# Islamic Financial Services Sector
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ABC Investments

P.O. Box 930059, Amman 11193, Jordan
Tel. + 962 (0) 6 5629300,
Fax. + 962 (0) 6 5682941
www.abci.com.jo
(A wholly owned subsidiary of ABC (Jordan))

**Prepared by:**

Tanya Khammash

**Research Department**

Tanya Khammash
Head of Research Department
tanyak@abci.com.jo

Zein Alkhas
Research Analyst
zeina@abci.com.jo

**Brokerage**
Tel. + 962 6 5629300 (ext. 360)

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## 1.0 EXECUTIVE SUMMARY

The turn of the millennium has seen the Islamic financial services sector become a dynamic and fast-growing global phenomenon. Since its inception three decades ago, the sector has moved into the limelight, evolving into a feasible and competitive segment of the overall financial industry. Today it is estimated that there are over 300 institutions offering Shari'a-compliant financial products in over 75 countries, at least 90 takaful operators, and in excess of 200 Shari'a-compliant mutual funds. The size of Islamic banking and non-banking financial services world-wide in 2006 is estimated by the Islamic Development Bank of Saudi Arabia at USD 900 billion. The average annual growth of the sector is currently in excess of 15% and is forecasted to grow at between 10-15% over the next decade, given the high wealth and liquidity in Gulf countries resulting from the rise in oil prices, in addition to growing demand for Shari'a-compliant products.

Islamic financial institutions currently exceed 300 institutions in over 75 countries

Perceptions of the Islamic financial markets have developed substantially in recent years, where in the past the market represented, for some, a market for liquidity management and inexpensive short-term financing, now it is viewed as a market with opportunities in funds, asset and wealth management.

.... including the Financial Services sector

The dynamism of the Islamic financial services industry is being felt in both the traditional Islamic financial centres and other markets. New Islamic financial institutions are emerging rapidly in the industry's typical markets, namely the GCC countries and Malaysia, and are starting to trickle into new markets such as Syria, Lebanon, Jordan, the United Kingdom and Canada.

The Islamic financial services industry is expanding its reach outside the GCC and Malaysia into new global markets

The Islamic financial services industry remains dominated by Islamic banking, which has in recent years grown faster than conventional banking, and is expected to expand even further in the future. The prospects of the industry have induced some conventional banks to convert to fully-fledged Islamic financial institutions, as was the case with the Kuwait Real Estate Bank last year, and more recently, the Industrial Development Bank of Jordan has announced intentions to convert to an Islamic Bank.

The industry is dominated by Islamic banking, which has grown in recent years at a faster rate than conventional banking...

Not only are new Islamic banks and Islamic windows of conventional banks emerging at a rapid pace, but Islamic banks are also going global in a bid to serve the international Muslim population. The historical tendency has been for the concentration of Islamic financial service providers to be located in the Middle East and Southeast Asia, primarily in Bahrain and Malaysia. However, not content to sit on the sidelines, large international players such as Citibank and HSBC are now competing for a slice of the business. Furthermore, financial capitals around the World are expanding their infrastructure in order to accommodate for the newly emerging Islamic financial system.

...stimulating the entry of international players to the market

The emergence of Islamic financial services coincides with the financial liberalisation and globalisation of many countries, forcing companies to develop technologies and enhance their human work force to adapt to the growing demand for greater product mix and the heightened competition in the global market.

Given the expected performance of the Islamic financial services industry and the tremendous growth in its global landscape, the potential client base no longer remains confined to Muslims. The Islamic financial industry has moved into the mainstream, extending its appeal to non-Muslims by offering opportunities for investors to diversify their portfolios. The broad appeal of Islamic finance lies in its provision of new classes of assets, instruments and products, thereby opening up windows of opportunity for investment and diversification.

The client base of Islamic financial services has extended beyond the Muslim population...

...due to the creation of new products and opportunities for diversification and investment

Islamic financial services are in a state of constant evolution in response to market forces, levels and extent of demand, and regulatory changes. Following interest-free banking and the popularisation of murabaha, musharaka and ijara facilities, the more recent development of sukuk is taking the global financial market by a storm.

While the growth in demand and supply of Islamic financial services is set to grow exponentially on a global scale, so are the challenges. A sound regulatory framework, global consensus amongst Shari'a scholars regarding permissible products, and a clear understanding and acceptance is needed to ensure that the opportunities offered by the industry are fully grasped.

