The Future of ISLAMIC FINANCE

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Wider spread: strong expansion is expected as more and more countries, from Turkey to Nigeria to China, offer Islamic bonds and financial services Dreamstime

Growth survives the storms

Safe investments and sizeable potential markets continue to buoy the sector, reports **David Oakley**

Islamic finance has weathered the storm. One of the world's fastest growing asset classes before the financial crisis hit in August 2007 continues to expand, albeit at a slower pace.

The Dubai debt standstill that rocked the industry a year ago looks more like a tremor than the cataclysm that was feared at the time, and the internal wrangles over the definition of what is religiously compliant appear to be resolved.

Islamic finance banking assets have risen by 8.9 per cent this year, valuing the industry at $895bn, according to the latest figures from The Banker and Maris Strategies. Since 2006, the industry has more than doubled in size, as more individuals and institutions have sought to save or invest in an Islamic, or sharia-compliant, way. This means avoiding earning money through interest, known as *riba*, which is seen as sinful under Islamic law as the creation of money from money itself is considered immoral.

Financial Markets series

Nick Edmondes, joint head of Islamic finance at law firm Trowers & Hamlins, says: "Islamic finance has withstood the financial shocks relatively well, as it is not exposed to the toxic mortgage-related assets and derivatives that have hit the conventional financial sector."

Razi Fakih, deputy chief executive of HSBC Amanah, the Islamic finance arm of HSBC, adds: "The financial crisis didn't have a direct impact on the Islamic industry, partly because the Islamic financial institutions were based in emerging markets, which weren't significantly impacted."

However, there have been casualties this year, as the fall-out from the financial crisis and the Dubai debt standstill took its toll.

Some Islamic banks faced large losses because of their exposure to ailing property markets. The

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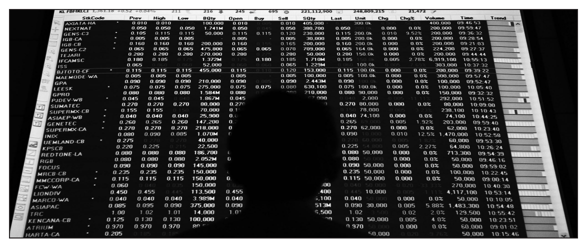

On FT.com

Sharia-compliance remains top goal
HEDGE FUNDS The Dubai debt crisis last year may well have made the medium-term prospects for a vibrant sharia hedge fund industry somewhat better

Range grows in wake of crisis
PRODUCTS Property investment remains a favourite, but Islamic bonds have started to regain the momentum they saw before the financial crisis

Market poised for expansion
GUEST COLUMN **Joseph DiVanna** of Cambridge-based adviser Maris Strategies explains why banks and financial services providers are increasingly optimistic

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A region abounding with potential

North Africa

Egypt leads among nations seen as ripe for expansion, writes **Robin Wigglesworth**

Tall but not wide: Faisal Islamic Bank has just 24 branches across Egypt
Alamy Images

The headquarters building of Faisal Islamic Bank is one of the more imposing towers in Cairo, capital of Egypt. Severe, angular and decorated with Koranic verses, it looms over its neighbourhood.

Yet in spite of the impressiveness of the headquarters of the country's largest Islamic bank, the sharia-compliant financial sector remains a backwater in the poor, populous and fast-growing country.

Egypt's Islamic financial institutions hold about 3-4 per cent of the country's total banking assets, says a report by McKinsey, the consultancy.

Many observers say Faisal Islamic Bank represents the unrealised potential of the sector in Egypt. The sharia-compliant bank was incorporated in 1977 but has only 24 branches.

Kuwait Finance House was founded the same year, but has more than 50 branches just in its domestic market – an admittedly richer but far smaller country than Egypt.

"Islamic banking hasn't really developed in Egypt, at least considering [the banks'] potential," says Radwa El-Swaify, an analyst at Beltone Financial, an Egyptian investment bank. "They haven't worked very hard, they have relatively few products and carry lots of non-performing loans."

On paper, Islamic banking should be a perfect fit for Egypt. Modern Islamic banking was arguably founded in Mit Ghamr, a village on the outskirts of Cairo, in the early 1960s. Egypt's 86m inhabitants remain severely underbanked: only about 10 per cent have bank accounts. Apart from a Coptic Christian minority, the country is overwhelmingly Muslim.

