ISLAMIC FINANCE

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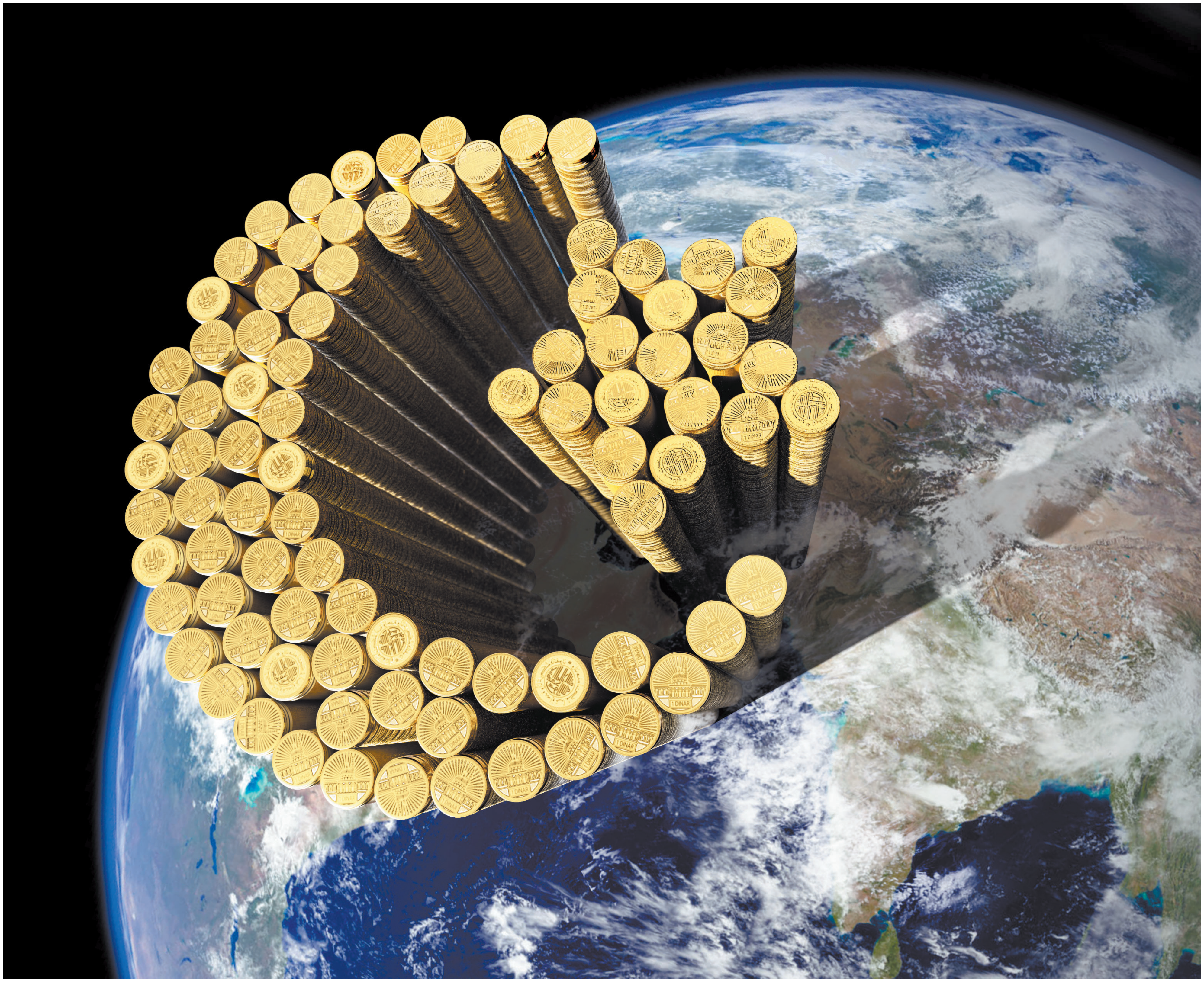

Sector shrugs off global gloom

Not surprisingly, the strongest growth has come from south-east Asia, says **David Oakley**

Islamic finance has passed a significant landmark. Despite turbulence in Europe and rising fears of a global downturn, sharia-compliant assets have surged past the $1,000bn mark, recording another year of double-digit growth, according to research by The Banker magazine and Maris Strategies, the research and advisory group.

It is an impressive feat, given the turmoil not just in Europe but in the Middle East and Africa, which is the main region for Islamic finance, along with south-east Asia, especially Malaysia. This big centre has not been affected by turbulence either in the west or at home.

Financial Markets series

Nicholas Edmondes, joint head of Islamic finance at Trowers and Hamlyns, the law firm, says: "Islamic finance is going great guns in East Asia, because the economies there are doing well. But it is doing well in the Middle East too. It is becoming more embedded there."

Tunisia, Egypt and Libya have had regime changes, while Bahrain, one of the main centres of Islamic finance, has seen disturbances and protests against the ruling family.

