bln (USD666.1mln) Islamic financing, to support capacity expansion. The financing deal, which was structured under the Murabahah or cost-plus arrangement, was jointly financed by Al Rajhi Bank, National Commercial Bank, Riyad Bank, Samba Financial Group and Saudi British Bank[12]. Also in 2014, a telecommunications provider in Malaysia, Maxis Berhad, secured RM2.5bln (USD767mln) Shariah-compliant deal to support capital expenditure and refinancing. In October 2014, the London Battersea Power Station redevelopment project secured a Shariah-compliant syndicated financing of GBP467mln (USD754mln), as part of a GBP1.35bln financing package for the second and third phases of the project. Malaysia's Maybank Islamic provided GBP200mln of the Islamic financing, while the rest was split between Malaysia's CIMB Bank and Standard Chartered Bank. Shortly following this development, the Bank of England announced that it would conduct a feasibility study in 2015 to develop a Shariah-compliant liquidity management tool for Islamic banks to use[13].

The mutually beneficial relationship between Islamic finance and real sector activity will likely drive the growth of the industry going forward. The industry is set to expand its offering to global and multinational corporations in advanced countries such as the US and EU, with its growing IFIs' capabilities and advantage of having wider investor base for fund raising objectives. Financing options are abundant, ranging from sukuk to Islamic financing – these instruments, in various forms and tenures, have supported economic activity in a number of sectors. In turn, the industry benefits from a stable and growing economic environment, as its growth is linked to profit-sharing contracts.

Increased cross-border activity

International transactions in Islamic finance have intensified in recent years, supported by clearer regulations, established IFIs venturing abroad, multilateral support and the attractiveness of key Islamic finance jurisdictions. In the Islamic banking sector, for example, several large GCC IFIs such as Al-Rajhi Bank of Saudi Arabia and Kuwait Finance House of Kuwait have set up operations in Malaysia, Turkey, Pakistan. An Islamic bank of Bahrain has established a presence in many countries including Jordan, Tunisia, Sudan, Turkey, Bahrain, Egypt, Algeria, Pakistan, South Africa, Lebanon, Syria, Iraq and Saudi Arabia[14]. The proliferation of large and international IFIs in these domiciles creates healthy competition amid greater transfers of expertise. In this regard, support from multilaterals such as the IFSB has been imperative to allow more cross-border transactions to take place; for example, the work of IFSB takes into account Islamic finance operations dual-banking system, which is the norm for these jurisdictions.

Cross-border Activity in Islamic Finance

Banking operations → Sukuk issuances → Development financing

Source: KFH Research, February 2015

[12] IFIS, Zawya
[13] "London's Battersea secures GBP467mln Islamic financing", Reuters (October 2014)
[14] Bank's website

Cross-border transactions and deals

In the sukuk market, an emerging trend is the prevalence of cross-border issuances and listings, most notably in Malaysia. As the leading sukuk domicile, Malaysia offers a steady stream of investors, ample liquidity and a supportive regulatory infrastructure. Between 2009 and 2014, 23 sukuk totalling USD12.3bln have been issued in Malaysia by international issuers from Saudi Arabia, the UAE, Kuwait, Singapore, Turkey, Hong Kong and Kazakhstan[15]. The type of issuers range from multilateral entities, sovereign entities, conglomerates, palm oil companies and more recently, financial institutions.

Apart from pure commercial deals, cross-border transactions in Islamic finance encompass development-related financing as well. In 2013 and 2014, the IDB provided Islamic financing to Uzbekistan, Uganda, Guinea, Mozambique, Sierra Leone, Gambia, Indonesia, Bangladesh, Burkina Faso and Maldives[16]. These loans were utilised for infrastructure building (including utilities, and healthcare) and to support the administrative, judicial and security affairs of these nations.