The growth in the sector is necessitating the existence of a sound regulatory framework and consensus regarding what is compliant with the Shari'a

In Jordan, Islamic financial services first emerged in 1978 with the establishment of the Jordan Islamic Bank for Finance and Investment. It has since then developed to include a second Islamic bank, the International Islamic Arab Bank, a subsidiary of Jordan's largest bank, the Arab Bank. Moreover, in the pipelines are efforts to convert the Industrial Development Bank to an Islamic bank. Islamic finance in Jordan has also extended to include three takaful (Islamic insurance) providers and a number of investment companies that are also compliant with the Shari'a.

Islamic financial services appeared in Jordan with the establishment of the Jordan Islamic Bank...

While the sector is still in its infancy compared to a number of countries in the region, the recent rise in number of Shari'a-compliant businesses and conversion of companies to Islamic service providers highlights the anticipated market demand for such services. It is expected that growth in Islamic financial services in the Kingdom will be slow but steady, lagging behind the development of the sector in surrounding countries in the short-term. In the longer term, we would expect to see a definite presence of Islamic financial service providers in the market, claiming a sizeable portion of the market share. However, we do anticipate that the financial sectors of Jordan will remain dual systems providing both Islamic and conventional banking and financial services.

...however, the surge in number of Islamic financial providers in recent years highlights expectations of strong demand for such services in the market

## 2.0 INTRODUCTION

Islamic financial products are products that comply with the Shari'a or Islamic laws. The Shari'a prohibits interest and investment or dealings with businesses of alcohol, pork meat and gambling. It also requires that all financial activities be based on actual business activities

With a Muslim population of in excess of 1.6 billion globally and growing, financial services institutions worldwide are increasingly creating financial products compliant with the Shari'a. In addition to Islamic banking, there are a broad array of Islamic financial products offered, including securities, mutual funds, direct investments in IPOs, sukuks, leasing and real estate products, alongside corporate finance services, private equity, hedge funds, venture capital, commodities, and takaful (Islamic insurance).

The growing Muslim population globally is bringing about a growth in the number and variety of Islamic financial products available

The creation of modern Islamic finance started out with Islamic banking, first emerging in Egypt in the 1960s. Since then, Islamic finance has evolved and spread to other countries, particularly the Gulf countries, which, due to the abundance of wealth resulting from excess petro-dollars, have experienced double-digit growth levels.

Recent macroeconomic and political factors played a vital role in inducing a requirement to deal in products with an Islamic identity

The rapid burgeoning of the industry has become particularly evident in recent years, sparked initially as a result of the first Gulf war of 1990, which had the effect of pushing up oil prices and boosting revenue in oil-rich countries. The abundance of wealth created a need for appropriate Shari'a-compliant investment vessels in which to channel excess funds. The September 11th terrorist attack on the United States had the effect of changing the investment strategies and preferences of Arab investors dramatically; where in the past investments had been directed to Europe and the United States for maximum returns, Arab investors are now preferring to keep their investments closer to home, particularly in response to the political mood in the United States and the low-returns on the dollar. Furthermore, the second war on Iraq, accompanied by the worldwide spread of stereotyping Muslims as terrorists, has enhanced the desire of Muslims to deal in products that promote a stronger Islamic identity.

Furthermore, the heightened structural reforms in financial systems, liberalisation of capital movements and investment, and global integration of financial markets have further facilitated the expansion of Islamic finance through encouraging foreign investment, cross-border investment and overall investment activity. This was particularly true for the GCC countries, where growing awareness and demand for Shari'a-compliant products alongside the high liquidity from oil revenues gave them new eminence on the international financial front.

To date, the greatest proliferation of Islamic finance has taken place in the GCC countries, followed by Malaysia and Iran. The annual growth rate in these countries has been registering double-digit figures, and the growth in the assets of Islamic banking has exceeded the growth in the conventional banking.

Growth of the sector has been highest in the GCC countries, Malaysia and Iran....

Popularity of Islamic products is not confined to only the Muslim population. Moreover, although Islamic financial services are concentrated in the Middle East and Southeast Asia, these services are beginning to emerge in Europe and the United States. The rising demand from both Muslims and non-Muslims is forcing multi-national companies globally to consider the impact of Shari'a-compliance on their businesses.

... but is emerging in regions as far away as the United States and Europe

### 2.1 Principles of Islamic Finance

Islamic finance is broader than merely the prohibition of interest; prohibition is of transactions that have elements of "riba" and "gharar", as explained in the table on the following page.

