



HAWKAMAH
THE INSTITUTE FOR CORPORATE GOVERNANCE

BUILDING ISLAMIC CAPITAL MARKETS

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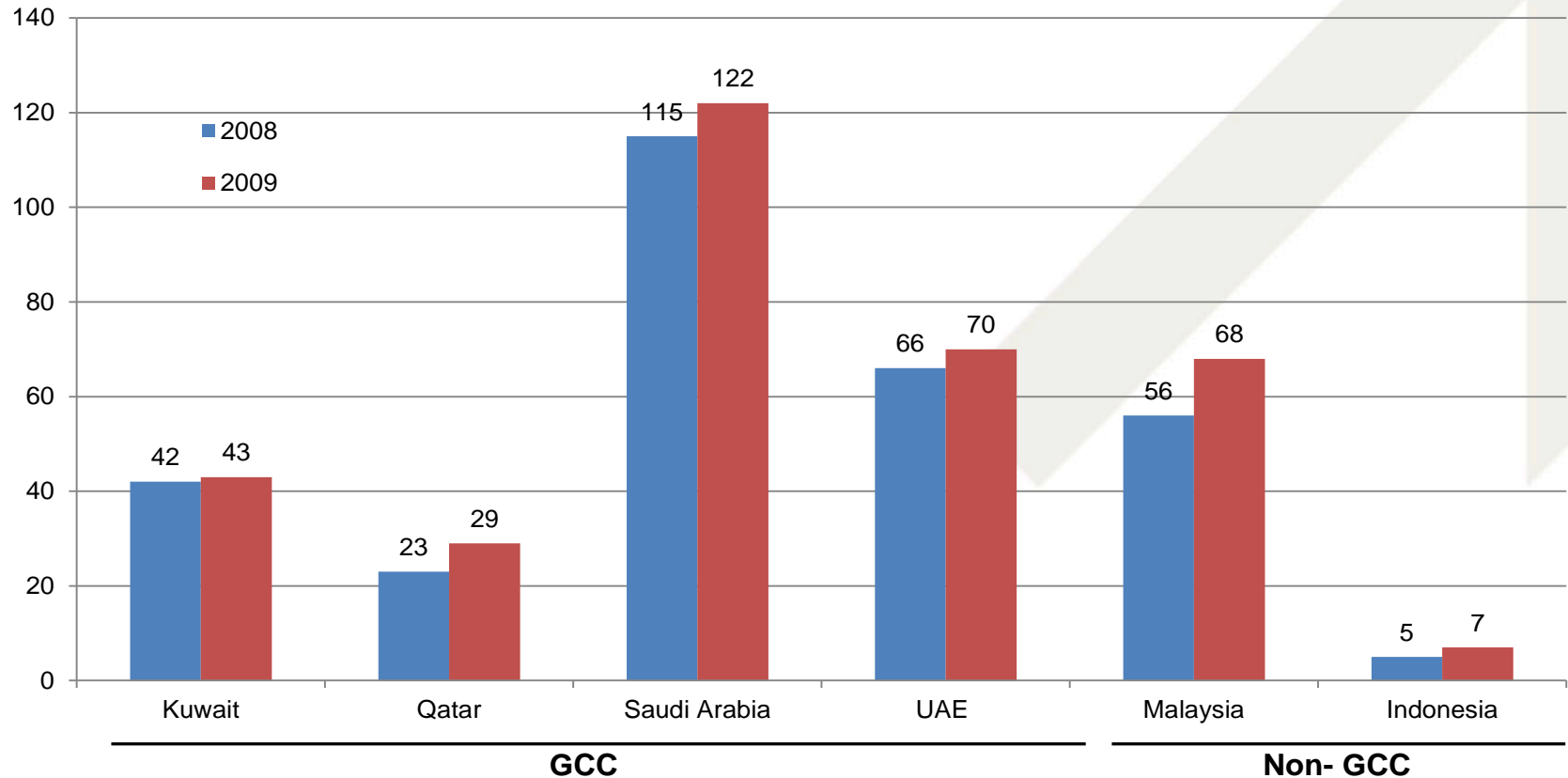
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ISLAMIC CAPITAL MARKETS: POSITIVE FUNDAMENTALS