The failure of Islamic finance to establish itself in Egypt is partially due to the whiff of scandal that still hangs over the sector. In the 1980s, a number of small Islamic financial institutions collapsed, wiping out the savings of many Egyptians.

While experts say most were little more than speculative financial ventures with dubious religious credentials, their failures tarnished the industry's reputation in Egypt, according to analysts.

Moreover, the religious imperative to avoid interest, or *riba*, is not as strong in Egypt as it is in the more conservative Arab Gulf.

Following the Islamic banking scandals of the 1980s, Egypt's leading cleric, Sheikh Mohammed Sayed Tantawi, the Grand Imam of Al Azhar Mosque and University – which has been a leading centre of Islamic studies for centuries – issued a fatwa indicating that simple bank interest would be permitted as long as it was not excessive.

Even the more devout, poorer segments of society took note. Omar Elhitamy, the managing director of Orascom Housing Communities, a social housing development company, says that "not one" of the company's largely low-income housing customers raised religious concerns over conventional interest-bearing mortgages.

"Al Azhar is the religious reference point for most Egyptians, and it has said that conventional banking can be okay, so customers don't feel they will go to hell if they use it," says an Egyptian financier.

Politics is also an impediment. The Muslim Brotherhood is the main political opposition to Hosni Mubarak's largely secular government, and the authorities have as a result been unenthusiastic about backing Islamic finance.

"You often need to tweak laws and regulations to enable Islamic finance," says Sameer Abdi, head of Ernst & Young's Islamic financial services group in the Middle East and North Africa. "The Egyptian government and regulators would need to make a conscious decision to do this."

Elsewhere in Muslim North Africa, the industry is not doing much better. There are fully fledged Islamic banks in Algeria and Tunisia, and Islamic "windows" at conventional banks in Morocco and Algeria.

But overall, the Islamic share of banking assets remains less than 1 per cent, according to the McKinsey report.

Yet experts and industry executives agree that Islamic finance has plenty of potential across the region, particularly in Egypt.

Al Baraka Banking Group, a Bahrain-based, Saudi-backed regional Islamic bank, and Abu Dhabi Islamic Bank both own large stakes in sharia-compliant lenders in Egypt, and plan to expand their operations.

There has also been progress on the capital markets side.

Khaled Serry Seyam, the chairman of the Egyptian stock exchange, says that the bourse is working with the Egyptian Financial Supervisory Authority on regulations that will enable the sale of sukuk, or Islamic bonds.

Faisal Islamic Bank is perhaps a sign of a shift in the fortunes of Islamic banking in Egypt.

The sharia-compliant lender reported that net profits rose 45 per cent to E£123.8m ($21.4m) on revenues of E£1.8bn last year, according to the most recent English-language financial report available.

Five branches are scheduled to open this year.

Growth survives the storms

Continued from Page 1

banks facing the biggest problems tended to be based in the Middle East rather than Asia, which had learnt its lessons from the crises of the 1990s and has more robust local capital markets.

In the Middle East, Gulf Finance House, formerly one of the strongest institutions in the region, faced problems on some of its debt. Investment Dar, which was seen as a success story before the financial crisis, also had issues on some of its loans.

Malaysia, one of the big markets for Islamic finance, has run into some troubles, as global headwinds stalled growth of the sukuk, or Islamic bond, market, one of the most high-profile and successful asset classes in recent years.

Generally, problems over the standardisation of products and liquidity management, where difficulties in raising money mean investment projects can suffer, continue to hold back the sector.

Regulators and bankers are attempting to address these issues. In Kuala Lumpur, an International Islamic Liquidity Management Corporation has been established. This will issue short-dated debt that can be used by banks and other companies to manage liquidity in a sharia-compliant way.

In the Middle East, the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are promoting increased standardisation and harmonisation of sharia products to improve the industry's credibility and make it more appealing for investors.

In spite of the problems, many analysts insist the potential for further growth is great, as only a small percentage of Muslims, estimated at about 12 per cent of the 1.6bn globally, use Islamic finance.

And it is not just in the Islamic world where bankers see possibilities for expanding the product.