The principles of an Islamic financial system are based on compliance with the Shari'a, which originated from the Quran and the Sunnah. The basic principles are as follows:

- The most widely known principle associated with the Shari'a and the Islamic financial system is the prohibition of interest or riba. Because interest is predetermined, fixed and is guaranteed regardless of the performance of the investment, it is considered to be riba and is therefore prohibited. Worth clarifying, however, is the fact that profits and returns on investment are permitted and even encouraged under the Shari'a, as long as they result from successful business operations and the generation of additional wealth.
- The second principle relates to the concept of risk sharing, whereby the provider of the financial capital and the entrepreneur share the business risks in return for a share in the profits.
- The third principle is the prohibition of speculative behaviour, which therefore disallows transactions that involve substantial uncertainty, gambling and risk.
- The fourth principle indicates that only investments compliant with the Shari'a may be categorised under the Islamic umbrella. Investment in businesses relating to gambling, pork and alcohol are prohibited.

Principles of Islamic finance are based on compliance with the Shari'a, which entails the prohibition of riba...

... the concept of risk sharing

... prohibition of speculation

... investment in Shari'a-compliant businesses and products

The table below highlights the definitions of some of the key Islamic financial terms.

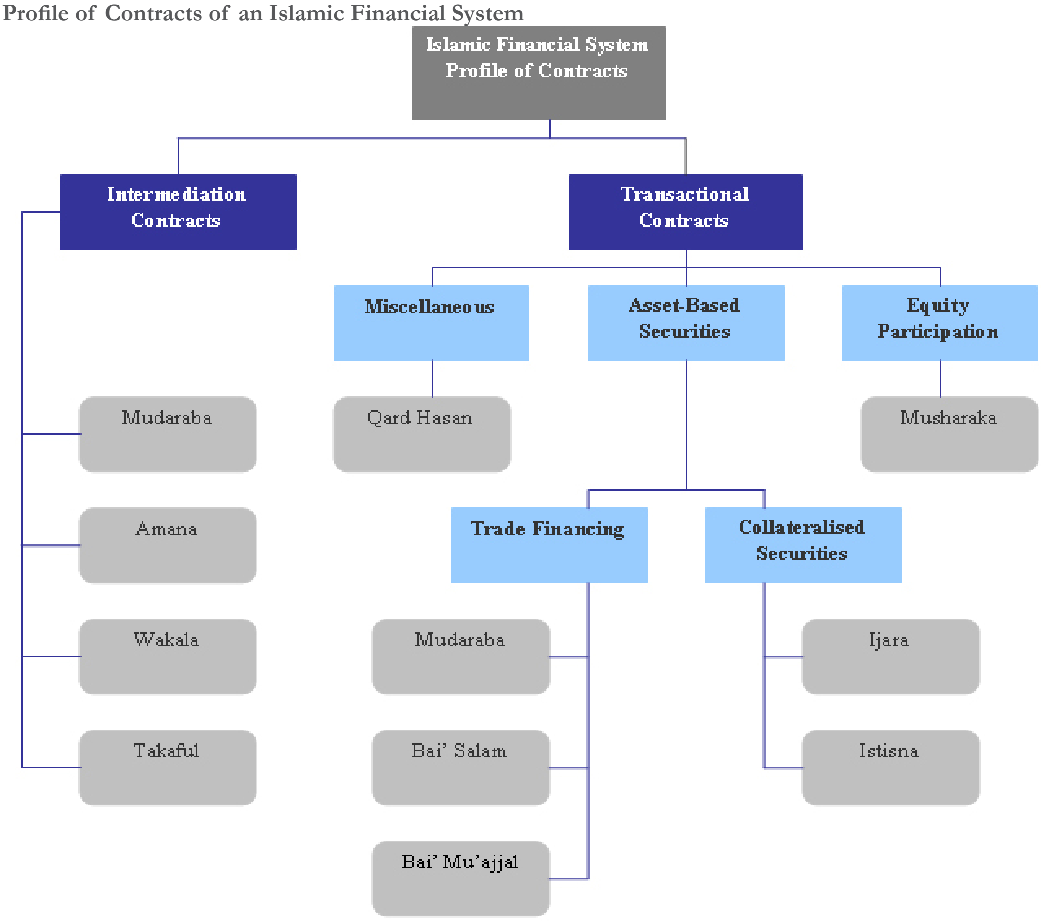
Important Islamic financial and non-financial terms