Some strategists say that worries about the stability of the island kingdom is driving business away, although, so far, western banks remain based there and Islamic finance products are still in demand.

The global financial crisis has had a big impact on the Middle East, particularly in the United Arab Emirates and Kuwait, where highly leveraged groups, such as Islamic investment companies and banks, have been hit.

A weak property sector has taken its toll, either because of property and loans on the books of Islamic banks and other institutions or because they use property for collateral.

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Sector shrugs off the gloom

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Changing hands: vast numbers of unbanked Muslims are expected to boost sector Dreamstime

In Malaysia, however, the reverse is true. This year's vast growth in the issuance of local-currency sukuk, or sharia-compliant bonds, emphasises the country's importance. The health of the sukuk market underlines the rising interest in Islamic finance, as the demand for sharia-compliant products spreads around the Asia-Pacific region.

Overall, Islamic finance, which allows Muslims to invest in a way that complies with strict religious laws that ban such things as paying interest and taking risks through speculation, is a relatively new financial product, at least in its current form.

The modern use of Islamic finance dates back to the 1960s, when some wealthy Muslim investors felt they needed a way to protect or enhance their wealth without breaking Koranic rules.

It was only in 2002 that the first modern sukuk was launched, highlighting how fast Islamic bond issuance and the broader market have grown in a short space of time.

In 2011, Islamic finance assets expanded to $1,086bn, a 21.4 per cent increase on the previous year, maintaining a double-digit annual growth rate since The Banker launched its survey of Islamic financial institutions in 2007, when the global credit crisis first emerged.

Just under three-quarters, or 72 per cent, of institutions reported growth in assets, while 25 per cent recorded a decline, says The Banker. Similarly, the vast majority – 80 per cent – showed positive pretax profit growth.

Certainly, the Dubai debt standstill of 2009, which raised the spectre of defaults across the Middle East and saw many institutions rethinking their use of Islamic finance as an alternative to conventional fundraising, has been consigned to a footnote for many investors and strategists, and is no longer seen to be damaging sentiment.

This is because banks and companies in the Middle East and Africa have generally not been as highly leveraged as those in the western world. They had, in many instances, raised rather than lowered capital ratios ahead of the 2007 credit shocks.

Other reasons for the sector's resilience include growing interest in alternative markets, in both the Muslim and non-Muslim world.

China is increasingly looking at Islamic finance as a different way to invest. With more than 80m Muslim residents, the country has awarded its first Islamic banking licence and a number of big conventional banks are reported to be considering how they can create Islamic-compliant products.

In September, Khazanah Nasional, Malaysia's sovereign wealth fund, launched the world's first Chinese-currency Islamic bond. The renminbi sukuk was heavily subscribed by a variety of investors from Singapore, Hong Kong and Europe.

In Indonesia, positive developments include the resolution of tax problems and the reform of the approval process for Islamic banking products. Australia is also looking at legal reforms to encourage sukuk issuance, while Singapore has changed laws to create a market in Islamic property investment trusts.

Many strategists say more growth is inevitable in this market, because vast numbers of Muslims do not use conventional banks. They are the potential customers that strategists are convinced will give the sector the next big boost.

Figures from the Statistical, Economic and Social Research and Training Centre for Islamic Countries (Sesric) show that while Islamic products represent about 1 per cent of the global financial system, Muslim countries account for about 7.6 per cent of the world's nominal gross

> Vast numbers of Muslims do not use banks. They are the potential customers that will give the sector a big boost

domestic product. Growth among the 57 Muslim nations is also much higher than in the rest of the world, Sesric adds, underlining the potential.

As these nations become more sophisticated, more of their citizens are bound to start using banks and financial institutions, with many likely to want to do so in line with their religion, say strategists.

However, the one region that has proved disappointing for some is the UK, the main centre for Islamic finance in the non-Muslim world. Since the British government decided not to issue a sovereign sukuk, there is a sense the market has lost its momentum.

Another area that needs to see progress is standardisation in areas such as accounting and regulation.

However, Khairul Nizam, deputy secretary-general of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), says: "We are making progress in this area, both on accounting, regulation and financial reporting. I think the market has made great strides."

Progress on harmonisation is considered by many as the key to the further evolution of the market. It will not be easy to create more standardisation and transparency in an industry that relies on its diversity.

Scholars, by their nature, will disagree, and what is deemed Islamic-compliant in Malaysia may not be accepted in the Middle East.

Yet, if groups such as the AAOIFI can bring about more clarity to products, then Islamic finance can grow further and, one day, reach its full potential.

Uprisings should provide a fillip

North Africa

Ascendant Islamists are enthusiastic backers, reports **Robin Wigglesworth**

Counting in Cairo: the religious imperative to avoid interest, or *riba,* is lower in Egypt than in more conservative Arab states Reuters

Modern Islamic banking was arguably founded in Egypt more than 40 years ago, and while north Africa is home to more Muslims than anywhere except Indonesia, the region has remained an industry backwater for years.

