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## Chasing the Crescent Moon

*Yael Bizouati*  
*April 30, 2007*

For the past 10 years, Shariah-compliant investing has largely been relegated to corners of the capital markets industry, and products that catered to Muslim law were seldom thought of as anything more than a niche offering on Wall Street and beyond. As Muslims make up roughly a quarter of the world's population, the banks have certainly been aware that the market exists, but with sacred strictures against interest charges and debt securities, few thought there was any real money to be made. That was the old way of thinking.

Today, the Islamic finance market has been experiencing such an expansion in both volume and awareness that many observers and participants believe it's one of the fastest-growing sectors in global finance. With an annual growth rate estimated at 15% and a market exceeding \$700 billion, according to a **KPMG** report, Islamic finance is attracting large financial institutions as well as smaller investment firms in a race to tap what has quickly become an enormous and very lucrative market. Even certain governments have joined the bandwagon, and just last week, Britain announced it would issue Shariah-compliant bonds, becoming the first Western nation to do so.

"You're going to see a real explosion of interest in Shariah-compliant products," says **Eric Meyer**, chairman and CEO of New Canaan, Conn.-based **Shariah Capital**. "I am seeing a real interest we never saw previously."

Islamic finance complies with Shariah - Islamic law based on the Koran. Shariah, which means "the way" or "the right path," prohibits, among other things, the payment of interest, investments in companies that carry a high level of debt as well as investments in businesses that produce alcohol, tobacco, entertainment, pornography and such commodities as pork. For example, the leveraged buyout of Turkish alcohol distiller Mey Icki by Texas Pacific Group in June of last year would be off-limits to Shariah-compliant investors on multiple levels.

Experts in the field attribute the sudden and rapid growth to a confluence of factors. Over the past decade, Islamic economies have been building an increasing account surplus, says **Doug Johnson**, CEO and chief investment strategist of **Calyx Financial**, a Wall Street-based investment management firm specializing in Shariah-compliant funds.

In the Middle East, the surplus stems from the petrodollar boom, while in Southeast Asia, it is a consequence of structural changes associated with the 1997 currency crisis. Also, Johnson says, US interest rates have been extremely low and as a result, have inflated not only the US economy but also the economies of the developing world.

The overriding theme, Johnson says, is that "there is a great deal of liquidity that is looking for a home."

### Finding the way

Marrying conventional finance with Islamic tenets has generally proven to be a challenge that few were willing to confront. But as smaller trailblazers have been able to generate enthusiasm from the market, the large financial institutions have begun issuing their own

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Shariah-compliant products. Earlier this month, UK-based Lloyds TSB launched the first Shariah-compliant business account, while UBS teamed up with Hong Leong Islamic Bank to sell structured products that comply with Islamic law. Deutsche Bank, HSBC and Barclays Capital have also announced plans to dive into the market.

And it's not just the banks. Moody's Investors Service recently opened an office in Dubai to serve market participants in the Middle East, and Standard & Poor's last week unveiled a fully investable GCC Shariah Index designed for Muslim investors. Meanwhile, new products continue to filter into the Shariah-compliant marketplace, and the Central Bank of the UAE disclosed last week that it is considering how to make certificate of deposits available to Islamic investors.

The enthusiasm has spilled over to Western policy makers. Preceding the announcement that Britain would offer Shariah-compliant bonds, the UK's Treasury Minister, **Ed Balls**, announced earlier this month that Britain would conduct a study to analyze the feasibility of the government becoming more involved in Islamic finance. The effort, he said in a statement, is designed to "promote new ways for British Muslims to bank, save and borrow using Islamic finance products."

Moreover, business schools have started to offer courses on the topic of Islamic finance, a sign that the recent growth will be sustainable, as the biggest hurdle to Shariah-compliance - the learning curve - will be lowered for future finance pros.

### The rise of sukuk

One of the areas that has been at the forefront of the recent growth in Islamic finance is sukuk - commonly referred to as Islamic bonds. Just a few years ago, sukuk were considered esoteric instruments that attracted few converts. Today, however, Islamic bonds have been accepted as a classic Shariah-compliant financial product. They have similar characteristics to conventional bonds, the difference being that they are asset-backed and represent proportionate beneficial ownership of the underlying assets, explains a KPMG report.

According to **Fitch Ratings**, the size of the sukuk market, including both domestic and international issues, is estimated at approximately \$60 billion, with total sukuk issuance in 2006 totaling \$20 billion - an almost 50% increase over the previous year and a staggering hike compared with the \$800 million issued in 2001. Fitch says issuance is expected to continue to increase, due to high oil prices swelling regional liquidity and creating huge infrastructure spending.

A separate report from KPMG also attributes their popularity to the fact that Islamic bonds have been particularly important in addressing one of the most pressing issues in the industry: "The ability to invest surplus funds held by Islamic banks in quality, shorter-term financial instruments that meet Shariah principles."