- Muslim population of the world today is estimated at about 1.5 billion, representing a sizeable 24% of total world population of 6.3 billion: Under-banked & with limited access to finance.
- Muslim countries largely Emerging economies with positive demographics leading to high labour force growth rates and economic growth prospects
- Scope for core infrastructure, housing & development finance
- Latent Islamic funds in global financial institutions is about US\$1.3 trillion while the Islamic financial market is estimated to be US\$230 billion in size, with an annual growth rate of 12% to 15%.
- Some 250 Islamic financial institutions currently operating in about 75 countries.
- Globally more than 100 Islamic equity funds manage assets in excess of US\$5.0 billion.

Source: Various; Bursa Malaysia, <http://lfxsys.lfx.com.my/others/bm2ICM.pdf>

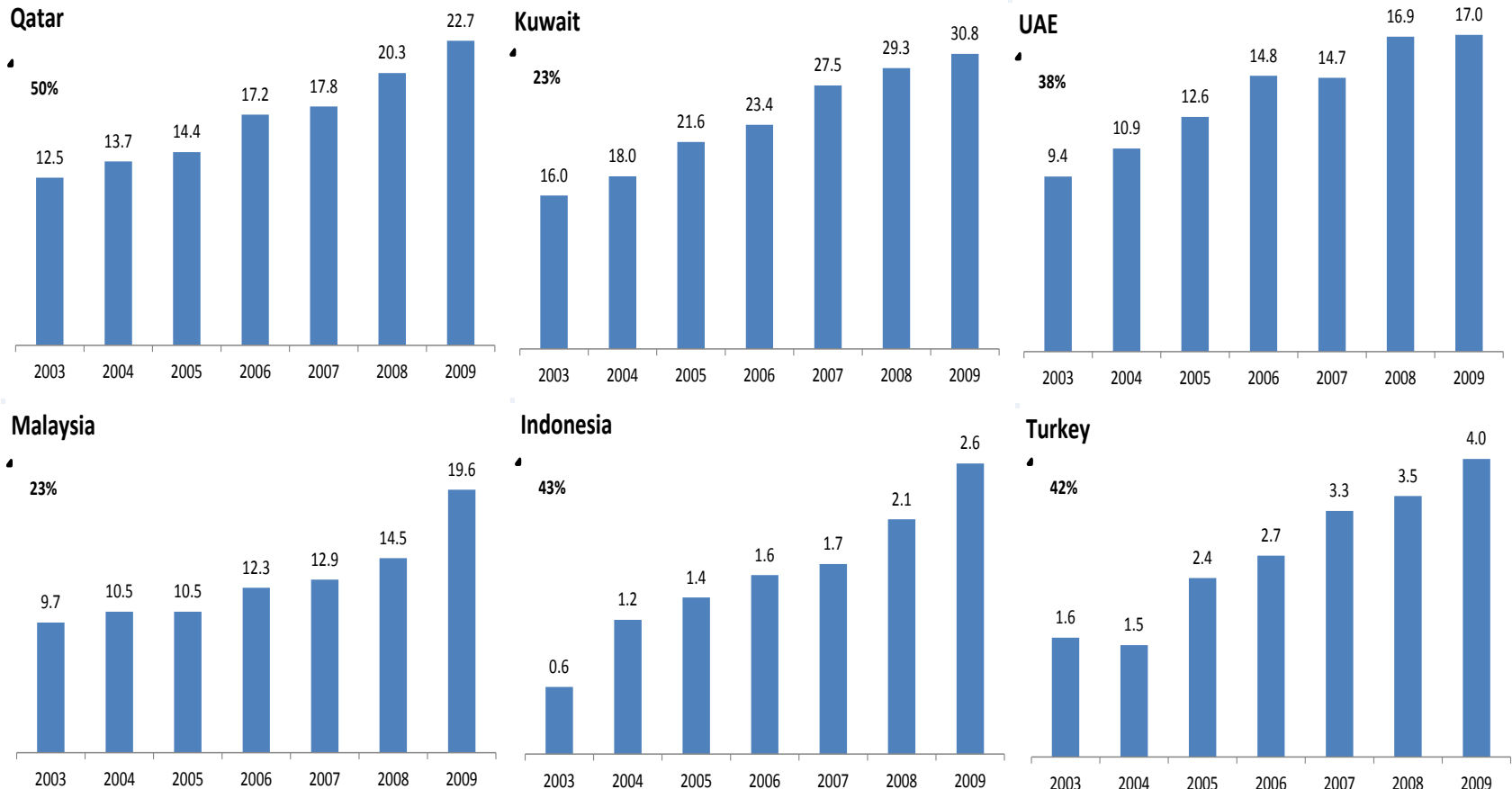
IF Islamic banking sector has proved relatively resilient to the recent Global Recession and Financial Crisis: Assets (US\$ bns) continued growing by 10-12% over 2008-09



