Foreign & Commonwealth Office

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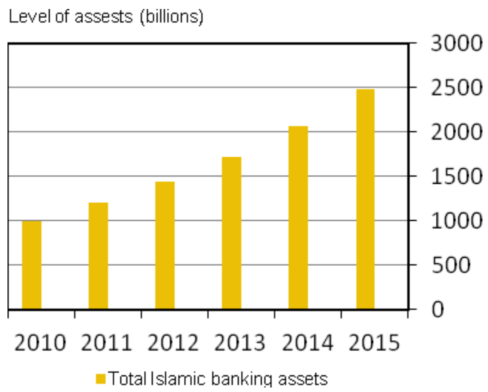
Islamic finance: foreign policy opportunities

1. The following note provides an overview of the growth potential of the international Islamic financial sector, and the opportunities this provides the UK. Islamic finance (IF) can feed into HMG's foreign policy objectives, notably efforts to support post Arab Spring transition economies and our Emerging Power Initiative. Furthermore, pursuing these objectives can also support the UK's commercial interests within this industry, notably the consolidation of the City's position as the Western centre for Islamic finance.

Market potential

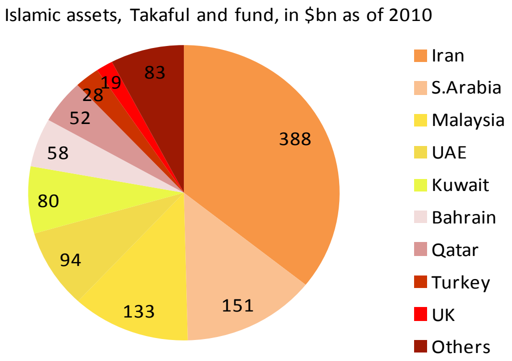
1. Islamic finance is a growing part of the international financial system with assets of $US 1.2 trillion, which represents approximately 1% of global banking assets. With an estimated annual growth rate of 10-15% it is likely to become an increasingly important financial market in the future. By 2015 the industry is forecast to be worth nearly $2.5 trillion (figure 1). This is predominantly driven by expansion in the Gulf, which commands a third of the industry, but Islamic financial centres also exist in Malaysia and London, which is worth $19 billion (figure 2).

Figure 1: Islamic banking growth potential



Source: The Banker

Figure 2: Islamic assets in $bn by country



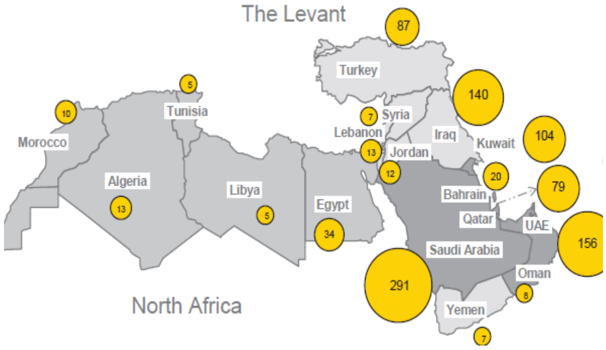
Source: Ernst and Young

2. The industry has significant growth potential particularly considering the world's Muslim population, now at around 1.8 billion, is rising by an estimated 1.5% per year. Furthermore these populations are predominantly based in key growth regions. For example 253.9 million Muslims live in the 10 fastest growing economies in the world (2011-2015).These regions are generally under banked, thus demand for financial services will continue to increase. Whilst demand primarily comes from the worlds Muslim population there is also growing demand from non Muslim contingents, for example a quarter of Malaysian IF customers are not Muslim.

Middle East and North Africa

3. The Islamic financial market has not yet developed to the same extent in North Africa as it has in the GCC (figure 3). The Arab Spring and election of Islamist governments could drive expansion of IF in this region as grass roots demand for IF increases. Since the uprisings there has been a push to legalise or incentivise IF in these markets. For example Morocco plans to allow its first Islamic bank to open in 2013. Likewise Libya and Oman have both approved laws to allow Islamic banking into the market. These three countries had no Islamic banking assets in 2010 but by 2015 Ernst and Young estimate they will have \$10bn, \$5bn and \$8bn respectively which, whilst still small, represents significant growth. They also estimate the industry will grow 1192% in Algeria, by 395% in Egypt and 220% (from a significantly larger base) in Saudi Arabia by 2015.

Figure 3: Estimated Islamic banking assets 2015 ($bn)



Source: Ernst and Young

Asia

4. There is also growth potential in Asia. Malaysia is already the Asian Islamic financial centre, with about \$133bn of Islamic assets and is continuing to grow. The key catalyst for this growth is tax exemptions on infant Islamic banks and products with a strong regulatory system. Whilst Malaysia aims to consolidate its market leader position, Indonesia is beginning to reduce barriers to IF. The Deputy Governor of the Indonesian central bank estimated that Islamic banking could make up over 15% of banking assets in the country within 10 years, something supported by research from Standard and Poor.

<u>UK opportunity: Foreign Policy</u>

Middle East and Northern Africa

5. IF provides a significant opportunity to support transition countries following the Arab Spring. These countries face a number of economic challenges including the lack of adequate banking coverage and access to credit which reduces private sector growth. For example World Bank analysis suggests that only 18% of adults in the Middle East and North Africa (MENA) have a formal account, the lowest account penetration in the world. Inclusive financial systems serve a vital purpose, offering savings, credit, payment, and risk management products, without which small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and slower economic growth. Evidence of this is provided by the World Economic Forum's Global Competitiveness report which finds that seven out of the eight Arab Spring countries highlight access to finance as one of the most significant barriers to business growth. It will be vital for the region to implement policies to overcome this barrier.

