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Emerging Trends and Opportunities in the Islamic financial Industry

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ABSTRACT

This paper provides an overview of recent developments in the Islamic financial sector from the perspective of conventional finance. It also highlights new trends emerging in the Islamic financial industry and the resulting impact they have on broadening and deepening the Islamic financial market. HSBC Group's involvement in the Islamic financial industry over the years is reviewed, as is its historical involvement in providing correspondent banking services and the recent establishment of a dedicated Islamic banking and finance group within this multi-national institution. Three specific trends emerging across the Islamic financial industry are discussed: asset securitization, private equity, and banking services for Muslim communities in OECD countries. Also covered is the relevance of these emerging trends to the U.S. market.

I. INTRODUCTION

The Harvard Islamic Finance Information Program should be commended for its role in promoting understanding and cooperation in the Islamic financial sector, because in any market, shortfalls in reliable data can hinder expansion. And while there are far more important measures, one indication of the growing prominence of Islamic finance is the number of conferences now devoted to this $90 billion sector.

II. HSBC AND ISLAMIC FINANCE

What connects the HSBC Group to Islamic finance? The foundation lies in its deep-rooted network in the Muslim world. The HSBC Group, as one of the largest financial services organizations in the world, operates under well-established names in the Asia-Pacific region, the Middle East, Africa, Europe and the Americas, in a total of 79 countries and territories. In particular, the Group has a presence in 20 of the 52 Islamic Development Bank (IDB) member countries, including five of the six Gulf Cooperation Council (GCC) states, Egypt, Malaysia, Indonesia, Turkey, and Pakistan. In some of these countries, HSBC was among the first banks to be founded. Furthermore, critical to HSBC's success has been its respect for customers, host countries, and local customs.

Beside local accommodations, the HSBC Group's global involvement in Islamic finance initially centered on providing support to its participants though the provision of correspondent banking services and on confirming letters of credit for trade-related business. As the Islamic banking sector gained critical mass and as the Group saw a steady increase in demand for Islamically-compatible products and services from its own client base across a number of countries, it decided to form a dedicated business unit focusing on Islamic finance.

HSBC Global Islamic Finance (GIF) was launched in July 1998, under Iqbal Ahmad Khan, and is housed in the Merchant Banking division of HSBC Investment Bank in London. From there, it draws upon the local market expertise of HSBC staff in each region to offer the full spectrum of advisory, financing, and dealing services to its clients, at retail, private, corporate, and institutional levels.

One of HSBC's first initiatives was the establishment of an independent *sharīᶜa* advisory committee to ensure that the Group's entire Islamic financial activities comply with Islamic law. The *sharīᶜa* advisory committee is the sole reference point for the Group's Islamic efforts. It is comprised of three highly regarded and experienced scholars: Mohamed Ali Elgari of Saudi Arabia, Muhammad Taqi Usmani of Pakistan, and Nizam Yaquby of Bahrain.

The second major step was the establishment of the IDB Member Countries Strategy Forum. Headed by the chairman of the HSBC Investment Bank, this Forum brings together product heads and specialists alongside senior executives from the Group's major subsidiaries and affiliates in the Muslim world. It plays an important role in maximizing synergy and harmonizing Islamic financial activities across the Group's commercial banking franchises. HSBC's focused efforts in Islamic finance ought to have a beneficial impact. Not only do they increase

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the mainstream relevance and credibility of Islamic banking, they also expand the competitive space available for the sector.

III. Sectoral Growth

Since the inception of the IDB, followed by the formation of institutions such as the Dar Al-Maal Al-Islami Trust, Albaraka Investment & Development Company, Dubai Islamic Bank, and Kuwait Finance House in the 1970s, the gaining momentum, sophistication, and market share of the sector is admirable.

Bahrain, where the Group's presence dates back to 1944 (through the British Bank of the Middle East, now HSBC Bank Middle East), has emerged as the international center for the industry. Other advancements can be attributed to the Central Bank of Malaysia, which has actively promoted an interest-free banking system alongside its conventional counterpart for several years. Moreover, in Saudi Arabia, the most profitable bank, year-on-year over the last few years, has been Al Rajhi Banking and Investment Corporation.

We are now witnessing the establishment of Islamic asset management, insurance, and leasing companies. The creation of a number of Islamic investment funds, especially on the equities side, and the advent of Islamic investment indexes points to a broadening and deepening of the market. The emergence of more participants will continue to provide the competitive spur for ongoing innovation and development.

Noteworthy is the continuing leadership of the IDB and, particularly, its creation, in partnership with DMI, of a $1.5 billion infrastructure fund. This fund will go some way toward meeting the huge infrastructure financing requirements of IDB member countries and increasing the embedded capital of these countries.