Source: World Islamic Banking Competitiveness Report 2010-11

ISLAMIC BANKING MARKET SHARE HAS RISEN ACROSS KEY GEOGRAPHIES

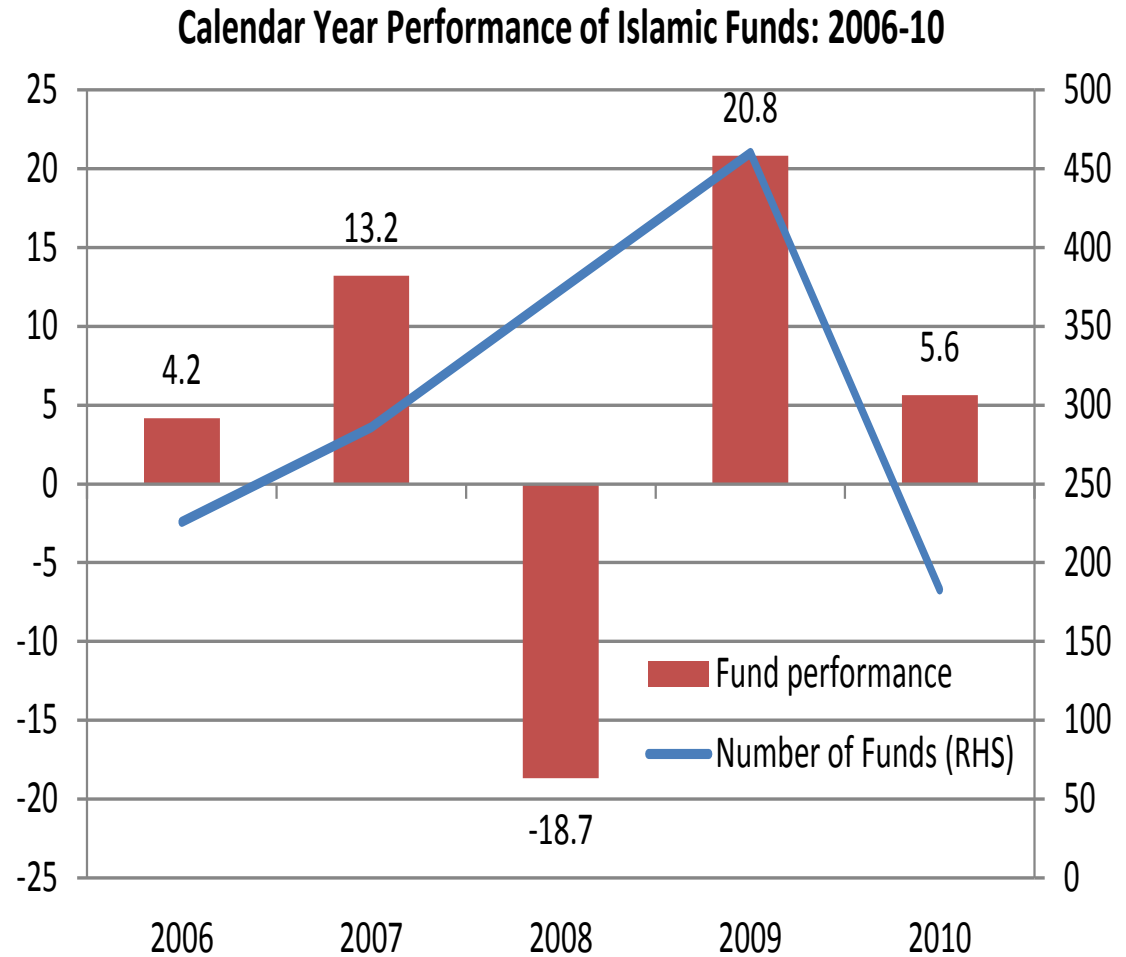
Although Islamic banking growth rate has declined in recent years, it continues to outpace growth in conventional banking and GDP growth



