US: POTENTIAL MARKET FOR ISLAMIC FINANCE

Islamic finance has made important strides into advanced economies in the US, Europe and Asia. US financial markets are the largest and most liquid in the world, and given the Islamic finance value propositions of a more stable financial system, the US market may benefit from increasing Islamic finance offerings. The importance of the US to the global economy and financial markets suggests ample potential for Islamic finance to take root in the country.

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WORLD'S ISLAMIC FINANCE MARKETPLACE

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Islamic finance and its potential in the US

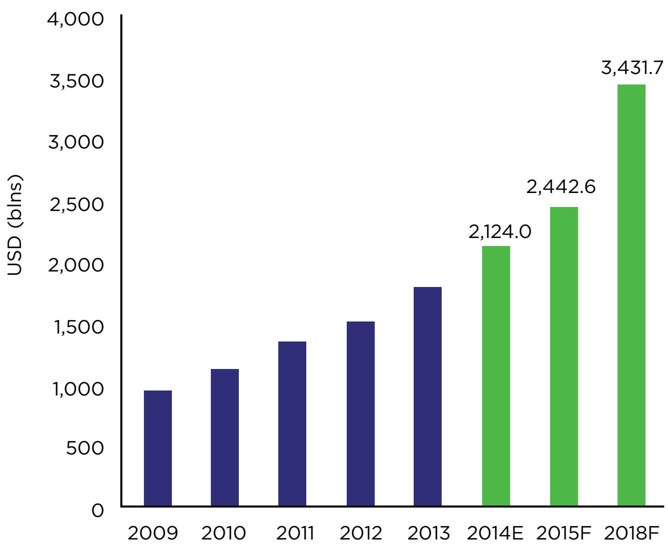
As at end-2014, the global Islamic finance industry, which comprises mainly Islamic banking, sukuk, funds and takaful, had amassed assets of more than USD2tln. A confluence of factors supported this growth, such as the growing wealth in predominantly Muslim countries, an increasing awareness of Shariah-compliant modes of finance, and improving regulatory clarity on Islamic financial instruments. By sector, households were an important client base for Islamic banks in key Islamic finance jurisdictions[1], while the sukuk market remained dominated by sovereign and quasi-government entities. The smaller Islamic finance segments of funds and takaful had served both corporates and households.

By geographical dispersion, the main Islamic finance domains were located in emerging markets such as in the Gulf Cooperation Council countries and parts of Asia, especially South East Asia. More recently, Islamic finance has made important strides into advanced economies in the US, Europe and Asia – most notably through Islamic capital market instruments. In 2014, the global sukuk market witnessed issuances from sovereigns in the UK, Luxembourg and Hong Kong. The sole issuer from the US was Goldman Sachs, a major investment bank that had issued a USD500mln Wakalah sukuk in September 2014 – the issuance attracted an order book of USD1.5bln. In addition to sukuk, Europe and the US are home to several Shariah-compliant asset management companies.

[1] KFH Research

The global Islamic finance industry has recorded a solid with the industry's assets growing at a Compounded Average Growth Rate (CAGR) of 17.3% between 2009 and 2014. By segment, the industry comprises mainly Islamic banking and sukuk, with an 80% and 15% share of assets. Going forward, the industry is expected to expand further, with total assets projected at nearly USD3.5tln by 2018[2].

Total Islamic Finance Assets (2009-2018F)

