Global Islamic Finance Forum 2012

Selecting the Right Business Model in Islamic Banking

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Key Themes

1. Islamic Banking & Finance – The journey so far
2. Business and financial risks in Islamic banking business model
3. Balancing profit and social needs
4. Better business model connecting to real economy
5. Key Conclusions

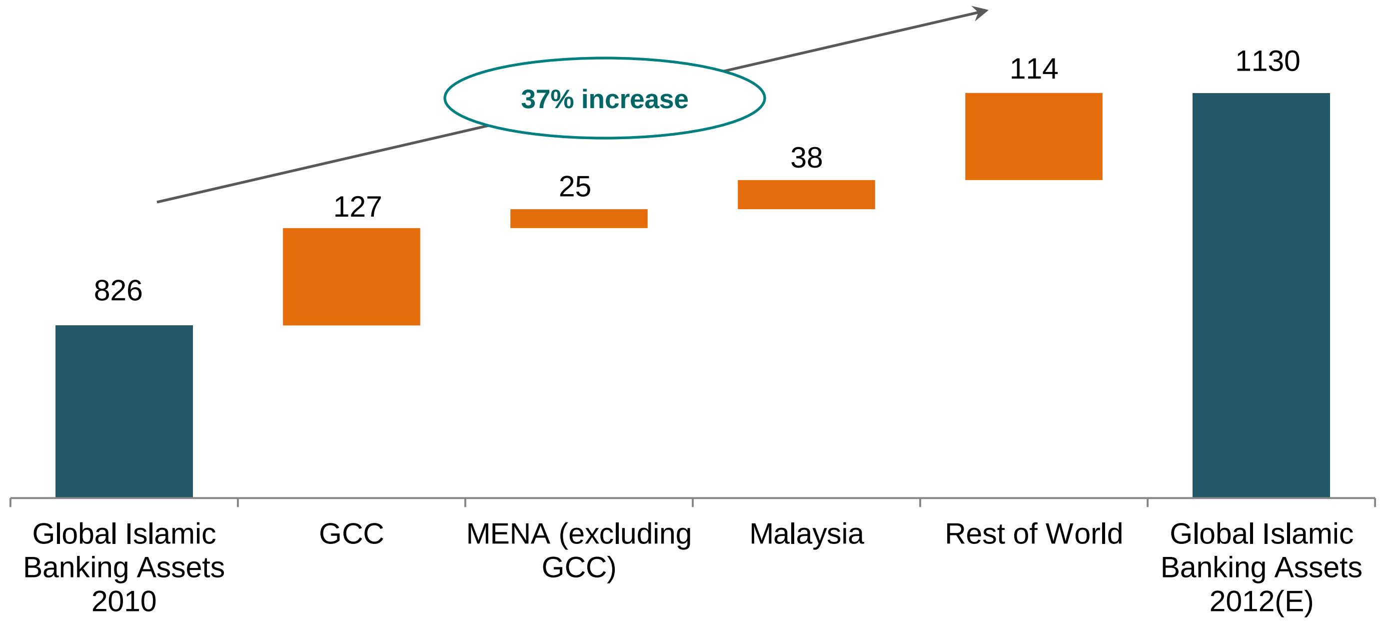
1. Islamic Banking – The journey so far

1. Islamic Banking & Finance – The journey so far

Islamic banking assets expected to cross $1.1 trillion in 2012

GCC banks will continue to be a major contributor to such growth

Islamic Banking Asset Growth (US$bn)