Source: World Islamic Banking Competitiveness Report 2010-11

ISLAMIC FUNDS CALENDAR YEAR PERFORMANCE

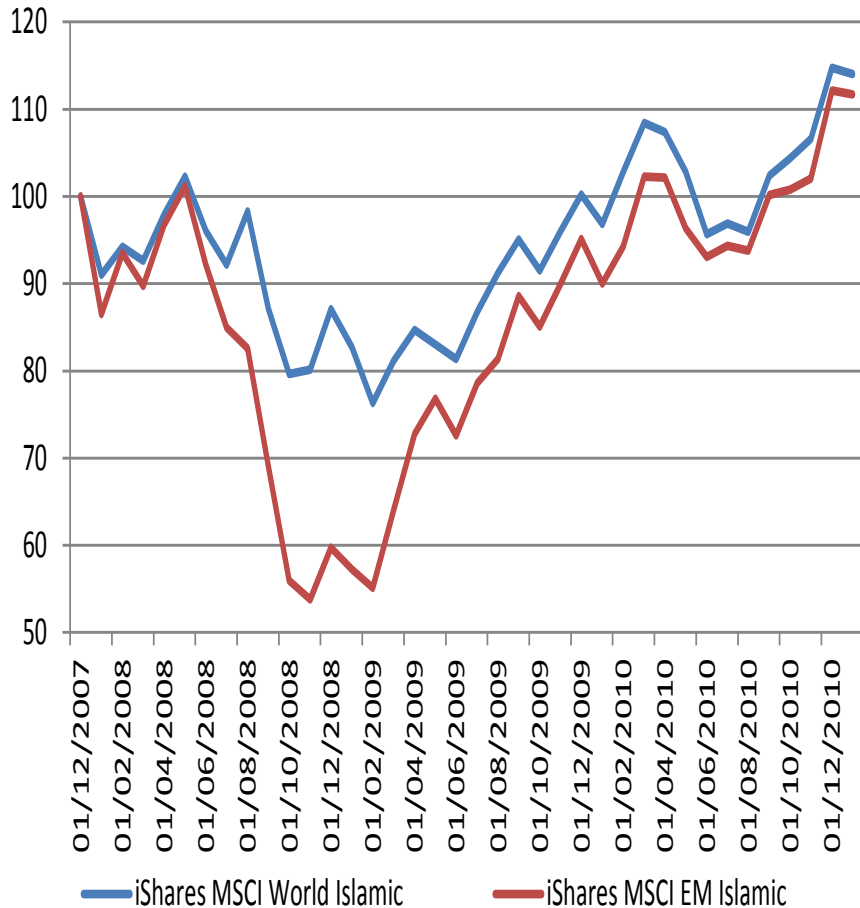
- Performance of the fund has been calculated as: $[(\text{Net Asset Value of the fund on the last day of the year} - \text{Net Asset Value from the first day of the year}) / \text{Net Asset Value on the first day of the year}] * 100\%$
- Performance dipped in 2008 before picking up in 2009.
- Number of funds and their average performance was lower in 2010.