In Europe, particularly London, the industry is growing strongly, with non-Muslim investors seeing this type of finance as a sensible way to diversify as it offers a distinct product that appears more resilient amid the uncertainty in the western markets, especially in the eurozone. Some fund managers consider the weaker peripheral economies too risky to invest in.

Islamic banks and institutions have grown without taking on to their books toxic assets, such as mortgage-related debt or complicated derivative products. They are not highly indebted, like many western banks, making Islamic-compliant products relatively safe investments.

There are particular opportunities for Islamic finance to grow in retail banking and the provision of financial services to small businesses. On this front, banks such as CIMB Islamic have expanded business in Asia, while ABSA Islamic Banking has extended its business in Africa. Citi Islamic Investment Bank is expanding in South America, Asia and Africa.

In Europe, London is seeking to consolidate its position as the gateway to Islamic finance in the western world. The UK first corporate sukuk was launched

> Nigeria and Senegal are set to issue their first Islamic bonds next year

in the middle of the year and Islamic banking continues to grow in the country. Investors remain hopeful the UK will issue the first sovereign western sukuk.

The French government announced new initiatives in July to facilitate the introduction of Islamic products, while Turkey produced the first sukuk offering from one of its leading banks.

In other parts of the world, China has approved Bank of Ningxia to offer Islamic financial services, India is considering introducing Islamic banking practices, while Australia is reviewing taxation treatment of Islamic finance, banking and insurance products.

In the Gulf, the population over the next decade is expected to soar by 30 per cent to more than 50m, increasing demand for products, says HSBC Amanah.

The use of Islamic windows by conventional banks in north Africa highlights another potential area of growth because of the continent's large Muslim population, many of whom do not use banks of any kind.

Nigeria and Senegal are set to issue their first Islamic bonds next year and in Kenya, the central bank has licensed two Islamic banks.

Oliver Wyman, the consultancy, expects Africa to double its income from this kind of finance by 2012.

Islamic finance has grown rapidly in a short time – it only properly took off after Malaysia issued the first sovereign sukuk in 2002. For this reason, the optimists are confident it will continue to grow strongly.

The sceptics, on the other hand, stress the limitations that strict religious rules place on product development.

They say the market is unlikely to see a meaningful expansion in some of the more sophisticated derivative products, which are commonplace in conventional finance.

For example, many Islamic scholars and investors see the much touted possibilities of developing a hedge fund sector appear at best debatable. Many see the term Islamic hedge fund as a contradiction that even the cleverest lawyers and financial engineers will struggle to overcome.

The limitations that religious boundaries place on a financial product explain why the industry represents only 1.5 per cent of the world's global financial assets.

This small percentage means there is vast scope for growth – but even the industry's biggest fans admit it will always remain a niche product.

Taking note: just M$18.9bn worth of Islamic bonds were issued in the first three quarters of this year Dreamstime

Malaysia seeks end to slide in issuance

Asia

Tax breaks and other initiatives are aimed at bolstering the sector's leading market, reports **Kevin Brown**

Malaysia's Islamic finance market is back in recovery mode this year. A slide in sukuk issuance has injected an air of urgency to reforms aimed at restoring confidence in the wake of the global financial crisis.

The value of Islamic bonds issued in Malaysia was just M$18.9bn ($6bn) for the first three quarters of this year, compared with M$32.3bn for the whole of last year and M$20.8bn in 2008, according to the Malaysian Securities Commission.

The unexpected slowdown comes as Malaysia, which dominates the sukuk market with more than 60 per cent of global outstanding stock, takes steps to protect its position as a leading centre for the US$1,000bn Islamic finance sector.

Najib Razak, the prime minister, announced in October that extra tax breaks would be available next year to promote innovation in Islamic financial products, and the government issued a US$1.25bn sukuk in May – its first in eight years – to help bolster the local market.

Separately, Bursa Malaysia, the Kuala Lumpur exchange, will soon allow issuers to sell sukuk that can be marketed direct to retail investors, and Bank Negara Malaysia, the central bank, is preparing to issue licences to two new banks to increase the capital base of the sector.

Zeti Akhtar Aziz, governor of Bank Negara, told the Financial Times in October that Malaysia's experience demonstrated the potential for Islamic finance to grow globally among non-Muslims – who now account for more than half of customers at some Malaysian institutions.

