Islamic finance

Calling the faithful

Western investors tap an emerging market in sharia-compliant products

It was one of the year’s big political flash points: the takeover of Britain’s P&O, an international ports operator, by DP World of Dubai caused a rumpus from Westminster to Washington, D.C. Politicians may have shunned the bid but investors did not—even though it was financed with a sukuk, a bond-like product compliant with the principles of sharia, or Islamic law. Demand was so strong that the initial $2.8 billion issue was raised to $3.5 billion, and ultimately drew $11.4 billion in subscriptions, about half of them from international investors.

No wonder investment bankers—who needed terms like riba (interest) translated only a year ago—no longer scratch their heads at the wonders of Islamic finance. Next week a new $2.5 billion sukuk offered by Nakheel, a big Dubai developer, closes. It will be the world’s second-largest such note—and could even surpass the one from DP World, Customs and Free Zone Corporation (PCFC), the parent of DP World. In the most recent such issue (an $800m sukuk from Abu Dhabi Investment Bank that closed on December 4th) nearly 40% of the investors came from Europe.

Islamic finance, long considered in the West as more of an oddity than an opportunity, is going mainstream. Standard & Poor’s, a rating agency, puts the market for Islamic financial products—banking, mortgages, equity funds, fixed income, insurance, project finance, private equity and even derivatives—at about $400 billion. It is estimated to have grown at some 15% annually in the past three years, and looks set to expand further as the petro-economies of the Gulf boom and Western investors become more comfortable with some of its cultural differences.

Once available only in mostly Muslim places like Malaysia and the Gulf (Bahrain was a pioneer), Islamic finance now appeals to some of the world’s biggest financial institutions seeking to tap into emerging markets. Investment banks, hedge funds and even pension-fund managers are getting keener. “This is a new, parallel financial system,” says Sameer Abdi of Ernst & Young, a consultancy. “It’s not something that can be ignored.”

No improprieties, no interest

To get the stamp of approval from Islamic scholars as sharia-compliant, a product should adhere to two principles: it must not pay interest, and wealth should not be generated from means considered improper: alcohol, gambling and tobacco, for example, are off-limits.

Although sharia-compliant products have been around for decades, there are several reasons why the market has taken off in the past few years. First is the sheer gush in parts of the Middle East where oil—and petrodollars—gush (see page 82). Rich Muslims have long parked much of their money abroad, and continue to do so. Mr Abdi says about one-third of investors in countries where there is a Muslim majority are seeking sharia-compliant products; another 50-60% will use them if they are “commercially competitive”.

At the company level, Middle Eastern institutions no longer rely exclusively on private financing (if they need to borrow at all). They are now shifting to public vehicles that offer access to international markets. As they become more conspicuous, such companies are seeking to comply with the Islamic traditions in their countries. So, for instance, Islamic finance has been used in big infrastructure projects.

Meanwhile, foreign investors want to diversify across countries and asset types. “As a global investor, you need exposure to this region of the world,” says Arul Kandasamy, head of Islamic banking at Barclays Capital, which helped arrange both the PCFC and Nakheel sukuk. In the Middle East more than 80% of fixed-income products are Islamic. Malaysia also has a big concentration: about 60% of the $40 billion global sukuk market is there.

Investors who used to hang back from these notes due to worries about the lack of liquidity—there is virtually no secondary market for most of them—are emboldened by the recent, bigger offerings. Mr Kandasamy says the average volume of trading in the PCFC sukuk has been $10m a day since its launch.

Finally, for foreign institutions raising funds, “this is another pool of money” to tap, says Matthew Sapte, a London-based lawyer working on Islamic-finance deals. “A number of European corporates are looking at this very closely.”

No wonder then that international banks are offering sharia-compliant products of their own. Some have long experience. Citibank, for instance, has offered Islamic products since the 1990s. ABN
Islamic finance is still just a sliver of the global financial market. And international investors still find aspects of it immature. For example, there is a dearth of credit ratings for Islamic products and institutions (which is also true of many conventional instruments in the Middle East).

If the industry is to avoid being "ghettoised", argues Ammar Ouesnine, an analyst at Standard & Poor's, it needs to shape up in several ways. First, it must become more standardised. Products considered sharia-compliant in relatively liberal Malaysia are off-limits in more conservative Saudi Arabia. Second, accounting standards and financial reporting must be better aligned. Third, he says, more innovation is needed, particularly in areas such as derivatives and structured finance. Fourth, there is a skills shortage, which is driving up salaries for anyone working in Islamic finance. Lastly, the industry needs to create new tools for assessing risk.