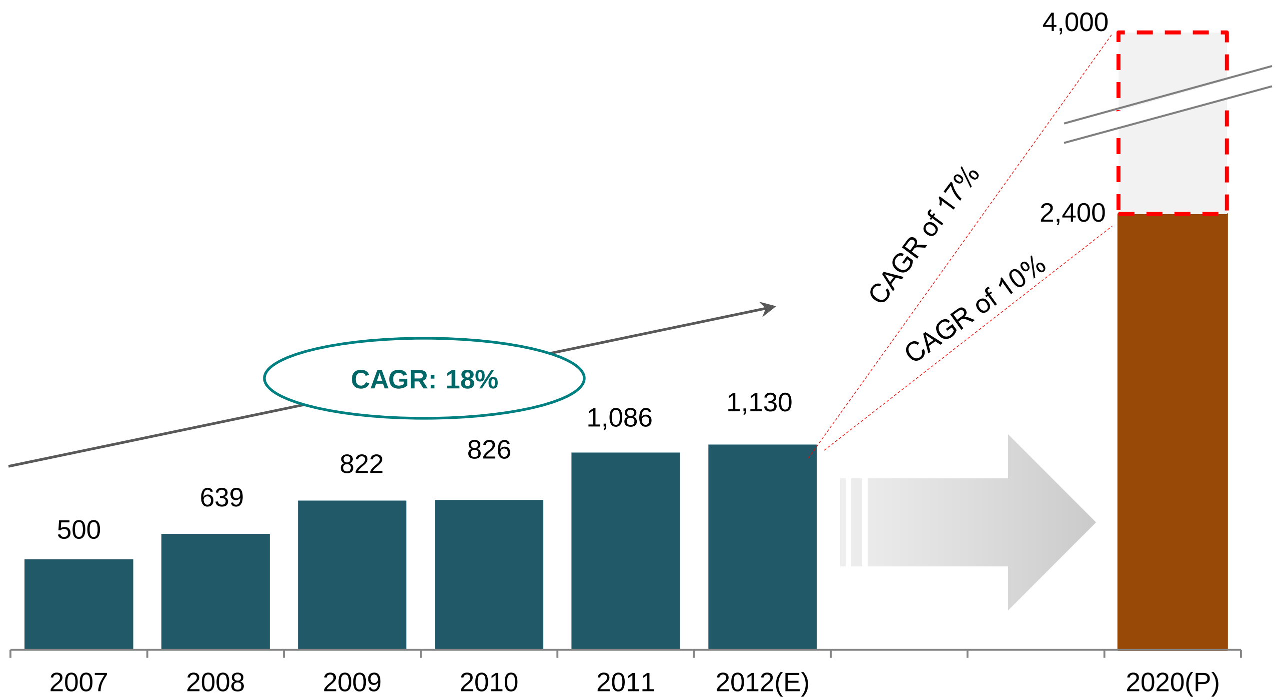
Source: E&Y, World Islamic Banking Competitiveness Report 2011-12

1. Islamic Banking & Finance – The journey so far

Although various research suggests a $4tn projection for Islamic banking assets for the year 2020 implying a growth rate of 17%, we feel this is untenable unless serious structural reforms are undertaken

A modest growth rate of 10% implying total assets of $2.4tn seems more likely in the current scenarios