"So long as we maintain products that are competitive, I believe [Islamic finance] will continue to grow at a very fast rate," she said.

Other officials have taken a similar line. Zarinah Anwar, chairman of the securities council, told an Islamic capital markets forum in Kuala Lumpur that Malaysia's "unparalleled" range of sukuk instruments gave the market a significant advantage over conventional traded debt.

> 'Having different schools of sharia thought is absolutely fine – it stimulates discussion'

"No one would have imagined the growth we have achieved in the past 10 years," she said, noting sukuk tend to be more transparent than conventional alternatives, adding to their attractiveness in the wake of the crisis.

Yves Mersch, a member of the governing council of the European Central Bank, said in Frankfurt in November that Islamic banks' lack of exposure to opaque assets and their reliance on deposits rather than wholesale funding helped make them generally robust. But he said problems with standardisation and limited liquidity management options for banks must be tackled to increase long-term stability.

The liquidity issue is being dealt with through the establishment in Kuala Lumpur of an International Islamic Liquidity Management Corporation, set up by the multinational Islamic Financial Services Board in October with strong support from the Malaysian authorities.

The IILMC will issue short-dated debt that can be used to manage liquidity. Some banks are also using a sharia-compliant commodities exchange on Bursa Malaysia, set up last year.

Experts disagree on the dangers of the lack of standardisation in products, which flows from differences in interpretations of sharia law by the four main Islamic schools, and the limited availability of scholars who can rule on product acceptability.

Daud Vicary, global leader of the Islamic finance team at Deloitte, said at a Global Islamic Finance Forum in Kuala Lumpur in October that the sector needed a clearer process for decision-making but "having different schools of sharia thought is absolutely fine – it stimulates discussion".

Nik Norzul Thani, chairman of Zaid Ibrahim & Co, Malaysia's largest law firm, says Islamic financial schools have achieved a harmonised view on 90 per cent of issues. But he says the increasing sophistication of Islamic financial products in Malaysia make it essential for scholars and bankers to communicate effectively: "The days when sharia advisers never went to a bank and bankers never read the Koran have gone."

Shadow of $26bn upset starts to fade

United Arab Emirates

Borrowers are back after Dubai World's successful restructuring, says **Anousha Sakoui**

It has been a year since Dubai shocked financial markets with a request from the state-owned conglomerate Dubai World for a standstill agreement with creditors over claims of about $26bn.

The market turmoil that ensued cut would-be borrowers off from the capital markets. There was no debt capital market issuance from UAE-based borrowers between November 2009 and March 2010, according to Dealogic, the data provider.

But by early this year, Dubai World's restructuring talks with creditors had made significant headway, allowing borrowers to return to capital markets.

Dubai Electricity and Water Authority (Dewa) was the first to test investor appetite. In April, the state-owned utility sold $1bn of five-year bonds, yielding 8.5 per cent, attracting more than $11bn worth of orders. Dewa was able to price the deal at a lower interest rate than initially expected.

Meanwhile, by September all but one of Dubai World's creditors had approved the plans.

"Since the beginning of September, when it looked like the restructuring would be signed, we suddenly saw a wave of issuers planning to access the market," says Farmida Bi, partner at law firm Norton Rose, "mostly well-established borrowers with a good base of underlying assets."

The positive sentiment created by the Dubai World resolution has had other effects. The Gulf emirate raised $1.25bn through a conventional sovereign bond issue that was oversubscribed.

In October, Dubai World succeeded in securing 100 per cent support for its restructuring after the only creditor that had not agreed to the plan was bought out of its position, according to people familiar with the situation.

"The fact that the [Dubai World] restructuring has been successfully agreed is a positive for the market," says Ms Bi. "It has provided an impetus for new deals to be done. It is not defaults that pose a potential problem for the market as a whole, but how they are seen to be dealt with."

By reaching full agreement, Dubai World was able to avoid the more costly and time-consuming route of pushing the plan through the special tribunal set up by Dubai to increase transparency.

The new bankruptcy framework was broadly welcomed as a regime based on "internationally accepted standards for transparency and creditor protection", as the government described it.

However, observers say it is too early to say whether the restructuring has set precedents.