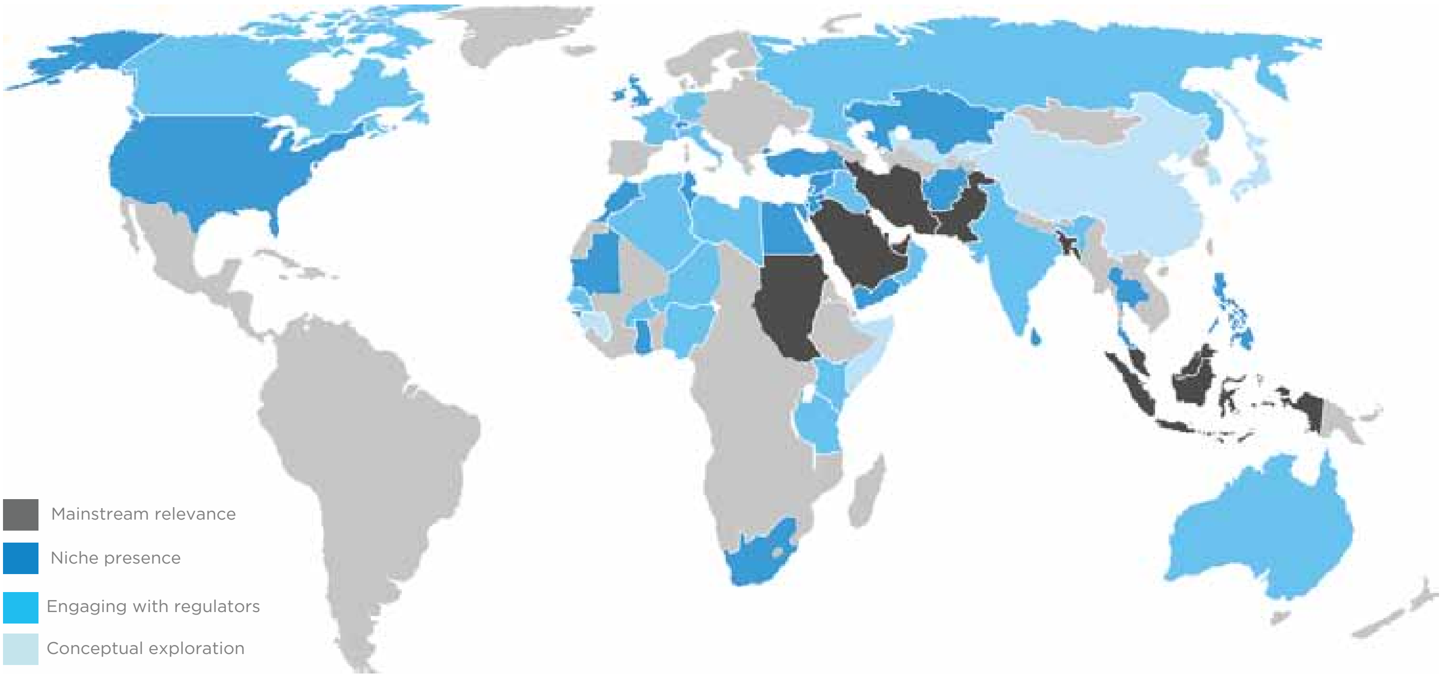


Source: KFH Research database

The key Islamic finance domiciles by assets are Malaysia, Saudi Arabia, the UAE, Kuwait and Qatar. In these countries, Islamic finance accounts for a sizeable and growing share of the domestic banking sector, catering to both large corporate clients and household financing. Between 2010 to 2014, notable Islamic financing deals spanned several sectors such as utilities, petrochemicals, real estate, air transportation, and telecommunications; mainly in Saudi Arabia, the UAE, Malaysia and Turkey. Similarly, the sukuk market has attracted both sovereign and corporate entities in key Islamic finance domains and amongst newer markets. Malaysia, in particular, has seen sukuk issuances from a diverse range of sectors such as infrastructure-based sectors (power and utilities, transport, telecommunication, oil and gas), construction, real estate, healthcare and education. Meanwhile, GCC-based issuers tap the market less frequently but with larger-sized issuances, mainly infrastructure-related sukuk. More recently, Turkey and Indonesia have become more active in the sukuk market, including issuances from the financial sector. Another notable trend in the past few years was the proliferation of Basel III-compliant sukuk, by financial institutions from Malaysia, the UAE and Turkey.

[2] KFH Research

Geographical Dispersion of Islamic Finance



Source: KFH Research

Overall, Islamic finance is now present in 70 countries (characterized as mainstream relevance or a niche presence) with more than 600 financial institutions offering some type of Shariah-compliant financial products, mainly in the Middle East and Asia. Several European countries such as the UK, Luxembourg, Germany and France have become increasingly active in Islamic finance. Meanwhile, selected countries in the African and Commonwealth Independent States (CIS) region are either engaging with regulators or exploring the concept of Islamic finance. Post financial crisis, Islamic finance continues to be a popular choice globally – while the global banking segment was estimated by the International Monetary Fund (IMF) to have experienced losses in the tune of USD3tln to USD4tln as a direct consequence of this crisis, Islamic finance were significantly less affected. Given the prevalence of Islamic finance in the global landscape amid its value propositions of a more stable financial system, the US market may benefit from increasing Islamic finance offerings.

Islamic finance: A more equitable alternative, stronger links to real activity

Islamic finance is an alternative system of financial intermediation, which seeks to promote economic growth while preserving social justice. In this regard, Islamic finance prohibits dealings in usury, excessive uncertainty, speculative activity, as well as financing of unethical goods and services. In addition, Shariah-compliant financial contracts are free from elements of coercion, corruption and deception. Importantly, Shariah-compliant product structures and transactions are business-friendly - underpinned by principles which support free markets, preservation of property rights, fulfilment of contractual obligations, governance and transparency. Amongst the key precepts in Islamic finance are the sanctity of contracts and the acknowledgement of property rights.