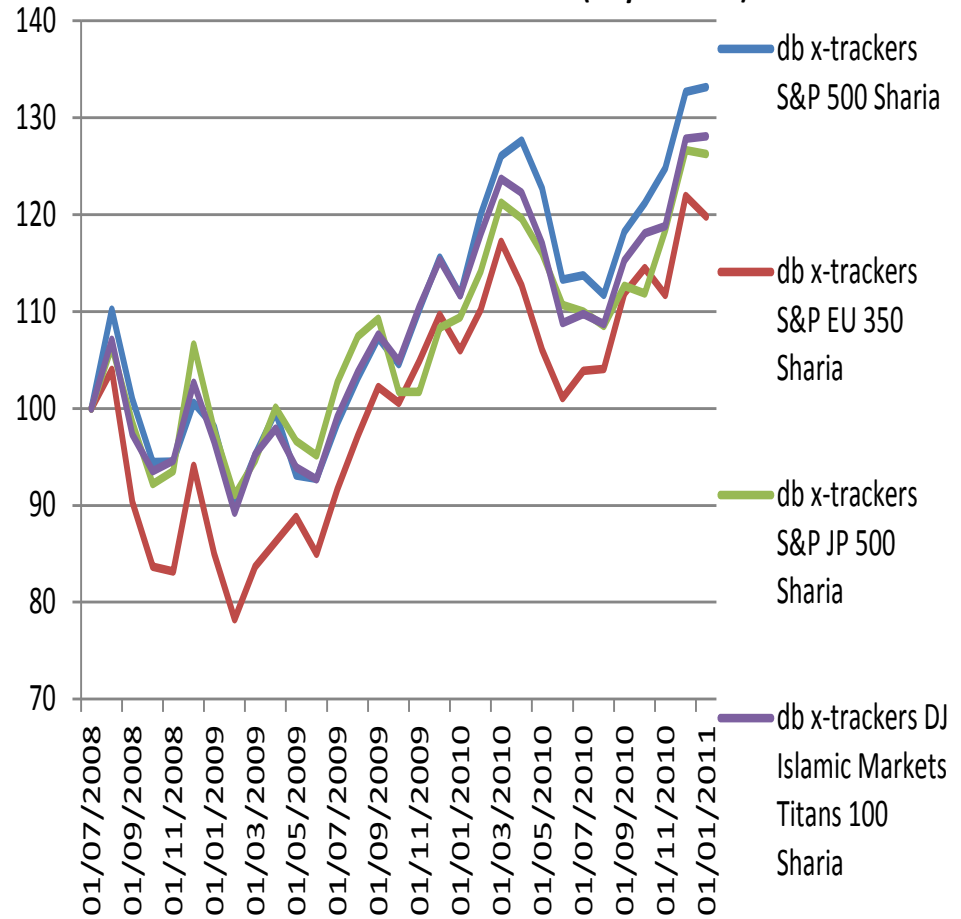
Source: Reuters

ISLAMIC EXCHANGE TRADED FUNDS PERFORMANCE

Performance of the Islamic ETFs: World vis-a-vis EMs (Dec '07=100)



Performance of ETFs Indices (July '08=100)



Source: Reuters

CHALLENGES FACED BY THE ISLAMIC FINANCE INDUSTRY

1. Lack of Money market and Capital Market Instruments
2. Lack of instrument & securities standardization resulting in higher entry & transactions costs
3. Low levels of trading liquidity
4. Lack of reliable, timely information & statistical data
5. Lack of regulatory convergence
6. Untested & opaque Islamic Insolvency & Creditor Rights Regimes
7. Limited human capital resources: e.g. Shari'a scholars

THE ROLE OF INSTITUTIONAL INVESTORS IN ISLAMIC CAPITAL MARKETS

- Institutional investors hold over 80% of corporate bonds in developed markets: their investment behaviour & strategy has a dominant influence on the pricing of these securities.
- Institutional investors generally are subject to restrictions on investing in non-investment grade securities: IF securities should aim to be rated. *Need CRAs with Shari'a compliance experience.*
- Institutional Investors need to be provided the option of investing in short, medium and long term Shari'a compliant instruments in order to overcome maturity mismatches: *Need to expand IF investment space*