6. Religious reasons for not having a formal account are most commonly cited in the MENA. Islamic law prohibits the payment or receipt of interest, financial speculation, and investment in socially detrimental activities. It also stresses the importance of profit and loss sharing and ensuring that financial transactions are underpinned by a tangible underlying asset. Developing financial products compatible with religious beliefs could potentially increase the share of adults with a formal account by up to 10 percentage points in the MENA[1]. This would further enhance economic development in the region. Since the Arab Spring, there has been increased populace demand for IF products, which incoming Islamist

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[1] Source: Demirguc-Kunt & Klapper (2012) Measuring Financial Inclusion: the Global Findex database, World Bank

governments are keen to support. This stance complements our commercial objectives, the UK is in a good position to respond and provide the services and expertise to support the development of this sector.

Asia

7. Malaysia and Indonesia are key Islamic financial markets now and in the future. Increasing links with these markets could help achieve the UK's commercial and foreign policy aims. Further research, possibly led by the South East Asia economist, is needed to understand what the opportunity for IF in the region is, and what Malaysia and Indonesia may want from the UK. One possible avenue which could be investigated is the overlap between IF and our Emerging Powers initiative.

UK opportunity: Commercial

8. Britain has the largest Islamic banking sector outside the Middle East and Asia boasting 22 Shariah compliant banks or banks with Islamic windows, 12 more than the next largest Western industry (USA). We have a good platform from which to consolidate our position as the Western Islamic financial centre, however we must not become complacent in a rapidly moving field. The main commercial opportunities for the UK, as highlighted by UKTI and HMT, include:

   - Exporting our expertise. The UK has a wealth of experience in services such as insurance, accounting, tax, regulation, product innovation, Islamic financial education as well as legal advice, as noted by UKTI's work in this area. For example, the UK boasts nearly 30 law firms operating substantial IF departments from London and has more than 10 universities and business schools offering qualifications in IF. There is significant demand for these services internationally, which has yet to be seriously rivalled by any other European financial centre.

   - Importing foreign investment. IF is starting to play a crucial role in infrastructure development in the UK. For example the US$2.4 billion ijara[2] financing to redevelop the Chelsea Barracks represents the biggest Shariah-compliant real estate projects in the UK. The Shard was also primarily financed by Sharia compliant investment products. Gulf sovereign wealth funds could provide a continued source of investment in the UK, including property investment in healthcare, education and social housing sectors. We should continue to ensure that the UK is well positioned to encourage this investment

Possible areas of future activity:

9. Undertake research into the exact channels through which IF can contribute to HMG policy objectives in each region; e.g. Asia, North Africa and the Gulf countries. This research could put forward recommendations on the specific policies needed to support these goals.

10. Continue to integrate the UK industry with the international Islamic financial sector, as well as showcasing UK expertise. This could be achieved through hosting the World Islamic Economic Forum in 2013, Ministerial visits with representative business delegation and Embassy engagements.

11. Analyse how we can better accommodate and reduce barriers to IF investment to support HMG's overarching aim to enable greater levels of investment in UK infrastructure.

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[2] See annex for definition

Annex A: Modern Islamic finance contracts[3]

There are a variety of commonly used Islamic finance contracts. Some of the most common examples are listed below. These contracts define types of transaction which underpin specific products – but they are not the products themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly in terms of their risk profiles and economic substance.

- Ijara: Leasing contract. The owner of an asset (the lessor) leases the asset to a lessee, who pays a pre-determined rental to the lessor for the use of the asset. An example of this would be that a bank buys a car and leases it to a customer. The duration of the lease and the terms of the rental are determined at the start. The bank retains ownership throughout and is the owner of the car at the end of the contract.

- Mudaraba: Profit sharing agreement. This is a variety of joint venture whereby two parties collaborate on a project, one providing the investment and the other providing the expertise. The profits of the venture are then shared between the two parties in proportions previously agreed in the contract.

- Murabaha: Purchase and resale contract. This is when one party, such as a bank, purchases an asset identified by a second party with the intention of immediately reselling it to the second party for payment of a pre-arranged sum at a set date in the future. This resale price will be higher than the original sale price and may be paid in instalments.

- Musharaka: Joint venture. An entrepreneur and an investor agree to collaborate on a project, both contributing capital in agreed measures. The contract also clearly sets out arrangements for the sharing of both the profits and the losses of the venture.

- Diminishing musharaka: Declining balance partnership. In this variation, regularly used for property transactions, the ownership of the asset is divided in to units, which one party gradually buys from the other, thus incrementally increasing their share until the full ownership of the asset is transferred to the single party.

- Sukuk: Investment certificates. These are investment certificates that are economically equivalent to bonds. Unlike bonds, which are debt-based instruments that pay interest, sukuk are asset-backed or asset-based instruments and represent the ownership (actual or beneficial) by the sukuk holders in an underlying asset. Returns are paid to the investors in line with their proportional ownership in that asset. Sukuk may be issued by governments or by private companies.

- Takaful: Insurance. This is a Shariah compliant mutual insurance arrangement. A group of individuals pay money into a fund, which is then used to cover payouts to members of the group when a claim is made.

[3] Source: HMT (2008) The development of Islamic finance in the UK: the Government's perspective