Seven Key Precepts of Islamic Finance

1. Eliminates pure debt securities from the financial system, replacing interest by rate of return earned ex-post on contracts of exchange or risk sharing
2. Calls for bank deposits to be collected on a profit-loss sharing basis rather than fixed predetermined liabilities
3. Promotes financing of trade and exchange of goods and services to ensure a close link between real economy and financial sector
4. Upholds property rights for individuals and society, and clarifies the sources of individual ownership
5. Mandates fulfilment and sanctity of contracts and honouring of debt obligations
6. Emphasises principles of morality and ethics in business conduct, as well as rules of fair dealing and justice
7. Advocates sharing of risk and reward between the rich and the poor through certain instruments of re-distribution

Source: Mohieldin (2012)

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 . 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.

Going forward, 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 US and EU corporations, including the Fortune 500 companies.

US: POTENTIAL MARKET FOR ISLAMIC FINANCE

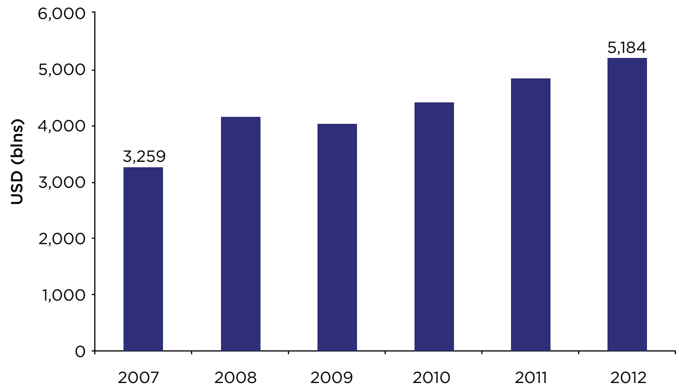
Potential role of Islamic finance in the US

The importance of the US to the global economy and financial markets suggests ample potential for Islamic finance to take root in the country. Financial markets in the US are the largest and most liquid in the world[3]. Major financial services sub-sectors in the US include banking, asset management, insurance and venture capital. It has been estimated that US asset managers serve over 55% of the global pensions market[4]. As such, the growth of the US asset management industry is dependent not just on domestic factors, but is also related to global trends.

Asset management

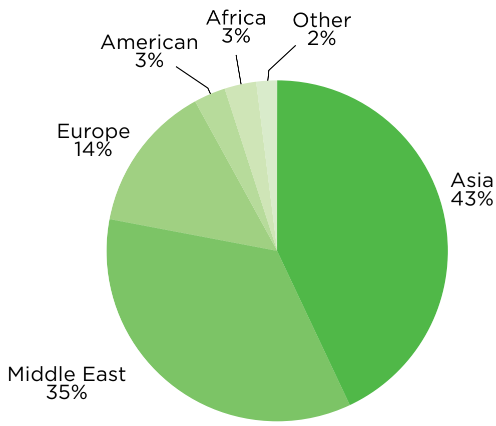
Globally, the asset management industry continues to expand, supported by the growth of both High Net Worth Individuals (HNWIs) and increasingly sophisticated middle-class populations. In 2013, total assets under management (AuM) globally increased 13% to a record USD68.7tln[5]. By region, AuM growth recorded strong increases of 14% to 20% in North America, the Middle East, Africa and Asia. Of importance, retirement needs are growing rapidly, while retirement systems remain mainly publicly-funded and thus, require more participation from private funds. The global old-age dependency ratio, which measures the number of elderly people (aged 65 and above) as a share of those of working age (15 to 64 years range) is forecasted to more than double to 25.4% in 2050, up from 11.7% in 2010[6]. A higher ratio implies more pressure on national retirement funds as there is a relatively smaller working population supporting dependents such as retirees and youth. Given the US' reputation as a large and highly liquid market, retirement funds from all over the world are invested in US-domiciled funds. By region, US-based fund management companies are increasingly focusing on the rising wealth and economic progression in key growth markets of Asia, the Middle East, South America and Africa[7].

Global Sovereign Wealth Funds Total Size (2007-2012)



Source: SWF Institute, PWC, KFH Research

Global Sovereign Wealth Funds Total Size (March 2013)



Source: SWF Institute, PWC, KFH Research

Apart from retirement funds, an importance source of growth for US asset management companies is sovereign wealth funds. Between 2007 and 2012, the total size of sovereign wealth funds globally grew by a Compounded Annual Growth Rate (CAGR) of almost 10%, amounting to more than USD5.2tln in 2012[8]. Almost 80% of these funds are domiciled in Asia and the Middle East, regions which are also home to the biggest Islamic finance markets in the world. As these funds continue to grow and as Muslim populations

[3] Select USA
[4] Select USA
[5] "Global Asset Management 2014: Steering the Course to Growth", Boston Consulting Group
[6] "Old-age dependency ratios", The Economist, (May 2009)
[7] "US Asset Management: Strategic Imperatives for Asset Managers", PWC (May 2013)
[8] SWF Institute

Selected Sukuk Issuances by United States-based Companies

Issuer	Date	Amount (USD mlns)	Sector	Structure	Tenor (years)
GE Capital	Nov 2009	500	Financial Services	Ijarah	5
Goldman Sachs	Sept 2014	500	Financial Services	Wakalah	5
International Finance Facility for Immunisation	Nov 2014	500	Financial Services	Murabahah	3

Source: Zawya, KFH Research

in these domiciles intensify demand for Shariah-compliant modes of investment, US-domiciled asset management companies have an additional window of opportunities to increase Islamic finance offerings to suit investors' needs. As of 15 December 2014, there were eight Islamic funds operating in the US, with total AuM of USD3.9mln. Meanwhile, five Islamic funds globally were geographically-focused mainly in the US, totaling USD3.7mln[9].