SHARI'A COMPLIANT PENSION FUNDS AND VENTURE CAPITAL FUNDS: Nascent but promising industry

Pension Funds:

- Islamic pension funds have a well-diversified portfolio whose composition is regulated to ensure stability and to guarantee that the investments are both socially and economically desirable, such as infrastructure projects.
- **Islamic mortgages** would be an attractive proposition for pension funds

Venture Capital Funds:

- Venture capital funding complies with one of the cornerstone principles of Islam: it provides much needed investment to start-up companies in return for potential rewards, while accepting the risks that may be involved in such a deal. This type of structure is the classic form of *Musharaka* financing used over many centuries in the Islamic world.
- By providing funds to budding entrepreneurs with economically viable ideas, Islamic venture capital can help to promote innovation, job creation and development of fast growing industries.

INFRASTRUCTURE, PUBLIC FINANCE & DEVELOPMENT FINANCE

- MENA Region characterized young populations: need to provide core infrastructure – public utilities, education, health, transport etc.
- According to MEED Projects, in the Gulf region alone, about \$2.8 trillion worth of infrastructure projects are in the pipeline for the coming 15 years.
- Region's governments should utilise Sharia-compliant financial instruments to finance large scale infrastructure and public works projects.
- Governments in the region need to introduce Sukuk as part and parcel of public finance/ debt management framework.
- Use of Sukuk will provide regional governments with an alternative source of funding to smooth out volatile revenues from energy price fluctuations & diminish macroeconomic and financial vulnerability
- Development of a Government Sukuk market should be basis of corporate Sukuk market

INFRASTRUCTURE, PUBLIC FINANCE & DEVELOPMENT FINANCE

- Infrastructure funding through Shari'a compliant finance is clearly a highly attractive source for GCC governments' planned expansion plans (e.g. GCC Rail Network, GCC Power grid etc.).
- Cross-border potential: Shari'a compliant financing projects which originate in one country can source investors globally.
- Additionally, Development Finance Institutions such as the World Bank, ADB, IDB, EBRD should follow the example of IFC, which issued a Sukuk recently out of the DIFC.
- Governments, RFIs & IFIs issues should be basis of Islamic debt market and development of Islamic profit curve.
- Ample opportunity for Central Banks to be more active in Islamic Finance – through the issuance of Sharia-compliant T-bills (not relying on CD's alone).
- Requires re-writing of regulations (including tax & fiscal in some countries) to recognise Sharia compliant instruments.

ISLAMIC FINANCE IN LEBANON

- Lebanese lenders have seen an increase in lending to the private sector in the first 11 months of 2010. Total loans extended by Lebanese banks to the private sector grew by 23.1% to \$34.9bn at the end of November 2010. Bank deposits grew during the period by 9.7%, the equivalent of \$9.2bn, reaching a historical high level of \$105bn.
- Islamic Banking in Lebanon started in 2005, however it has yet to pick up.
- BDL announcement that it is considering introducing a product in Q1-2011 to help Islamic lenders manage their liquidity is a welcome move.
- Lebanon is a regular issuer of non-Islamic bonds but could tap IF market by issuing Shari'a compliant instruments as well.
- Proposed amendments to existing Islamic Banking Law will open new avenues for Issuers to issue Islamic Money and Capital market products.

Source: <http://www.businessweek.com> and ame.com

INSTITUTIONAL INVESTOR ACTIVISM-Conventional Finance

- Financial crisis: the underlying problem, internationally and regionally, was one of **governance**.
- Many parties have been blamed for the financial crisis – boards, senior management, regulators – for failing in their duties, but investors as owners cannot walk away from responsibility. Investors have a duty to act as share **owners** not just share **holders**.
- Emerging international best practices: in the epicentres of the financial crisis, the US and the UK, the governments are giving more rights and duties to the investment community.
- **Stewardship Code**, a corporate governance code for investors, was issued in the UK in July 2010, setting a clear benchmark of behavior expected of all investors.