Islamic Banking Asset Growth (US$bn) – The journey ahead



Source: Zawya, The Banker, MEED, LMH

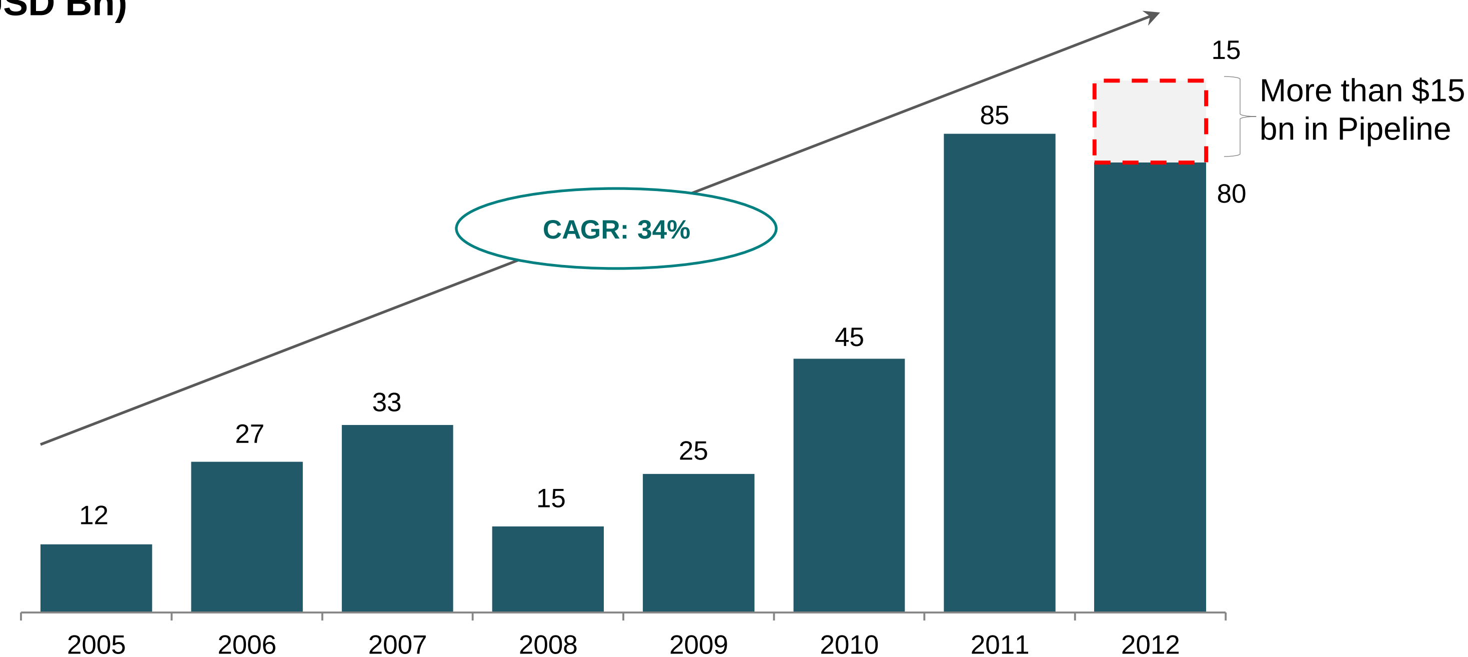
1. Islamic Banking & Finance – The journey so far

Sukuk becoming a dominant choice for raising funds

More than $15bn sukuk are still in the pipeline for the year 2012

More than 83% of Sukuks (amount wise) are issued locally

Global Sukuk Issuance Trend: 2005 – Sep 2012 (USD Bn)



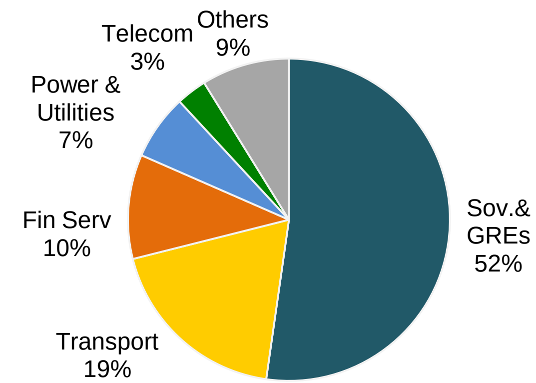
Source: Zawya

1. Islamic Banking & Finance – The journey so far

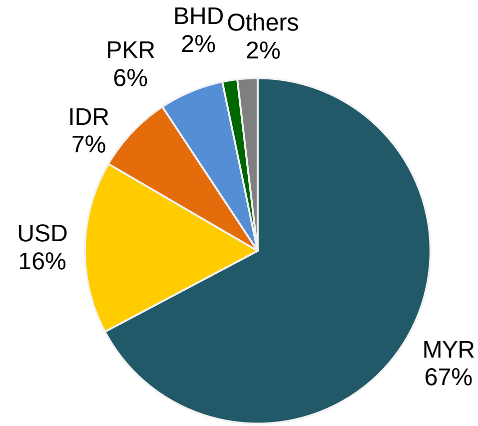
Sovereign and GREs are major issuers of sukuk and the proceeds are directed towards the real economy