Corporate financing

To date, sukuk issuances from the US were mainly from private companies; in contrast to many budding Islamic finance domiciles where the government was the first issuer of sukuk, to create a benchmark for private companies to follow suit. This development reflects the dynamism of the US financial market and suggests that Islamic finance has already taking place at industry or corporate level. In 2009, GE Capital issued a USD500mln 5-year sukuk to tap into Middle Eastern liquidity for its operations. GE Capital is the financial services arm of US conglomerate, General Electric, and provides commercial financing are to small and mid-sized companies across multiple industries. The sukuk was listed on both the London Stock Exchange and Bursa Malaysia. The assets underlying the Ijarah sukuk were interests in a portfolio of aircraft and rental payments from the lease of such aircraft.

More recently, two US institutions issued sukuk in 2014. Goldman Sachs, a leading conventional investment bank, issued a USD500mln Walakah sukuk in September; while the International Finance Facility for Immunisation (IFFIM) also issued a USD500mln sukuk in November.

The sukuk attracted an order book of USD1.5bln or a three times oversubscription rate. Strong demand enable Goldman Sachs to price the sukuk at 2.844%, a small premium to its conventional 2019 bonds, which offered a profit of 2.625%[10]. IFFIM, which is actually based in the UK, had issued its sukuk on behalf of the US-based Global Vaccine Alliance (GAVI) for the purpose of funding immunization programmes. Founded in 2000, GAVI has financed immunisation efforts in 73 countries, with half of its investment directed to 33 Muslim-majority countries[11]. The IFFIM sukuk attracted a diverse range of international investors, with 68% based in the Middle East and Africa, 21% based in Asia and 11% in Europe[12]. The sukuk also marked one of the first issuances with an explicit social objective and is the largest sukuk issued by a non-profit organization.

[9] KFH Research
[10] Thomson Reuters
[11] "Sukuk for vaccine fund ushers Islamic finance into ethical sphere", Reuters (December 2014)
[12] Zawya

Key Financial Services Sub-Sectors for Islamic Finance in the US

Asset management → Corporate financing → Household financing

Source: KFH Research

Islamic banking

Meanwhile, Islamic banking may attract both the Muslim population residing in the US, as well as consumers interested in ethical financing. The Muslim population in the US stands at just under 1%[13] or around 2.6mln people. By 2030, this figure is set to grow to 6.2mln people. A key challenge, however, is to emphasis the ethical value propositions offered by Islamic finance – to improve its appeal to the mass market beyond religiously observant Muslims. Specifically, Islamic banking does not allow activity related to unethical activity such as consumption of alcohol, gambling and many others.

Conclusion

Given the value propositions of Islamic finance, the industry will likely expand in the US. A few niche areas are expected to benefit, namely asset management, corporate financing and household financing. On the flipside, US companies are also important providers of Islamic financial services and invest significantly in Shariah-compliant instruments such as sukuk. Amongst the niche areas, the strongest potential is in asset management, as the US is a key destination of funds from the Middle East and Asia, among others. Supported by ample liquidity, private retirement funds and sovereign wealth funds from these key Islamic finance regions head to the the US – and given the proliferation of Islamic finance in these jurisdictions, US-based funds may expand Shariah-compliant offerings. Another potential area is corporate financing, as evidenced by several issuances by US private firms in the oil and gas and financial services industries. And lastly, household financing may also be a growth area for Islamic finance in the US, especially if Islamic banking can be marketed as an ethical alternative.

On another note, conventional financial institutions in the US also provide services for Islamic finance and are important investors in selected sukuk. For example, in the sukuk arrangers league table of 2014, US-based JP Morgan was ranked as the tenth biggest sukuk arranger globally, with four deals totaling USD1.3bln. In addition, US-based investors including from US offshore centres are key participants in sukuk – especially for sukuk issued by GCC countries, which tend to be denominated in USD. As such, Islamic finance also provides opportunities for US companies to benefit from the rapid growth of key Islamic finance regions. Overall, given the prospects for these niche areas amid increasing participation of US-based entities in Islamic finance, it is likely that the industry will continue to expand in this country.

[13] Pew Research (2011)

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