There are fully fledged Islamic banks in Algeria, Egypt and Tunisia, and Islamic "windows" at conventional banks in Morocco and Algeria. But overall, the Islamic share of banking assets in north Africa is less than 1 per cent, according to McKinsey, the management consultancy.

However, the winds of change sweeping across the Arab world have toppled the rulers of several north African countries – Tunisia, Libya and Egypt – and could bode well for the development of Islamic finance. Islamists look set to gain power in all three countries, and their representatives have indicated they intend to encourage and nurture domestic Islamic banking industries.

In his October speech declaring Libya's official "liberation" from Col Muammer Gaddafi, Mustafa Abdel Jalil, chairman of Libya's National Transitional Council, said that sharia law would be the basic source of future legislation.

"We are working to establish Islamic banks that are far from [the payment of] interest," Mr Abdel Jalil said. "There is a righteous intention to purify all the financial laws. Perhaps in future, all financial interest will be cancelled in accordance with Islamic law."

In more secular Tunisia, Nahda, the moderate Islamist party that has emerged as the largest in the constituent assembly and boasts the new premier, Hamadi Jebali, has emphasised it will not turn the whole banking sector Islamic, but has indicated it will encourage Islamic finance to develop in the country.

Jalloul Ayed, Tunisia's finance minister, said this year that the new government intended to tweak legislation to give Islamic banks and conventional banks equal tax treatment and to introduce a regulatory framework for Islamic bonds – with the long-term aim of turning the country into a hub for Islamic finance.

Best Bank, part of the pan-Arab Al Baraka Islamic banking group, was founded in Tunisia in 1983, and the son-in-law of ousted dictator Zein al-Abidine Ben Ali founded Zitouna Bank in 2010. But the two banks still account for an "insignificant share" of the banking industry in Tunisia, Mr Ayed concedes.

International financial institutions with Islamic arms are said to be considering setting up local branches when security improves and uncertainty reduces. Those with large Islamic capital markets teams hope to help these countries raise funds for investment, to cover budget deficits and – in the case of Libya – help rebuild the country.

> International institutions with Islamic arms are said to be considering setting up local branches when security improves

Egypt is potentially the biggest prize of them all, particularly for Islamic banks that focus on retail services. The country has a severe lack of banking facilities – only about 10 per cent of the population have bank accounts – and Islamic financial institutions only hold about 3 to 4 per cent of total banking assets, according to McKinsey.

However, the industry's growth has been hampered by a series of Ponzi schemes that operated in the 1980s and advertised themselves as Islamic banks. When the schemes collapsed, they wiped out the savings of many Egyptians and tarnished Islamic finance for decades.

As a result of the scandals, Egypt's leading cleric, Sheikh Mohammed Sayed Tantawi, the Grand Imam of Al Azhar Mosque and University – 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.

The religious imperative to avoid interest, or *riba,* is therefore lower in Egypt than in more conservative Arab states. Yet the ousting of former president Hosni Mubarak, and the success of the Muslim Brotherhood's political party, Freedom and Justice, in the recent elections, has given the local industry new-found optimism.

Bahrain-based and Saudi-owned Al Baraka Banking Group wants to add 20 branches in Egypt to the 30 it already operates there by 2015, according to Adnan Yousif, the chief executive.

The bank also plans to open 10 more branches in Tunisia by 2015 and is seeking to set up a representative office in Libya

While there will clearly be a more favourable political environment for Islamic finance in north Africa, some experts are still cautious, pointing out that conventional banking is well entrenched.

Tunisia and Egypt already have several Islamic banks, but they have grown slowly, stunted by the fact that many locals have little objection to paying or receiving interest on loans and deposits.

In Egypt in particular, the stigma surrounding the industry will take a long time to expunge.

Malaysia moves further ahead in bond issuance

Asia Pacific

The country has doubled sales over the past year, says **Kevin Brown**

If there was any doubt about Malaysia's continued dominance of Asia-Pacific Islamic finance it will have been dispelled by the huge growth this year in the issuance of local currency sukuk, or sharia-compliant bonds.

Sales for the year to the end of November reached M$43.5bn ($13.9bn), according to figures compiled by Bloomberg – more than double the M$21.4bn achieved over the same period of 2010, while global offerings were up by 73 per cent to $24.8bn.

Malaysia could push even further ahead, if all or part of a M$33bn sukuk issue being considered by the country's UEM Group and the state pension fund goes ahead in the wake of the M$23bn acquisition of Plus Expressways, a toll road operator.

The proposed issue would be a record for Malaysia, raising nearly three times as much as a M$12bn offering by Binariang GSM, a telecoms operator, in 2007. It could also push 2011 global offerings of Islamic debt past the all-time high of $31bn recorded in 2007 – if the whole amount was raised before the end of the year.

More importantly, however, the robust health of the sukuk market reflects growing interest in Islamic finance, as the appeal of sharia-compliant instruments spreads around the Asia-Pacific region in the wake of the global financial crisis.