Though GCC was vibrant during this period, Malaysia is still the lead issuer

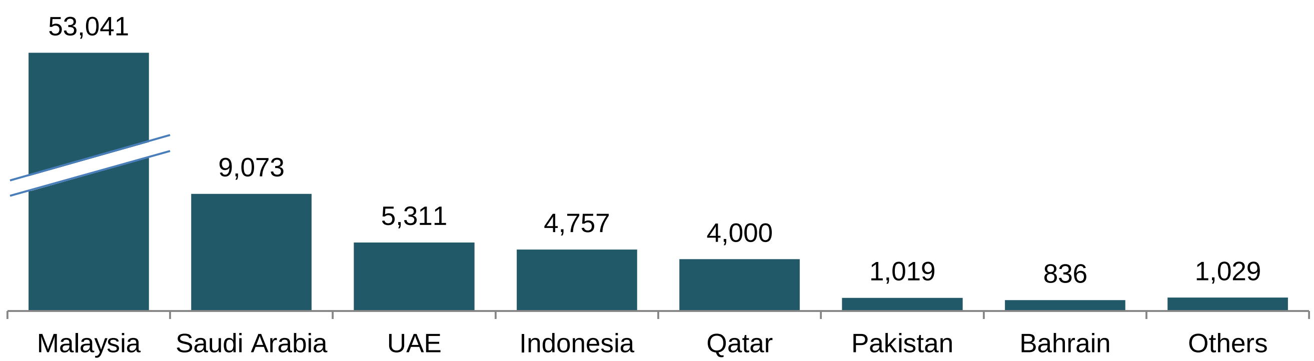
Sukuk issued by Sector (YTD Sep 2012)



Sukuk issued by currency (YTD Sep 2012)



Sukuk Issuance by Country YTD Sep 2012 (USD Bn)



Source: Zawya

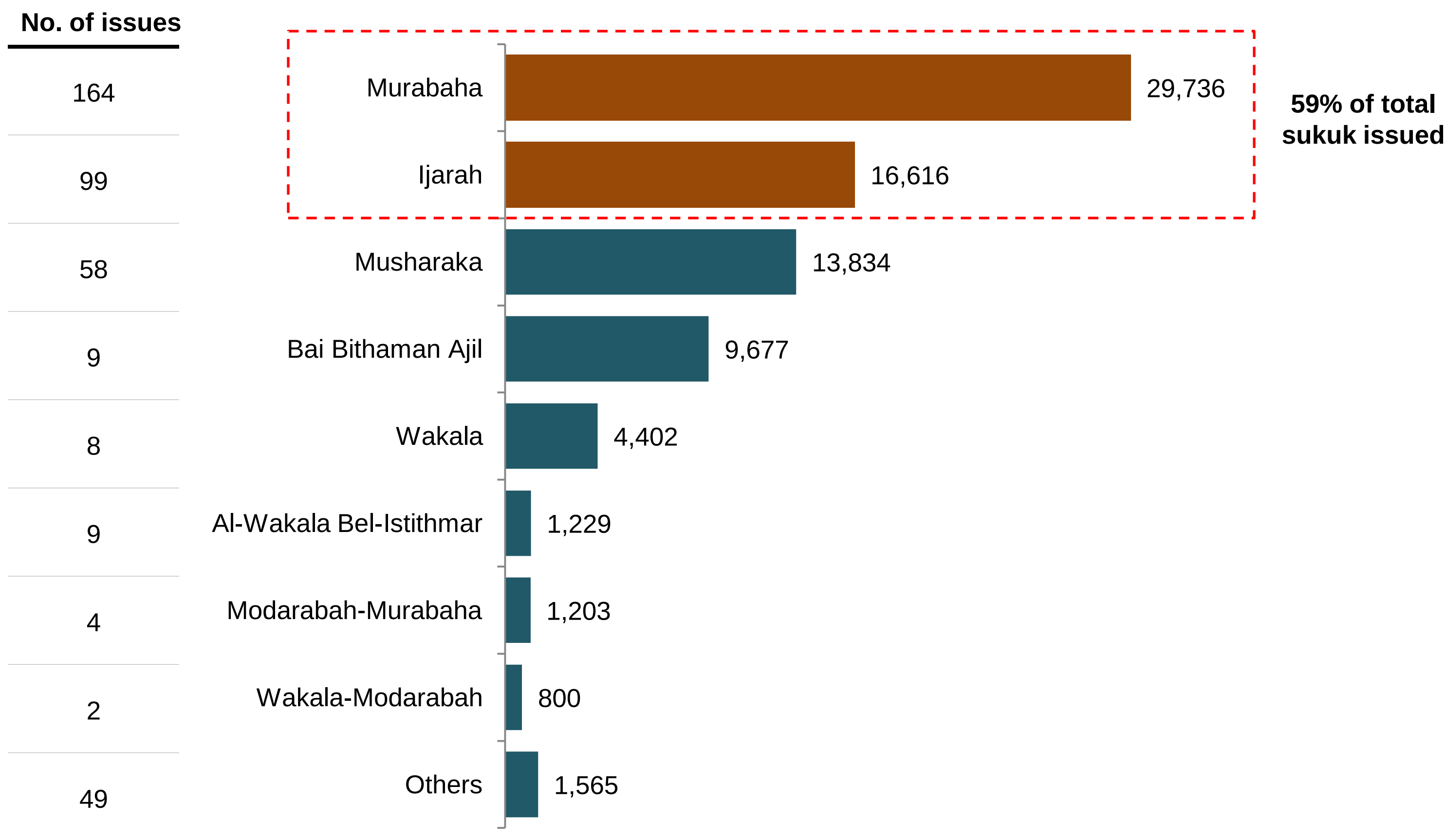
1. Islamic Banking & Finance – The journey so far