Also, the work of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) deserves highlight. AAOIFI is spearheading efforts to unify accounting and auditing reporting standards and is setting up new fiduciary benchmarks for Islamic financial institutions.

Continued forward movement also depends on attention to the financial infrastructure, especially an Islamic interbank money market, and to reforms of the monetary, fiscal, and legal frameworks of Muslim countries. Concerted support from regulatory authorities within and multilateral collaboration across Muslim countries will be required to achieve an Islamic common market or an "Islamic dinar" that is more than a translation currency.

IV. Islamic Finance in the United States

Three specific trends in Islamic finance signal opportunities and potential in the U.S. market.

A. Asset Securitization and Secondary Markets

Securitization addresses some of the pressing issues currently faced by the Islamic banking industry, such as effective management of short-term liquidity and marketability of medium- to long-term assets. Islamic banks will be able to increase transaction maturities, contribute to a diversified pool of lease assets, and, through securitization, produce a readily tradable yet *sharīʿa*-compliant investment. A well-structured securitization product could also diversify financial risks across different sectors, improve asset/liability matching from the investor's perspective, reduce overall financing costs, and enhance return through cross-border tax benefits. In recent months, two Gulf-based Islamic financial institutions have already implemented such programs. We are likely to also see some securitizations in the Middle East, especially for infrastructure projects.

It is likely, however, that much of the early volume will originate in the United States. The largest leasing market in the world, the U.S. accounts for 40% of the global total and offers investors the broadest range of leased-asset classes and industries. In addition, the U.S. is favored as the dollar remains the currency most widely held by Islamic investors and the preferred vehicle for minimizing currency risks. And while it is the fastest growing market in the world for asset-backed securities, even in the U.S. securitized leases represent a nascent segment. Only in recent years have annual issues have ranged from $3 billion to $5 billion.

B. Private Equity

With the opening of equities as an asset-class, Islamic investors are becoming increasingly sophisticated in the management of their portfolios. The drive toward enhanced yields and the desire to manage their funds more efficiently has led Islamic investors to seek opportunities in private equity.

Although there is a steady increase in both private and retail banking appetite for private equity products, very few currently exist. This will change in the near future: at present, at least one major Islamic bank is beginning to carve out a niche. The HSBC Group earlier this year arranged for Crescent Capital, a subsidiary of First Islamic

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Investment Bank, the first conforming acquisition financing. The establishment of a new Islamic investment bank focusing on private equity also bodes well.

The U.S., again, as the largest economy in the world, offers Islamic investors the greatest opportunities in private equity. However, in time the Middle East will generate opportunities for investors, as large family-run businesses broaden the management base of businesses and look to local capital markets as a source of finance.

C. Banking for Muslim Communities in OECD Countries

Islamic banking and finance is spreading quickly in the Muslim world. However, Muslims in Europe and the U.S. have had few options. Until lately, their alternatives had been a handful of credit unions and the Amana Mutual Funds, managed by the Saturna Capital Corporation with the assistance of the North American Islamic Trust. To a large extent, these institutions have been dependent on non-Islamic financial institutions or stem from national Islamic organizations. In some ways, the situation has been reminiscent of the Muslim Pilgrims Saving Cooperation in the Far East or the experience of Egyptian savings banks in the 1960s.

Today, Islam has been identified as the fastest-growing major religion in the U.S., and the Muslim population in America is estimated at six to nine million. On average, it is younger, somewhat better educated, and has a higher median income than the total U.S. population. Moreover, in an increasingly global market, the U.S. cannot ignore one-fifth of the world's entire population and the largest religious group in 30 countries. Nor should American institutions ignore that the value-oriented system of Islamic banking appeals, as well, to those looking to invest in a socially responsible manner. Islamic banking in the U.S. is built around 3 themes: community banking, ethical investment, and affinity marketing.

In recent years, banks such as the United Bank of Kuwait have begun to offer Islamic financial products, starting with home-financing schemes. Multinational banks familiar with Islamic finance are beginning to take closer looks at the U.S. market. However, they face distribution difficulties (with the Muslim population generally scattered across the country); potentially significant revamping of legacy computer systems; and hurdles in complying with secular authorities. It is, no doubt, only a matter of time before a number of these institutions, and perhaps other banks from the Muslim world, begin to offer Islamically-compatible products in the United States.

V. Conclusion

The HSBC Group sees tremendous opportunities and challenges in Islamic finance. Several developments will contribute to vigorous and sustained growth of this industry: the maturing of fledgling institutions; the regular entry of additional participants into the marketplace of Islamic finance; the need for more asset diversification and management competence; increasingly complex techniques and structures; and expansion into new markets. The HSBC Group, with its presence throughout the Muslim world and commitment to Islamic finance, is keen to promote the sector's evolution and development.

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