..... (Contd) INSTITUTIONAL INVESTOR ACTIVISM

- In conventional companies, Investors are becoming more active taking an interest in the companies where they acquire a stake, i.e., display more shareholder activism in the future to protect their interests. Islamic Finance Investors should also follow suit.
- Tools include integration of governance factors in the investment process, dialogue and engagement, contact with regulators, proxy voting, shareholder proposals and legal action.
- S&P/ Hawkamah Pan Arab ESG Index - a tool for investors.
- Management should be accountable to shareholders of Islamic Banks and sound principles of corporate governance need to be solidified in board rooms of asset managers to ensure good risk management and sound investment performance by the Islamic bank.

HAWKAMAH'S TASK FORCE ON CORPORATE GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS

- Hawkamah's Task Force on Corporate Governance of Islamic financial institutions (IFIs) has developed a Policy brief based on a survey of Corporate Governance frameworks of Islamic banks in 8 MENA Countries. (http://www.hawkamah.org/sectors/taskforces/files/Draft_Policy_Brief-July%2029-2010.pdf)

Main recommendations of Policy Brief are:

1. The corporate governance code for Islamic Financial Institutions is strongly recommended to be made mandatory by law/regulation.
2. The Annual Corporate Governance report issued by the SSB should be made a part of the Annual Accounts to be distributed to all shareholders and IAHS.
3. Board evaluation procedures should be put in place for IFIs Boards as well as the Shari'a Supervisory Board members.
4. Shari'a Governance system should ensure that it imposes responsibility & accountability on SSB members to be responsible for the Shari'a compliance of the product or transaction from the product development stage through to its implementation.

5. The corporate governance framework should incorporate shareholders as well as investment account holders (IAHs)



Establishing an International Islamic Capital Market

Some building blocks:

- Abide with international standards for securities issuance
 - DIFC has launched a Sukuk documents standardisation initiative
- Recognise IF services in Free Trade and Investment Agreements
- IFI passport and regulatory Mutual Recognition Agreements (MRAs)

GENERAL AGREEMENT ON TRADE IN SERVICES (GATS)

- The GATS agreement under the WTO recognises the growing importance of trade in services for the growth and development of the world economy;
- Aim is to establish a multilateral framework of principles and rules for trade in services with a view to:
 1. Expand such trade under conditions of transparency and progressive liberalization;
 2. Introduce new regulations, on the supply of services within the member territories in order to meet national policy objectives.
- **GATS should incorporate principle of “functional equivalence” between conventional and Shari’a compliant finance**

FREE TRADE AGREEMENTS (FTA)

- Free trade agreements (FTAs) have proved to be one of the best ways to open up foreign markets absent multilateral agreements.
- GCC has already signed 2 FTAs with Singapore and European Free Trade Association (EFTA)
- Trade in Services Chapter of these agreements include section which covers financial services. Upon request from the GCC there has been included an annexure on Sharia' compliant financial services.
- Purpose is to have these countries recognise Shari'a compliant services as a financial service that may be offered in their jurisdictions.
- Countries should follow suit of the GCC and should elaborate on Shari'a compliant financial services under the 'New Financial Services' section introduced under the WTO.

ISLAMIC FINANCE PASSPORT Proposal

- Mutual Recognition Agreements e.g. DIFC-Malaysia good starting point for recognising IF products & services
- The MIFID concept of 'European financial passport' should be developed for the Islamic Financial Industry as well.
- GCC moving towards greater economic & financial integration
- Starting point could be a GCC Islamic Finance Passport:
 1. IFIs would have pass porting potential
 2. Regulated Funds passport
 3. Takaful & Re-Takaful passport
- IFSB could set guidelines in cooperation with country authorities & regulators

ISLAMIC FINANCE STANDARDS

- The IFSB has been main standard setter.
- AAOIFI has issued:
 - Accounting Standards,
 - Auditing Standards,
 - Governance Standards
 - Ethics Code
- But Central Banks & Regulators need to impose these Standards and Guidelines & ensure compliance

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