Are we benefitting from all approved structures

The Murabaha and Ijarah structure are still the preferred choice of sovereign issuers

This raises the question: When do we move from undeveloped plots of lands to more real structures having elements of real recourse to assets (economy)?

Break up based on Sukuk Structure: YTD Sep 2012 (USD Bn)



2. Business and financial risks in Islamic banking business model

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Islamic banks have a unique risk profile because of the need to be Shariah-compliant

Islamic banks are very sensitive to displaced commercial risk because they have restricted access to the short-term funding options used by conventional banks

Displaced Commercial risk

Islamic banks typically obtain the majority of their funds from mudharaba and wakala investment accounts and, at first glance, this arrangement appears to provide the institution with a significant buffer against losses.

However, during losses banks are more reluctant to use customer money to cover losses. The fear is that disappointed customers would withdraw the rest of their funds in a run on the bank. So, Mudharaba and Wakalah funds may only provide a buffer in theory.

Dominance of asset based financing and lack of short term instruments only serves to lengthen the liquidity gaps

Liquidity risk

Islamic banks have restricted access to the short-term funding options used by conventional banks. Since all transactions must be linked to a tangible, underlying asset – this rules out purely financial contracts like repos and Certificates of Deposit. As a result, there is a big, unpopulated gap between cash and long-term papers.

The dominance of asset based financing only serves to lengthen the liquidity gaps because exits from these transactions are not always agreed in advance.

Source: Extracted from PWC's report, "Growing pains - Managing Islamic banking risks"

2. Business and financial risks in Islamic banking business model

Key unique risks faced by Islamic banks

The real estate boom in the GCC has led to Islamic banks having half of their assets backed/linked to real estate

Real estate concentration risk

Real estate risk concentrations are common among Islamic banks – their geographic reach tends to be limited, as do the type of assets they are able to accept. Hedging is mostly out of bounds, and risk transfer via securitization may be difficult to achieve.

Unlike conventional banks, real estate exposure for Islamic banks does not necessarily come in the form of a loan. Instead, the exposure typically takes the form of a profit-sharing contract – the Islamic banks put their own money at risk in the form, effectively, of an equity stake / and in the substance.

Contractual complexity of Shariah compliant transactions gives rise to additional operational risks

Operational risk

Islamic banking products can involve a number of separate contracts, giving rise to additional legal risks. Each Islamic transaction has multiple steps and each step takes time and involves a fresh contractual agreement, magnifying the scope for disagreements and complications.

They also have to face thorny operational risks associated with the administration of their business – paperwork and book-keeping. Though these risks look similar to conventional banks', in practice, they are made more taxing by the contractual complexity of Shariah compliant transactions: the wrong contract could be used, or the wrong terms could be applied.