Among other developments, Australia is considering legislative changes to encourage sukuk issuance by abolishing double taxation, while Singapore changed its law this year to facilitate the establishment of an Islamic real estate investment trust.

There has been a significant setback, however, in South Korea, where legislation that would have created a more level playing field for Islamic investment products was abandoned this year. This came amid controversial claims that there was a possibility that funds could be siphoned off to terrorists.

More positive developments have included moves by Indonesia to resolve tax problems and reform the approval process for Islamic banking products.

Bankers say the region is seeing greater enthusiasm from non-Muslims for a range of Islamic instruments.

These include sharia-compliant syndicated loans, mortgages and even credit cards, which charge a fixed fee on unpaid balances, rather than interest.

Non-Muslim interest was clearly a factor in the pioneering renminbi sukuk offered in September by Khazanah Nasional, Malaysia's sovereign wealth fund, which was increased from an initial target of Rmb300m ($47m) to Rmb500m after attracting significant backing during early marketing.

Awaiting the green light: UEM's M$33bn sukuk issue would be a record Reuters

The offering, the world's first Chinese currency Islamic bond, was 3.6 times subscribed and attracted a diverse group of investors, with 30 per cent located in Singapore, 26 per cent in Hong Kong and 6 per cent in Europe.

The renminbi sukuk demonstrated the innovative nature of Malaysia's Islamic financial sector, which has grown in the space of less than 20 years to become the world's largest outside Iran and Saudi Arabia, according to the 2011 Global Islamic Finance Report by BMB Islamic of the UK.

Malaysia accounted for 58.7 per cent of global sukuk sales in the first eight months of 2011, according to Thomson Reuters data.

Its Islamic capital market has been growing at an average of 13.6 per cent a year for a decade, says Nik Ramlah Mahmood, managing director of the Malaysian Securities Commission (MSC). It was valued at M$1,050bn at the end of 2010.

The country has introduced incentives to encourage further growth, and in particular is targeting bond programmes aimed at financing infrastructure needs, estimated by the Asian Development Bank at more than $8,000bn over the next decade.

Najib Razak, Malaysia's prime minister, announced in the budget in October that additional tax breaks for sharia-compliant debt would be introduced next year, alongside an extension of income-tax deductions for foreign-currency instruments to 2014.

Officials acknowledge, however, that the future pace of growth may depend on resolving a number of difficult issues, including disparities in legal, regulatory and tax frameworks, and differences in the interpretation of compliance with sharia law.

"Concerning greater international harmonisation in the interpretation of sharia principle[s], while the areas of differences in opinion are not substantial, there are still consequent limitations in the ability of an issuer to offer a truly global Islamic product," Ms Ramlah of the MSC told a conference in Kuala Lumpur in October.

The issue of different religious tests has been a particular difficulty in attracting investment from the Middle East and Gulf regions, where Malaysia's approach to granting permission for innovative Islamic financial products is often regarded as unduly liberal. Only 1 per cent of investors in Khazanah's renminbi *sukuk* were located in the Middle East.

Nevertheless, bond market experts are predicting continued rapid growth, as Islamic scholars continue to develop structures that allow a range of products to be offered, while governments gradually reform legislation to remove impediments such as tax disadvantages.

Davide Barzilai, a Hong Kong-based Islamic finance expert at Norton Rose, the law firm, says international agreement on religious compliance would be a significant boost for Islamic finance in the region. However, he says that its rapid economic growth suggests the issue will not prove a serious barrier to growth in the long term.

> There is growing non-Muslim interest in Islamic instruments

"There is a lot of wealth out there that could be channelled into this sector, but governments do need to have the building blocks in place," says Mr Barzilai.

Saudi Arabia and Qatar spread their wings

Gulf banks

Camilla Hall looks at where and why institutions are doing well

Of all the Gulf's Islamic banks, one stands out in the crowd.

Al Rajhi has quietly emerged as one of the world's largest sharia-compliant lenders and has maintained slow but steady growth.

Against a backdrop of improved lending conditions in Saudi Arabia, the Arab world's largest economy, the Riyadh-based bank reported a year-on-year increase in third-quarter profits of 18 per cent.

It credited these results to higher revenue from fees and investment income.

The bank is more than 30 years old and is still part-owned by family members. Business is dominated by domestic customer deposits, but, once a humble money exchange, Al Rajhi has increased its balance sheet to $50bn.

"Al Rajhi bank is truly a stand-out performer which has [made it] through the crisis quite well," says Raghu Mandagolathur, head of research at Markaz, a Kuwait-based investment bank.

The bank's cheap cost of funds – thanks to its large deposit base – and Islamic branding have put it among the top stock picks of institutions such as Deutsche Bank and Lebanon's Bank Audi.

Although international investors cannot directly buy stocks in Saudi Arabia, they can acquire them through swap agreements or exchange traded funds.