"Bankruptcy laws in Dubai still remain relatively untested and hence there aren't any substantive precedents that bondholders can look to in terms of creditor protection," says Chavan Bhogaita, head of research at the financial markets division of National Bank of Abu Dhabi.

Investor sentiment has recovered far enough to allow the Dubai government to start talks to raise up to $1.5bn through a multi-currency Islamic bond issue in Malaysia. It is Dubai's first attempt to tap Islamic investors since October 2009, when it sold nearly $2bn worth of sukuk – bonds issued in accordance with Islamic religious principles.

"We are seeing straightforward sukuks and more structured deals, including securitisations with a true sale of assets," says Ms Bi. "Investors are scrutinising the underlying assets of businesses and not just the creditworthiness of borrowers. Many companies are now looking to set up programmes that give them a lot of flexibility."

Mr Bhogaita says investor sentiment towards the Dubai debt story has changed substantially over the past nine months, allowing high-quality Dubai borrowers to access the debt capital markets once again. However he warns: "We have to be careful in extrapolating from the Dubai World case, as much of the debt concerned wasn't Islamic debt, and the main Islamic instrument that was involved – the Nakheel December 2009 sukuk – was repaid on time and in full without any restructuring or delay."

> 'It is not defaults that pose a potential problem for the market but how they are seen to be dealt with'
>
> **Farmida Bi**
> **Norton Rose**

Islamic bond issuance has yet to recover to pre-crisis levels, though. So far this year there has been just $13bn issued – down from the $17.5bn issued last year.

Debt capital markets issuance from the UAE more generally is also down. According to Dealogic, just $10.7bn has been sold this year – half the $21bn last year.

Ms Bi says there has been some nervousness in the wake of the Irish debt crisis, but "in the absence of any other major crises, there is a positive feeling about next year. The markets probably won't grow as quickly as in the boom years of 2006 to 2008. But that is not a bad thing."

Nascent sector looks for new model

Investment banks

Crisis-savaged organisations need to diversify, says **Robin Wigglesworth**

Looking into the future: the full-scale Islamic banking example of CIMB may be an example for others Bloomberg

Islamic investment banks and companies mushroomed across the Middle East in the years preceding the financial crisis, buoyed by increasing religious sensibilities and the flow of billions of petrodollars into the region.

Companies such as The Investment Dar in Kuwait and Bahrain's Arcapita and Gulf Finance House were among the most profitable institutions in the region and broadened the Islamic finance industry's geographical footprint and sophistication.

But while most Islamic commercial banks have fared relatively well, the financial crisis caused billions of dollars of losses and exposed severe problems in the business models of many Islamic investment banks.

Moody's said in a recent report on the sector: "The speed at which the [sharia-compliant investment banking] model failed was alarming: the most innovative and in-demand concept since the birth of modern Islamic finance around 40 years ago was wiped out in just a few months.

"Despite being a very profitable and robust concept, the . . . model did not survive its first wave of negative economic cyclicality," the rating agency said.

The ingredients of the crises were the same at most institutions: mismatches between short-term debt and long-term investments, sector concentration, poor risk management, and a reliance on bulky but volatile mark-to-market investment revenue, rather than diversified, fee-based income streams.

Gulf Finance House, once one of the most prominent Islamic investment companies, went through a selective default on some of its debts after tough negotiations with creditors.

The Investment Dar, which owns part of UK carmaker Aston Martin, has also defaulted and is still locked in protracted talks with its lenders over a repayment plan.

Other Islamic investment companies, including Arcapita and Unicorn Investment Bank, have fared somewhat better, but their liquidity, financial performance and capital base have come under "tremendous pressure", according to Moody's.

This has led many bankers and analysts to call for a rethink of how Islamic investment companies operate. "Islamic investment companies have to take a step back and look at what works and what does not in the 'new normal'," says a senior Bahrain-based banker. "Catering to regional demand for sharia-compliant investments is clearly a sustainable business model, but how to do that will have to fundamentally change."

Atif Abdulmalik, chief executive of Arcapita, one of the oldest Islamic investment banks, concedes that the industry has lessons to learn. But he says the "engine needs fine-tuning, not a complete overhaul. The industry deserves much credit. It's been through an extremely testing situation and, despite its youth, it has done relatively well."