Another growing trend is the cross-border listing of sukuk. Apart from Malaysia, in other markets cross-border listing of sukuk is an emerging trend most notably on the Luxembourg Stock Exchange (LuxSE), the London Stock Exchange (LSE) and the Irish Stock Exchange (ISE). Since 2002, more than 50 foreign sukuk were listed on the LSE while the ISE has seen more than 40 similar issuances. Meanwhile, 17 foreign sukuk have been listed in on the LuxSE. Elsewhere, competition for listings is picking up between major Islamic finance exchanges.

The formation of the IILM aimed to facilitate effective cross-border Islamic liquidity management. The sukuk launched by the International Islamic Liquidity Management Corporation (IILM) are considered important milestones in facilitating cross-border finance flows amongst jurisdictions where Islamic banks operate. Collectively, the various coordinated efforts and expanding bilateral relationships between Islamic finance practising countries is serving as a catalyst for expanding the outreach and growth of the Islamic finance sector.

[15] IFIS, KFH Research. Includes issuances by multilateral entities such as IILM and IDB.
[16] IFIS

Improving industry infrastructure (including regulatory developments)

In the regulatory sphere, key trends include the introduction of Islamic finance-specific regulations in new jurisdiction, increasing centralization of Shariah boards in fairly established jurisdictions and a deeper look into Shariah structures and its applications. Supporting these developments are domestic central banks and securities / exchange commissions; and at the international stage, multilateral institutions such as the Islamic Development Bank Group (IDB), Islamic Financial Services Board (IFSB), International Islamic Liquidity Management Corporation (IILM) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), among others.

Broadly, Islamic finance regulations have undergone several stages. The initial introduction of Islamic finance in jurisdictions such as Malaysia and Bahrain were supported mainly by appendages to existing laws on conventional banking and finance. As the industry gained firmer footing in these jurisdictions, separate Islamic finance regulations were formulated and set the precedent for regulatory developments future Islamic finance domiciles. In the past few years, potential Islamic finance domiciles such as Morocco, Kenya, Tajikistan and many others are in the midst of formulating specific regulations to support the growth of Islamic finance. These regulations are an important stepping stone for the industry, as it would also provide legal assurance for existing financial institutions to invest in domiciles that are new to Islamic finance; examples include major financial players in the conventional industry which typically open Islamic windows, as well as large IFIs from established Islamic finance jurisdictions looking to expand to new frontiers of growth.

Amongst more established Islamic finance countries, matters related to Shariah-compliance continue to garner more regulatory introspection.

In 2014, Oman and Indonesia[17] had announced the move towards more centralized Shariah boards, to further streamline and improve Shariah standards in the country. Meanwhile, Malaysia in 2013 had enacted the Islamic Financial Services Act (IFSA), which provides further differentiation of Shariah-related deposit versus investment accounts. Similarly, Malaysia has also made steady progress in the issuance of Shariah standards to guide industry practices - the Murabahah standard was issued in 2013, while the standards for other key contracts of Mudharabah, Musharakah, Ijarah, Wadiah and Istisna, are in progress.

Beyond Shariah-specific matters, Islamic finance has also made significant progress in prudential and supervisory standards and accounting conventions. These developments are important, as the industry seeks to expand into more countries and will likely compete with a conventional sector that has established its regulatory standards. The stability and competitiveness of the Islamic financial sector is imperative to maintain confidence in the system. In this regard, the IFSB issues standards on a vast range of issues in Islamic finance, such as capital adequacy, liquidity managements and many others. These standards act as non-binding guidelines for IFIs, and have taken into account cross-segment interactions between Islamic banking, sukuk, funds and takaful. The IFSB currently has 184 members operating in 44 jurisdictions. Meanwhile, the IILM regularly issued highly rated short-term sukuk to enhance cross-border liquidity flows, international linkages and financial stability of the Islamic financial institutions. Importantly, the IILM sukuk satisfy the requirements of the Basel III Liquidity Coverage Ratio (LCR) and are thus widely sought after as solutions by Islamic financial institutions.