In its recent report on the Islamic banking industry, Deutsche Bank forecast more than 20 per cent earnings growth for Al Rajhi this year and next.

Customer loyalty, cheap funds and branding are all crucial to that growth, analysts say.

However, difficulties include high levels of leverage compared with its peers, its relatively new corporate banking book, and its undiversified funding mix, according to Moody's Investors Service.

Beyond Saudi Arabia, the bank has expanded into Malaysia, the world's Islamic finance hub, as well as Kuwait and Jordan.

Al-Rajhi's success has coincided with the growing demand for sharia-compliant banking in the region.

Islamic banking assets in the Middle East and north Africa increased to $416bn last year and the industry is forecast to more than double in value to $990bn by 2015, according to a report by Ernst & Young, the consultancy, in November.

During the first nine months of this year, net income of the 20 publicly traded sharia-compliant banks increased 10 per cent, and third-quarter earnings increased 16 per cent year-on-year, according to Markaz.

The region's sharia-compliant banks are also well placed to serve the needs of north Africa, where revolutions have brought potential for the development of the Islamic finance industry, which had previously been stifled.

The financial crisis was a tough ride for many of the Gulf's Islamic lenders, particularly in the United Arab Emirates and Kuwait, where over-leveraged Islamic investment companies and banks suffered alongside their conventional peers.

In addition, sharp falls in property prices damaged the sharia-compliant sector, as Islamic banks often use property to collateralise their debt.

Some progress has been made on sharia-compliant debt restructurings in the region, such as Investment Dar – a Kuwaiti finance house – which reached a deal with creditors this year. However, stresses remain.

In addition to Al Rajhi, Deutsche Bank points to two Qatari banks – Masraf Al Rayan and Qatar Islamic Bank – as potential global institutions.

Although both are still small, they have the strong backing of the Qatari government and are well placed to take part in the financing of the country's 2022 World Cup infrastructure development.

Qatar Islamic Bank, the largest sharia-compliant lender in the country, saw third-quarter net profit rise 34 per cent, reflecting an increase in investment income, while Masraf Al Rayan's rose 5 per cent, according to Zawya, a data provider.

This year, the Qatari central bank ruled that only fully-fledged Islamic banks would be allowed to operate under the sharia-compliant banner, a decision that was seen as a boost for Islamic lenders in the oil-rich country.

As a result, some banks have moved to sell their Islamic banking arms, though most lenders are just transferring sharia-compliant assets to the conventional side, with the permission of clients, analysts say.

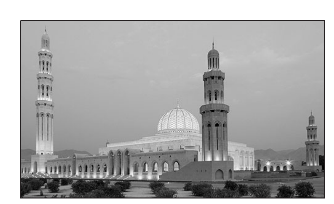
Oman, the only Gulf state that did not previously allow Islamic banking, granted its first licence this year.

As Islamic finance grows in popularity across the Gulf, regional banks will have a chance to spread their wings.

However, if asked to choose one safe bet, analysts often revert to Saudi Arabia.

"Al Rajhi is one of the strongest brands in Islamic banking," says Emad Mostaque, Middle East and north Africa strategist at Religare Capital Markets, the investment bank.

"In a sector where trust is paramount, it should continue to grow profitably and gain market share."



Oman, the only Gulf state that did not previously allow Islamic banking, granted its first licence this year

Islamic Bank of Britain: the UK is advanced in retail services such as car loans Alamy

Sukuk required to secure pole position

Profile
London

UK government has missed an opportunity to confirm the City's place as a western hub

London is winning the race to be the hub of Islamic finance outside the Muslim world – but enthusiasm for the product has waned amid turbulence in the eurozone and the aftershocks of the global financial crisis.

The decision by the UK government to put on hold plans for the first Islamic sovereign bond from a western country is also seen as a big setback.

Such an instrument would have provided investors and banks with a highly rated, potentially liquid security that might have sparked more bond issuance.

Even mainstream names such as Tesco, the UK retailer, might have been encouraged to launch these type of bonds had the UK government gone ahead with an initiative that was launched with much fanfare in 2006.

Farmida Bi, partner at Norton Rose, the law firm, says: "It would certainly help the UK market if the government decided to go ahead with a benchmark sukuk. It could galvanise the market and would lead to more interest in Islamic finance in London and [continental] Europe."

The UK put the plans on hold because of the financial crisis, as it was feared a new instrument, which would have been the first Islamic bond to be issued by a western government, might struggle to attract demand in difficult market conditions that have been made worse by the troubles in the eurozone.

However, London still remains the main arena outside the Muslim world for Islamic finance.

Elsewhere in Europe, progress has stalled. France was possibly the best placed to compete with London. It has a population of 7m Muslims compared with the UK's 2m and changed its tax and legal codes to help Islamic investors. However, problems over banning the face veil and burka, which incorporates the veil, in public places have put off investors.

In Germany, attention has been distracted by euro troubles. In the US, a market that some consider could become the biggest in the world, there is still ambivalence towards sharia products.