None of these challenges is insurmountable. This is an era of financial innovation where investors delight in exploring new areas of risk. Cultural barriers are there to be crossed.

**Buttonwood | Ageing bull**

**NEW YORK**

With few places left to turn, investors have pinned their hopes on the stockmarket

ROCKY is returning to American cinemas this Christmas. And the financial markets increasingly resemble Sylvester Stallone's ageing pugilist: they may get knocked about a bit, but they always seem to bounce back.

In recent weeks disappointing economic data have pointed to the possibility of an American recession in 2007. The dollar has weakened sharply, raising the spectre of the complete collapse that bears have been predicting for years. And on December 4th Pfizer, the pharmaceuticals giant, saw its share price plunge after yet another drug failed the testing process (see page 69).

But the stockmarket has rolled with the punches. And other asset classes have been similarly buoyant. The spreads (extra yields) on corporate bonds and emerging-market debt are low by historical standards; commercial-property valuations in America and Britain are high.

The general explanation for this bullishness is that the world is flush with liquidity. But liquidity is one of those catch-all phrases that is not as good as it sounds—a bit like saying "there are more buyers than sellers", which is itself a cliché of dubious merit (for every buyer who makes a trade, there must be a seller).

What does appear to be clear is that investors are happy to take on risk and eager to buy any asset that offers a higher yield than government bonds. And even those investors who do worry about the American recovery, or about political risks in the Middle East, have to think twice before they sell. The corporate sector is still increasing profits and churning out cash in the form of dividends and share buybacks. Every Monday seems to bring news of a mega-merger; on December 4th, it was the combination of Bank of New York and Mellon Financial (see page 79). Potential bid targets from the private-equity sector get larger and larger (the latest tittle-tattle is about Home Depot, worth over $100 billion if you throw in debt). Why sell your shares if someone might be willing to buy them tomorrow at a 20% premium?

As for the dollar, the reason to worry would be if a falling currency prompted foreign investors to demand higher yields on American Treasury bonds to compensate them for the risk. That might really push America into recession. But it is not happening so far; yields have been falling.

All this adds up to what Jim Cramer, the hyperactive pundit of American financial television, describes as "one of the best markets I've ever seen." Bulls are talking about double-digit stockmarket returns in 2007; thanks to a combination of stockmarket rerating (higher price-earnings multiple) and growing profits.

So what might spoil the party? One problem, as the producers of the Rocky series know only too well, is that sequels are subject to the laws of diminishing returns. Once bond spreads and property yields are low, there is no longer much scope for further capital gains.

That is why investors' hopes are pinned on the stockmarket in 2007; share valuations are only at historically average levels. But company profits are at a 40-year high as a share of American GDP. If profits were about to revert to the mean, share multiples should fall below average.

The bulls do not think that will happen soon. But whereas one more year of above-average profits growth is possible, three or four more are hard to imagine.

Clearly, the use of borrowed money to enhance returns (often referred to as the "carry trade") means that the markets are vulnerable to a change in sentiment. When the trend changes, as it did in May, there will be a mad rush for the exits. As Bill Gross of Pimco, a bond giant, writes: "I have a strong sense that the ability to lever any or all asset returns via increasing leverage is reaching a climax."

Timing, however, is notoriously difficult. Bears can point to low share volatilily, as measured by the Chicago Board Options Exchange's VIX gauge, as a sign of investor complacency. But it may merely be that investors have seen no need to incur the costs of insuring their portfolios against loss.

The markets will thus need some sort of shove to push them off today's course. Higher unemployment would be one possibility. It might turn the housing-market correction into a rout. If the nuclear dispute with Iran were to escalate so that, say, the straits of Hormuz were blocked and crude jumped to $100 a barrel, investor confidence would take a hit.

But predicting such events is more in the realms of astrology than financial punditry. Sceptical fund managers have been forced into a position of being "fully invested and scared as hell." The knock-out blow will undoubtedly come (probably in the credit markets). But just like the Rocky franchise, bull runs on financial markets have a habit of going on much longer than most people expect.