| Term | Definition |
|---|---|
| Amana | Something given by one party to another party to keep for some reason such as safe custody. |
| Bai' Mu'ajjal | An agreement where the Islamic institution sells a good on the basis of a deferred payment in instalments or a lump sum, at a marked-up price. |
| Fiqh | Islamic jurisprudence, based mainly on interpretations of the Qur'an and Sunna. It covers the religious, political, economic and social aspects of life. |
| Gharar | Exposure to excessive or unnecessary risks in an exchange transaction as a result of uncertainty or ignorance regarding an essential element of the transaction, such as price, quality or quantity. |
| Ijara | An agreement where the Islamic institution leases a particular asset for a specified amount and period of time, with the option for the lessee to purchase the asset at the end of the period at a predetermined price. |
| Istisna' | A contract for the purchase of a good that is to be produced, whereby the price is paid in instalments based on the progress of production. |
| Mudaraba | A contract whereby the Islamic institution contributes the necessary capital to finance a project, while the entrepreneur contributes his/her labour, time and expertise. Profits are shared between the institution and the entrepreneur at a predetermined ratio. |
| Murabaha | A sales agreement whereby the Islamic institution purchases goods (at spot) at the request of the customer, and sells them immediately to the customer at an agreed marked-up price on a deferred basis. The buyer makes deferred payments to the seller equal to the cost of the goods in addition to the agreed upon profit margin. |
| Musharaka | An equity partnership whereby all partners participate in the investment and management of the project. Profits are shared according to a predetermined rate, while losses are shared according to equity contributions. |
| Qard Hasan | An interest-free loan where the borrower is required only to repay the principal amounts. The Islamic institution is entitled, however, to charge a service fee to cover any administrative expenses related to the loan. |
| Riba | The premium that is paid by a borrower to the lender over and above the principal amount, as a condition for the loan. |
| Salam/ Salaf | A sales contract in which the Islamic institution pays the purchase price in advance for the future delivery of a good at a specified date. |
| Sukuk | Similar to conventional bonds with the difference that these financial papers are asset-backed. Sukuk holders are entitled to a share in the revenues generated and in the proceeds of the realisation of the Sukuk assets. |
| Takaful | A collection sharing of risks by a group of individuals - insurance based on mutual cooperation, responsibility, protection and assistance between groups of participants. |
| Waqf | Assets that are purchased or held for socially beneficial purposes. |

Supporters of Islamic finance view the prohibition of interest/riba as a benefit to the Muslim economy; the sharing of profit in Islamic financial contracts heightens productivity and efficiency, since the return on the investment depends on the profitability of the investment. Therefore, investments will be made primarily in financially sound projects which have relatively higher expected returns.

Islamic finance benefits the economy through endorsing better investment choices

**Profile of Contracts of an Islamic Financial System**




Source: "Regulating Islamic Financial Institutions: The Nature of the Regulated" by D. Hawary, W. Grais, Z. Iqbal

## 3.0 CHARACTERISTICS OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

### 3.1 Components of the Industry

While Islamic finance has been around for hundreds of years, it wasn't until the 1970's and 1980's that it began to truly evolve and develop beyond Islamic banking. The main components of the Islamic Financial Services Industry (IFSI) today are:

Components of the Islamic financial services industry have expanded over the years beyond merely Islamic banking

- Islamic banks, to include full-fledged Islamic banks, Islamic subsidiaries, and windows of conventional banks.
- Islamic non-bank financial Institutions, to include Islamic leasing companies, finance companies, ijara and mudaraba companies, to name a few.
- Islamic capital markets, brokerage houses, investment banks and fund management institutions.
- Islamic insurance and reinsurance companies
- Islamic financial infrastructure and regulators.

## 3.2 Size of the Industry and Performance.

**Estimated Size of Segments (2005)**

| Segment | USD Billions |
|---|---|
| Islamic Banks (assets) | 250.0 |
| Islamic Banking Windows (assets) | 200.0 |
| Mudaraba Companies - Pakistan (assets) | 0.3 |
| Other Non-Banking Financial Investments (assets) | 4.0 |
| Sukuk (Outstanding)* | 18.0 |
| Malaysian Domestic Islamic Bonds | 17.0 |
| Islamic Mutual Funds | 11.0 |
| Shari'a Compatible Stocks (Market Capitalisation) ** | 300.0 |
| Takaful (Gross Written Premiums) *** | 5.0 |
| **Total** | **805.3** |

* Based on sukuk listed by the Liquidity Management Centre of Bahrain on October 1st 2006
** Based on applying the Dow Jones Islamic Market Index criteria to local share markets of three Islamic Development Bank (IsDB) Group member countries in 2004, then extrapolating to the IsDB global population to give the market cap.
*** Figure extrapolated by the IFSB based on year 2000 gross written premiums and previous growth rates