The largest sukuk to date was done early in 2006 by Dubai Ports, which raised \$3.5 billion through an issue co-managed by Dubai Islamic Bank and Barclays. Also last year, East Cameron Gas Co. of Texas became the first US issuer of sukuk, raising \$166 million through Merrill Lynch and Lebanon's Bemo Securities.

However, issuing bonds under Shariah law can prove tricky. One of the hindrances is that, thanks to their uncertain legal framework, Islamic bonds are difficult to get rated, and it is hard to obtain a legal opinion for securitization structures in some Middle Eastern jurisdictions. The Fitch report, however, notes that the market is evolving rapidly and a structured sukuk that involves a proper isolation of the assets and no guarantee from the originator may appear in the future.

Adding to the complexity is that sukuk has been relatively untested in insolvency proceedings. "They need to reform their bankruptcy laws," says **Michael McMillen**, a partner that specializes in Islamic finance at law firm **Dechert** and a professor at the University of Pennsylvania Law School. He notes, though, that "they are trying to address these issues."

McMillen argues that given the immaturity of capital markets in jurisdictions within the Islamic economic sphere, and given the recent enthusiasm for sukuk issues and securitizations, the legal and structural supports for securitizations should be areas of primary focus for the entire Islamic finance industry.

### Other hurdles

The cloudy legal framework is not the only challenge that the Islamic finance market is

facing. The abundant and ceaseless activity has generated many other impediments, including the fact that the available pool of Shariah scholars who have specific experience with Western financial services remains limited.

"There is a temporary demand-supply disjuncture," says **Stephanie Brown**, a managing director at Calyx Financial. "One of the greatest challenges within the asset management business is finding a sensitive team of Shariah scholars."

The dearth of experts doesn't stop there. A shortage of prime brokers willing to participate is another quandary faced by the market. "The problem is not Shariah, it's getting prime brokers in the US to utilize the structure, because it involves a lot of extra steps." McMillen says. "They'll do it if they'll make enough money."

Another concern and potential impediment to continued growth is the internal debate among Muslim investors and Shariah scholars about the interpretation and adaptation of what exactly is Shariah compliant. Opinions differ as to what extent the concept of Shariah is expandable, while some critics believe it is bound by strict rules and in need of more standardization.

The reading of the law also diverges among regions, particularly between Southeast Asia and the Middle East. Malaysia, which has a government-led initiative to develop Islamic finance, is known to be at the forefront, as many products, including sukuk, started there. Shariah-compliant finance and conventional finance coexist in the country, and some Malaysian products are not always accepted in the Middle East, which tends to hold more orthodox views of Shariah, says McMillen.

"In the Middle East, you have to make it work for the four main schools of Sunni Islam, and they differ in their interpretations, whereas in Malaysia, they say there are 72 [Islamic] schools, and if it works for any one of them, it'll just work," McMillen says.

Certain asset classes, such as private equity and real estate, are easier to adapt to Shariah laws. Hedge funds, with their ability to sell short, however, have been one of the main points of discord, as Shariah law dictates that one cannot sell what one doesn't own.

To that end, Shariah-compliant hedge funds aim to replicate the economic effect of a short sale, using certain Islamic financial instruments in conjunction with each other to offer the same kind of protections a standard hedge fund might offer. However, skeptics of Islamic finance have called the process disingenuous and hypocritical, and believe that the financial institutions are merely repackaging a short sale to appease Muslim investors.

"On the margins, you do hear critics who bring up this issue," Calyx's Johnson says, but he notes, "It's certainly not indicative of the trend and desire you see from a lot of people."

### **Debunking the stereotype**

Although Islamic finance has been demystified due to its increasing popularity and press coverage, myths and misconceptions regarding the topic are still common.

"Some think that we are all financing terrorism," says Brown. "The Western world has very strange visions of what is going on in the Islamic world."

Another myth is that Shariah-compliant products cannot provide returns similar to those of more conventional financial instruments. That sentiment, though, is rapidly fading, thanks in large part to the sukuk sector's popularity and its market efficiency. And with a competitive balance, one interesting development is that non-Muslim investors have been seeking out Shariah-compliant products as a way to sin-screen their portfolio and invest ethically.

Shariah Capital's Meyer argues that Shariah-compliant funds are just another strand of socially responsible investing. But he stresses that performance does count. "You always get back to the golden question: How are you doing in the market?"

Meyer, for his part, has seen enthusiasm for Islamic finance products percolate and last month his firm launched a Shariah-compliant trading platform with Barclays acting as the sole prime broker. Meyer calls the new platform a "historic" achievement for the market as it represents an opportunity for investment managers to offer a Shariah-compliant equivalent to their conventional portfolios without fundamentally altering their strategies or processes. The platform has already signed up one hedge fund manager, Boston-based GRT Capital, and he expects to add five or six more in the next couple of months.

"A lot of people said, Gee, it looks good on paper, but can it really be done?" he says. "Now I know we can build it and it can run smoothly."

Now that concepts are being translated into actual platforms, Meyer believes that the market for Islamic finance is finally "coming of age." He adds, "In 2007, it has arrived in Dubai, London and New York, and it's going to be taken much more seriously going forward."

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