The UK is the only country in the European Union to have Islamic banks. It is also developing its *takaful* market for Islamic insurance. The advantages of the UK for Muslim investors is the country's positive attitude to new forms of business, which many banks and institutions in the City see as a way further to diversify an already mature financial market.

The UK also has a strong foothold in developing products such as commodity *murabaha* – Islam's version of interbank short-term lending and syndicated loans. More money in this product flows through London than any other centre in the world.

On top of this, London has established the first secondary market in sukuk outside the Islamic world, albeit small. In addition, Islamic investors are seeking to buy property and assets in the UK in a way that fits in with their religion, which bans earning interest, speculating or risk-taking.

Not only does London have the expertise from its established Islamic banks, but the leading conventional banks in the City all have so-called Islamic windows. These provide investors with a range of products, including commodity *murabaha*, and expertise on syndicating sukuk.

London is also advanced in Islamic retail services, with institutions offering a range of Islamic banking products, such as mortgages and car loans. The Islamic Bank of Britain which, when it was granted a licence in August 2004, became the first Islamic bank in the UK, has continued to attract customers for mortgages, for example.

Still, there is a feeling among many bankers that for the market to move to the next stage, the government must launch a sovereign sukuk.

The UK's 2006 sukuk plan captured the imagination of many Muslim investors in the Middle East and met with a great deal of interest from investors at the time – and would likely do so again, say bankers.

One banker at a big City institution says: "I think it has been a mistake by this government not to revive the idea of an Islamic government bond. They worry about price and demand, but the UK gilts market is a haven.

"We are confident there would be strong demand for this product, as it is Islamic and would be denominated in sterling, which is what investors want, as there are so many problems in the eurozone."

Other bankers agree, saying London has the edge in Islamic finance outside the Muslim world because of its history of financial innovation.

A sovereign sukuk would be the next inevitable step, in their view, to cement London's position for good as the hub of Islamic finance in the west.

David Oakley

Industry urged to refocus on poverty

Microfinance

Calls grow for paradigm shift in lending, writes **Mehreen Khan**

Sharia-compliant retail products now come in every shape and size.

From mortgages to insurance and even the Islamic credit card, the choice and availability for Muslims seeking religiously compliant finance has never been greater. But one sector that has continued to lag behind is microfinance.

The dearth of Islamic microfinance institutions (IMFIs) is a glaring absence in the industry, according to development specialists.

With Islamic finance now expanding its range and geographical reach, there are growing calls for sharia-compliant financial institutions to focus on what have been labelled as the "unbankable" sectors of the Muslim world.

Muhammad Yunus, a pioneer of conventional microfinance in Bangladesh, is one of the most prominent voices to advocate a "paradigm shift" in Islamic finance towards poverty alleviation, which is often criticised for mimicking conventional instruments and an overconcentration on capital markets.

Islamic financial institutions are required to donate a percentage of their profits in *zakat* or charitable payments every year. Although most of these funds have been concentrated in projects that provide disaster relief, *zakat* could be an untapped source of funding for microfinance initiatives.

"The big Muslim finance houses have ploughed their assistance into basic needs, but now there is a focus on longer-term development," says Ajaz Ahmed Khan, an adviser at Care International, the aid agency.

"As the industry has grown, Islamic institutions have started developing corporate social responsibility wings and it makes no sense for them to sponsor non-sharia-compliant microfinance."

But obstacles to the provision of sustainable Islamic microfinance and microcredit schemes in particular are manifold.

Classic Islamic financing techniques are often costlier to administer at the micro level, making them more expensive for borrowers and unsustainable for the agencies that provide them.

Lenders are often required to locate, purchase and then resell the commodities they lend to clients – an onerous responsibility that has contributed to the limited outreach of individual institutions.

According to research by the Consultative Group to Assist the Poor (CGAP), an arm of the World Bank, IMFIs have an average client base of only 2,400 customers, a situation that can be attributed to a lack of trained practitioners and a shortage of funding.

Yet the demand for loans and services from low-income Muslim clients is high. About 40 per cent of the world's microfinance clients reside in Muslim countries, but sharia compliance makes up less than 1 per cent of the industry, according to the World Bank.

Large swathes of the Muslim world have no access to formal banking and up to 45 per cent of respondents to a survey by CGAP in Jordan, Algeria and Syria said they refrained from financial services that do not adhere to Islamic principles.

"Islamic microfinance has been going on for a long time. It is a way a lot of traditional Muslim communities have always funded trade and the purchase of agricultural commodities," says Aziza Atta, managing director of Alternative Finance and Marketing Consulting.

Conventional microfinance has been hit by a number of scandals recently, including accusations of extortion that has led to suicides among borrowers in parts of the Indian subcontinent.

Centred on principles of profit and loss sharing, Islamic finance is a broadly ethical approach that can act as a powerful tool in poverty alleviation by spurring new financing models, according to some in the development industry.