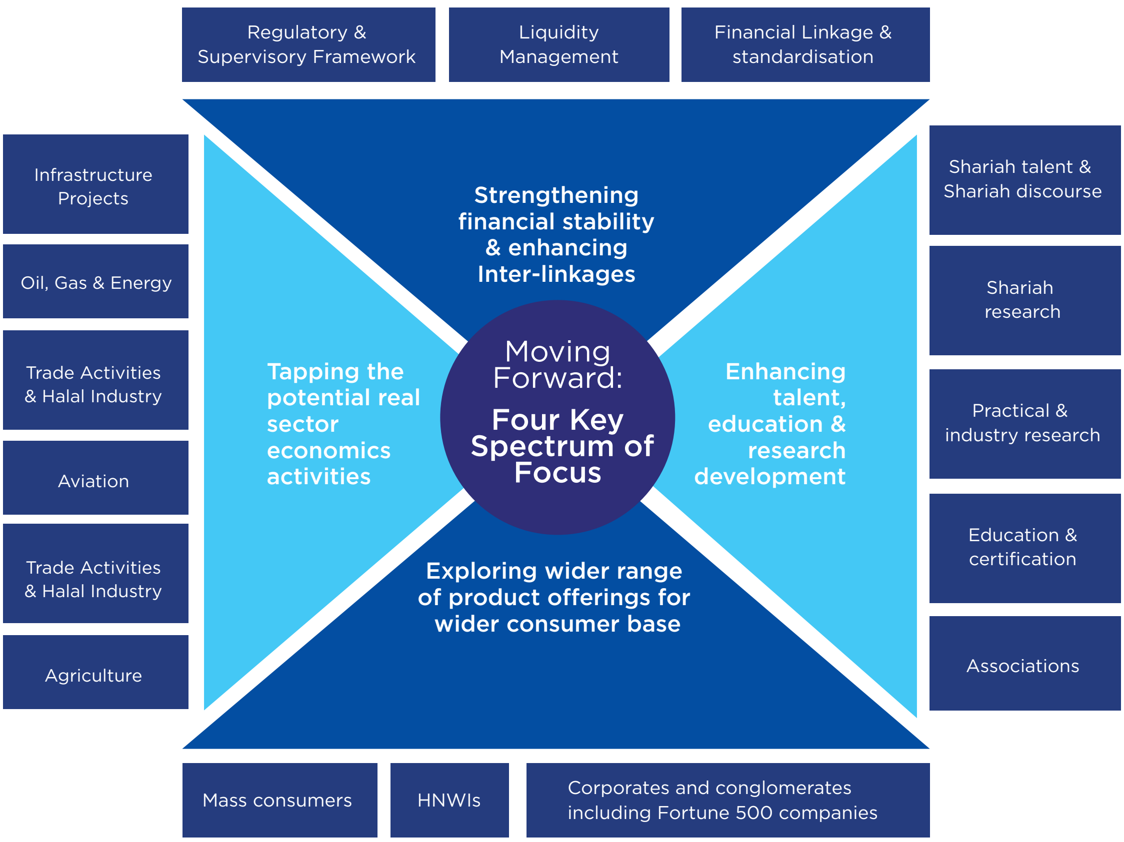
[17] Reuters

The Road Ahead

Islamic finance has come a long way from its beginnings in the 1960s. The industry has recorded double digit growth rates in all four segments, and has expanded to several geographical regions – including in the non-OIC countries. More importantly, the recent expansion of the industry in the last five years have been more meaningful, and marks the transformation of Islamic finance into a more competitive and resilient industry. Reflecting the growth and depth of the industry, Islamic finance has attracted a widening investor and issuer base, as well as more cross-border financial transactions. These development were well-supported by improvements in the industry's infrastructure, as regulatory developments continued to keep pace with industry and market demands.

Going forward, the industry is expected to expand beyond the USD3tln mark by 2018[18] and continue to evolve as an increasingly significant part of the global financial system. The growing participation of non-traditional Islamic finance domiciles in the US, Europe and East Asia will spur greater interest and innovation in Shariah-compliant financial services. The next five years will likely be marked by continued transformation of Islamic finance to better serve real economic activity in the global sphere.

Moving Forward: Four Key Spectrums of Developmental Focus



[18] KFH Research, February 2015