Other bankers say more extensive surgery is needed. Many Islamic investment banks in the Middle East are in reality little more than speculative real estate investors or private equity funds, financed by Islamic debt obtained from international and regional commercial banks, they say.

> 'The industry deserves much credit. Despite its youth, it has done relatively well'

After the sector's problems over the past two years, these banks will be much less willing to extend financing to Islamic investment companies, says the head of Islamic finance at a large international bank.

The future may lie instead with the more full-scale Islamic investment banking model followed by CIMB Islamic in Malaysia, and the investment banking arms of the large Saudi Islamic banks.

These entities largely eschew the proprietary investments and bulky asset management of most Islamic investment companies and resemble more closely the western concept of a full-service investment bank – but backed by a stronger retail bank.

"Thanks to the liquidity made available alongside the parent's safer funding mix, these investment banking subsidiaries/business lines can more easily weather unexpected ruptures in the economic cycle," Moody's noted.

This trend appears to be gathering momentum. Qatar Islamic Bank and Boubyan Bank in Kuwait have recently followed Saudi banks in setting up separate investment banking subsidiaries.

Al Rajhi Capital, for example, is the investment banking subsidiary of Al Rajhi Bank, one of the world's largest Islamic retail banks, and offers brokerage, asset management, advisory, research, capital markets and underwriting services.

"Having Al Rajhi Bank as our parent company matters, of course," says Gaurav Shah, chief executive officer of Al Rajhi Capital. "It makes us a strong, quality counterparty."

The future for some of the investment banks and companies that dominated headlines in the pre-crisis years is more uncertain, says Mohammed Abdulmalik, chief executive of Capivest, a Bahrain-based Islamic investment bank.

"A number are slowly crawling their way out of the mess, and have learnt some lessons, but I think the jury is still out on what the future looks like for some of them," he says.

"What is clear is that, whatever model emerges from the crisis, it will have to have more than the one line of business."

London and Paris battle for business

Europe

The City looks unlikely to be ousted from its position of strength, writes **David Oakley**

London calling: the UK capital has a wide range of Islamic banking expertise Alamy Images

The French like nothing better than to outshine the English.

Although the ideal platform for this is usually the rugby field, the French see an opportunity to challenge their counterparts on the other side of the English Channel by developing Paris as a centre for Islamic finance in Europe.

France, which has a Muslim population of 3.5m – twice that of the UK – is looking into legislation to allow the issuance of sukuk, or Islamic bonds, and would like to see more Islamic financial products developed in Paris.

Paris has made progress in the past two years – but in recent months the challenges of overtaking London have become clearer, as Muslim investors have increasingly shown a reluctance to switch their investments to the other side of the Channel.

Farmida Bi, a partner at Norton Rose, one of the leading law firms in the Islamic finance sector, says: "The headscarf issue [in France, headscarves are banned from public places such as schools and workplaces] is emotive. That has discouraged some Muslim investors from Paris."

The scale of the challenges in developing the infrastructure in terms of financial and legal expertise has also become more apparent, as London is a much bigger and more sophisticated financial centre, offering an ideal gateway to the rest of Europe.

London has five Islamic banks, while most of the conventional global banks in the City have Islamic sections that offer expertise on structuring financial derivatives, underwriting sukuk, and developing trade finance.

They also can offer the know-how for drawing up property deals and buying equity, which is extremely popular with Islamic investors.

London had a significant advantage, too, as it started introducing legislation much earlier than Paris. Since 2003, a number of finance acts have passed through parliament to help Islamic finance develop.

This addressed a variety of tax and regulatory barriers, such as making changes on stamp duty for the buying of property and the ironing out of tax problems in connection with the issuance of sukuk.

Jervis Rhodes, head of corporate banking at the Bank of Middle East and London, says: "You cannot compare any other European centre to London. It is where all the expertise is. It is ahead in terms of legislation and many Muslim investors want to buy property in London."

Certainly, the UK market continues to see strong demand for property.

Deals in Britain include the purchase of the UK headquarters of Procter & Gamble from Prupim, the property investment arm of Prudential, for a syndicate of Gulf investors, the purchase of BT's regional headquarters in Leeds from LaSalle Investment Management and the purchase of InterContinental Hotel Group's global headquarters in Uxbridge for a group of Gulf investors.