Al-Amal bank in Yemen is an example of successful innovation. In 2010, it won CGAP's microfinance challenge by pioneering a lease-to-purchase venture, which has borrowers work as salaried employees of the bank while also working on the project for which they receive the loan.

"Conventional microfinance agencies just [offer] one type of loan, but the needs of the poor are not [all] the same. Islamic microfinance techniques allow us to cater to the particular needs of clients," says Mr Khan.

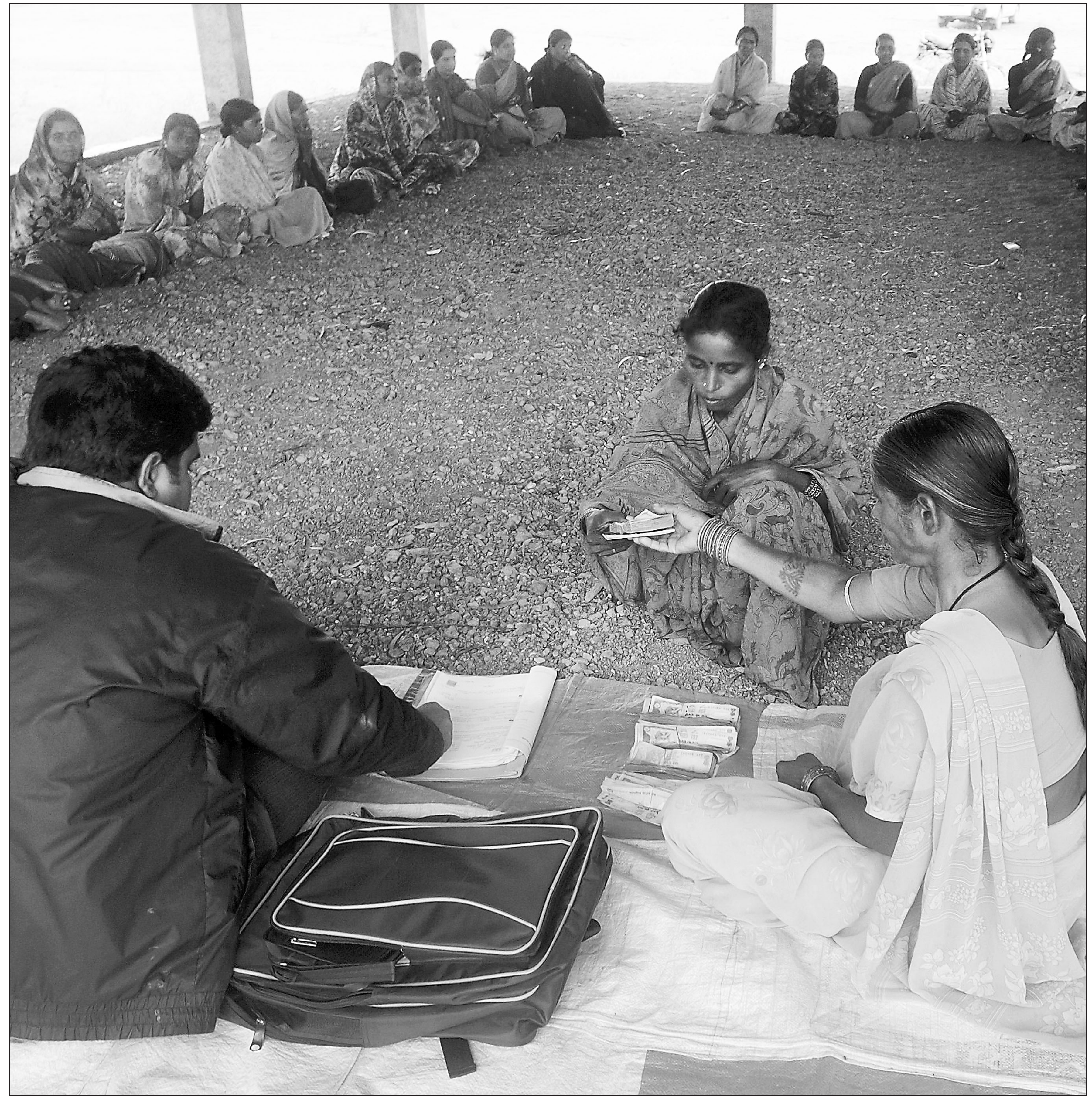
Demands for sharia-compliant microfinance reflect a wider push for a back-to-basics approach in Islamic finance. With the industry's rapid growth, financial engineering has given way to complex structures, such as those that underlie some Islamic bonds, introducing unwelcome risk.

Babar Khan, director of Ethos Human Capital, a sharia-compliant social enterprise, says: "Most people in Islamic finance need to ask why they are involved: 90 per cent of the industry is structured debt."

Based in the UK, Ethos promotes equitable investment in human and venture capital. Composed of professionals with experience in conventional finance, organisations such as this are at the vanguard of the return to first principles in Islamic finance, says Ms Atta of AFM Consulting.