Source: Extracted from PWC's report, "Growing pains - Managing Islamic banking risks"

2. Business and financial risks in Islamic banking business model

Key unique risks faced by Islamic banks

Basel III makes no distinction between conventional banks and Islamic banks

The liquidity requirements of Basel III will prove more difficult. Islamic banks face challenges in managing its liquidity

Capital management and Basel II / III

Risk and capital form the two most important pillars of the existing and new Basel framework. Islamic banks' risk profile may not be well reflected by the Basel II categorization – market, credit and operational risks are all measured according to the specific rules of Pillar I, but other risks which are important to Islamic banks, such as liquidity risk, concentration risk and fiduciary risk, are all approached more subjectively under Pillar II. The banks themselves will find it hard to produce robust numbers, particularly for Pillar II risks

Traditional risk types, like market and credit, come with thorny issues for the Islamic bank. Both require a wealth of historical data which the still-young Islamic sector simply does not have.

Basel III makes no distinction between conventional banks and Islamic banks**.** Though Islamic Financial Services Board (IFSB) is setting parallel standards for Islamic Banking such as equivalent Basel III norms, but in its current form it is lacking adequate tolls and resources. Given no other alternative, Islamic banks will have to adhere to Basel III norms (through their respective regulators). Furthermore Islamic Banks should be encouraged to adopt Basel III norms as designed by IFSB which has captured to a certain extent the realities of Islamic Banking.

The liquidity requirements of Basel III will prove more difficult. Islamic banks face two challenges in managing liquidity:

- surplus liquidity should not be transferred to conventional banks; and
- constraints on their borrowing limits access to liquidity when the bank is under stress.

Source: Extracted from PWC's report, "Growing pains - Managing Islamic banking risks"
Hogan Lovells, Current implementation status of Basel III, April 2012

3. Balancing profit and social needs

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Key functions of Islamic Financial Institutions

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1

Economic Prosperity

To spread economic prosperity by promoting and fostering Shariah principles in the real business sector

2

Effective Resources Allocation

To be supportive of areas where resources must be mobilized for the benefits of real economy

3

Investments

To invest and develop projects to create employment and develop right infrastructure for progressive societies

4

Financial Resources

To provide and create flexibility in the financing costs through diverse Islamic contracts in various areas

3. Balancing profit and social needs

The ethical, moral and social responsibilities aspect of Islamic banking makes the Triple Bottom line concept inherent rather than a choice

- In Islamic Finance, profit motive is not the ultimate in business but righteous conduct is. Compliance to Shariah makes this inherent in the system

"Wealth and sons are allurements of the life of this world; but the things that endure, good deeds, are the best in the sight of your Lord, as rewards, and best as the foundation for hopes" (Quran 18:46)

- Islamic banks are operate in a mixed economic-conventional banking system environment, hence the Social welfare oriented activities of Islamic banks will increase as Islamic banking becomes more established

"And whoever fears Allah, He shall make for him a way out of every difficulties. Moreover, He shall provide for him from where he has never conceived" (Quran 65:2-3)

- Islamic banks should play major roles in managing the Zakah and Sadaqahs fund which is used to finance poverty alleviation activities
- Equitable wealth distribution can be done through Qard-al-Hasan (benevolent loans) which is interest free loan that the Islamic teachings urge Muslim to make available to those who need it and know how to manage it

4. Better business model connecting to real economy

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- The initial model started was good – Profit Sharing through Musharakah and Mubarbah contracts. However, there has been a complete shift from Profit and Loss Sharing banking to a sales-based and debt-based system

- Competition and Regulations have led to a different trajectory – more convergence is seen towards conventional banking

- Shifting from asset backed structures to asset based structures has complicated the industry, hence not benefitting the real economy

- The challenge now remains on how we can avoid financing “asset bubbles” and ensure that the capital goes to the real economy

The KFH Group

KFH Research Ltd

5. Key Conclusions

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- Islamic banking industry has yet to build-its Best Ever Corporate Governance “PRACTICES”
- Islamic banking should not be limited to structuring of transactions or contracts, but should permeate every aspect of Islamic Banking – with all the related STAKEHOLDERS and its operating environment – making banking truly Islamic
- Self discipline, is the Golden Key
- There is a real need for constructive innovation that is able to harness the potential of the economy from the individual level to the enterprise level
- Finding the right LOLR (Lenders Of Last Resort)
- Building the right bridges of understanding with regulators and rating agencies
- Communicating the fact that Islamic Banking is unique and

  “ HAS TO BE TREATED THE WAY IT DESERVES”.

Thank you

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A KFH SUBSIDIARY إحدى شركات بيتك