In other areas of finance, such as sukuk, there have also been encouraging developments, with International Innovative Technologies, a technology company based in the north-east of England, issuing the first UK corporate sukuk in the summer.

Bankers and lawyers hope this might be the first of many other corporate sukuk deals in the UK.

There are also hopes that the UK government will revive plans to issue a sovereign Islamic bond, which would make Britain the first western country to do so.

Plans for this were announced with much fanfare before the financial crisis, but were put on hold because fears that such a bond might be difficult to price because of the uncertainty over the health of the global economy.

"We have not seen much progress of late on this," says Ms Bi. "But at some point, we are hopeful the government will again look at plans to issue a sovereign sukuk. It makes sense and would give London even more profile than it has today."

Elsewhere in Europe, Turkey is also seeing growth in Islamic finance.

Given that 99 per cent of its 70m-plus population is Muslim, the expansion of Islamic finance seems almost inevitable, particularly now that companies are allowed to issue debt in accordance with sharia-based rules. This prompted the issuance of the country's first corporate sukuk in the summer from Kuveyt Turk Katilim Bankasi, one of the country's leading banks.

For some investors, Germany, too, could prove a fertile market for the asset class because of the size of its Muslim population, which is more than 4m.

However, there is little evidence to suggest that London can be knocked off its perch as the capital of Islamic finance in Europe and the western world.

As Mr Rhodes says: "London is now the hub of Islamic finance in Europe and the main centre outside the Muslim world. "It is difficult to see any other centre challenging the City."

Bankers in Paris will continue to push for legal and financial reforms to enable the growth of the sector there, but for now – and in this regard – the French must accept the superiority of the English.

Presence and role of market remain marginal

US

Activity has been subdued since the Nakheel crisis, says **Aline van Duyn**

A year ago General Electric's financing arm made the headlines: it became the first western industrial company to issue a sukuk, or Islamic bond.

The ability of GE Capital to raise $500m to finance the leasing of aircraft – a deal which took more than a year to structure – was expected to open the door to other fundraisings by US companies, tapping into the large group of investors seeking financial instruments that comply with Islamic investment principles.

But soon after that the crisis at Nakheel, the property arm of state-owned Dubai World, and the suspension of payments on the property developer's bonds changed the mood of the market drastically. Not only did it raise questions about how sukuk should be structured – and how investors would fare during a restructuring of debt – but it also reduced the trade flows and demand for new financings.

As 2010 draws to a close, there have not been any deals by US companies after the GE Capital transaction in late 2009.

"Investors in the Gulf have been licking their wounds, and there has not been much activity," says Lewis Cohen, partner at Clifford Chance in New York, which worked on the GE Capital transaction.

The presence and role of the Islamic finance market in the US remains small and marginal compared with other western countries.

The number of Muslims in the US is estimated at anywhere from 2.5m, by the Pew Research Center in 2009, to 7m, by the Council on American-Islamic Relations. The uncertainty reflects the fact that religious orientation is not a question that is included in the census. Whatever the number, it is still small as a proportion of the US population of 310m.

Islamic financing activity in the US has been focused more on institutional investments than on creating financial and investment products for individuals. Before the financial crisis, for example, there were emerging-market funds or other investors in the US that would buy sukuk issues by banks or companies in Malaysia or Gulf countries as a way to gain exposure to those credits.

'Investors in the Gulf have been licking their wounds'
Lewis Cohen

In spite of a year of little activity, it is expected that 2011 will see some US companies following GE Capital – which has itself said it plans to follow up the original transaction with another. No specific date has been set, however.

The record low interest rates available in corporate bond markets in the US – and strong investor appetite for debt sold by blue-chip companies – also means there is little urgency for companies to diversify their funding sources.

According to bankers, discussions have started about trying to raise sukuk capital in 2011. However, the deals would probably take some time to come to the market, even once discussions pick up.

"Gulf investors are looking to diversify again," says Mr Cohen. "There are still some US companies interested in diversifying their funding sources, but in general sukuk funding is more expensive than regular bond markets and the deals have higher transaction costs.

"Over time, for some companies, it is worth developing a relationship with investors wanting to buy sukuk."