Generational shifts may be the catalyst for microfinance to catch up with other parts of the industry. "It is people of my generation who have the ideas and the expertise that will drive microfinance to become more structured," says Ms Atta.

"Islamic microfinance lags behind, but it is the not-for-profit mentality, rather than that of the big banks, that will force the breakthrough in the coming years."



Small start: about 40% cent of the world's microfinance clients reside in Muslim countries but sharia compliance makes up less than 1% of industry Bloomberg

> 'It is the not-for-profit mentality, rather than that of the big banks, that will force the breakthrough'

Compliance Universal standards will aid growth

The Islamic bond market has suffered a few knocks and scrapes in recent years, including its first defaults and a continuing, often heated debate over how the instruments should be structured. But it has remained resilient amid the global financial turmoil.

The yield of the HSBC-Nasdaq Dubai sukuk index has widened from the lows earlier this year to about 4.15 per cent at the end of November, but is still tighter than the 4.8 per cent yield at the start of the year. The index hit a high of more than 14 per cent at the peak of the financial crisis.

Issuance has also recovered strongly this year. Global sales of Islamic bonds hit $22.6bn by the end of November, according to Dealogic, the data provider, smashing last year's $16.1bn, and not far off 2007's $27bn record. Bankers are optimistic that sukuk sales will continue at a healthy clip next year as well.

"The European crisis has had an effect. The issuance windows have been shorter and fewer, and spreads have widened. But the market has proved resilient," says Mohammed Dawood, a managing director of capital markets at HSBC Amanah, the British banking group's Islamic arm.

The market has been supported by the liquidity of Islamic banks, which make up the main buying base for sukuk. With conventional, interest-paying instruments out of bounds, any excess cash has to be placed in Islamic paper.

This "captive bid" from banks that buy to hold until maturity means there is very little trading in the secondary market. However, it has ensured that many Islamic bonds trade at a tighter yield than comparable conventional bonds.

"A lot of conventional deals have been killed off by the crisis, but Islamic bonds are still going through," says Farmida Bi, a partner and expert on Islamic finance at Norton Rose, the law firm. "The demand has continued to be strong, and that has been reflected in the pricing of sukuk compared to conventional bonds as well."

This is particularly true in the Gulf, where Saudi Arabia's large Islamic banking sector typically snaps up any decently rated issue that comes on the market.

However, the Islamic debt market remains dominated by Malaysia. Malaysian issuers have made up more than two-thirds of this year's sukuk sales. While western countries that have expressed an interest in encouraging domestic sukuk markets – such as France and the UK – have put their plans on hold, bankers are pinning their hopes on Indonesia, Turkey and some central Asian countries. There has also been a trickle of sukuk sold by western companies keen to build business relationships with the Middle East and tap another investor base to diversify their funding avenues.

The international sukuk market remains a short-term one. The scarceness of asset managers such as pension funds and insurers that invest in sukuk means that banks – that favour shorter-term bonds – dominate the market. This ensures that most issues typically have a five-year maturity.

Governments and companies in Muslim countries that need longer-term funding are often forced to turn to conventional debt markets.

Sukuk continues to attract some controversy. Islamic law requires that a "real" asset such as land, a factory or business underpins the structure. This asset is placed in a special-purpose vehicle through a "true sale", and sukuk holders are paid a "profit rate" from the income derived from this asset, such as a lease.

In theory, holders have recourse to the underlying asset in a default, but in reality most Islamic bonds are structured so that they are "asset-based" rather than "asset-backed" – a distinction that can cloud whether a true sale has taken place. This causes confusion among some investors, who think they can seize the asset on default; and among Muslim clerics, who require a true sale. There is no overarching regulator for Islamic finance, but the rulings of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) are the most widely followed in the Gulf. In Malaysia and large parts of Asia, other guidelines are adhered to.

Sheikh Taqi Usmani, the head sharia scholar of AAOIFI, rattled the market in 2008, when he indicated that some structures did not follow Islamic jurisprudence closely enough. Bankers and other industry insiders say the controversy has died down since then, and only approved structures are now used.

Some fear that stricter interpretations will hamper the market's growth. Others say scholars should tighten standards further, to ensure that the industry moves closer to its devout roots.

"The laws in many jurisdictions aren't conducive for true sales, which is why the market has evolved the way it has," says Mr Dawood. "If we don't allow asset-based structures, then a lot of potential issuers will go to the conventional market, and it would hurt the industry's growth."

The sector is, for the most part, predicting another bumper year in 2012. Yet some experts caution that the Islamic bond market was dragged down in the wake of Lehman Brothers' collapse in 2008, and warn the same could happen if the eurozone crisis escalates.

"The market is optimistic right now, but that could change," Ms Bi says. "There is a lot of liquidity in the Islamic financial system, but I don't think the market has decoupled as much as many hope."

Robin Wigglesworth

Farmida Bi: The sukuk market is optimistic

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