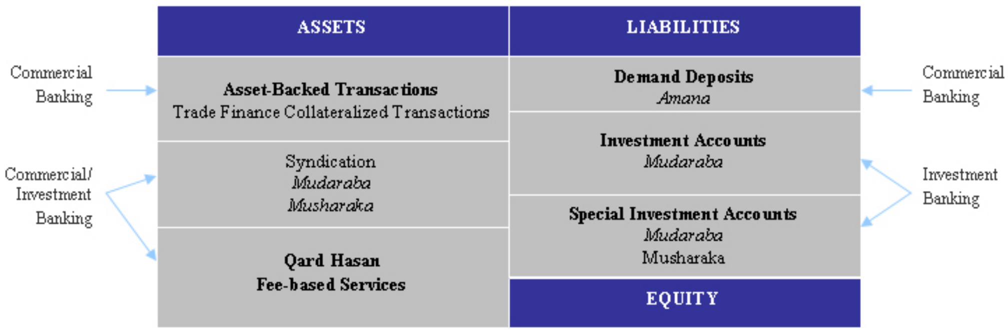
Source: Ten-Year Master Plan: Islamic Research & Training Institute & IFSB

Industry size estimated at USD 800 billion in 2005

The highest growth in the industry arose in the GCC countries, followed by Malaysia, Iran and Sudan. As evident from the table above, the Islamic financial services industry is still dominated by the Islamic banking segment, with total assets estimated at USD 450 billion in 2005.

### 3.2.1 Islamic Banks and Banking Windows

**Conceptual Balance Sheet of an Islamic Financial Institution**




Source: "Regulating Islamic Financial Institutions: The Nature of the Regulated" by D. Hawary, W. Grais, Z. Iqbal

Islamic banks and windows typically play the role of intermediaries, locating profitable projects and monitoring their performance on behalf of investors who deposits funds with the banks. As mentioned, Islamic banks and windows differ from conventional banks in their rejection of charging interest on loans and paying interest on deposits. While the principles of Islamic banking are the same as conventional banking in that funds received from depositors are used to finance borrowers, instead of charging interest on the financing provided however, Islamic banks share in the profits and losses of the borrowers' business transactions, and divide their share of the profit with the depositors of the funds. Accordingly, the operations of Islamic banks are viewed as being based mainly on profit and loss sharing (PLS) agreements, with the bank operating as the manager of depositor funds.

Islamic banks obtain their funds through a variety of methods, which include profit and loss sharing agreements...

Mudaraba and Musharaka are two of the most well-known profit-sharing arrangements in Islamic finance, and have been named as the "twin pillars of Islamic banking". Mudaraba is the method used by banks to raise funds. One party, the investor or depositor (called the "rab al mal") entrusts money to the bank, the mudarib, for the purpose of carrying out trade or business projects. The investor provides the entire financing for the project, while the bank contributes its time and labour

... with mudaraba and musharaka being the two most well-known types of agreements in managing the project to generate profits. A key point is that in mudaraba, the bank does not invest any funds, and the investor does not partake in the management of the projects. Typically, these agreements have a maturity date at which the principal amount invested or deposited is redeemed. Profits from the project are shared between the investor and the bank at a pre-determined ratio, with the percentage received by the bank representing a management fee. The bank as mudarib has a fiduciary duty to manage the funds of the investors, but any losses arising from the project, provided there was no negligence by the bank, are borne solely by the investor.

The basic mudaraba agreement has been extended to form a two-tier mudaraba whereby the banker acts as an intermediary, collecting the funds from the investor or depositor in the first tier, and offering the funds as financing to the borrower, or entrepreneur in the second tier. In the first tier of the agreement, the investor supplies the funds, which are then invested by the bank on their behalf. These funds are placed in an investment account with the bank, and these are recorded in the bank's balance sheet as part of the liabilities/equities side. However, the funds do not represent liabilities per se, as they are not guaranteed and they incur losses if the bank makes a loss, therefore, they more closely resemble equity.

The second tier is where the bank supplies the funds to the entrepreneur and they agree to share any profits arising from the financed project. For this tier, the bank utilises both deposits under investment accounts and regular demand deposits. Because demand deposits do not bear interest, they are therefore treated on the balance sheet as liabilities.

Musharaka, on the other hand, represents a partnership between two parties, both of which provide capital towards financing projects and both parties may participate in the management of the projects. Profits generated from the projects are shared between the two parties at a predetermined rate, allowing for remuneration of management efforts, and losses are shared based on equity participation.

There are two types of musharaka contracts; permanent musharaka, where the Islamic bank participates in the equity of a project and receives a share of the profit on a pro rata basis, and the period of the contract is not specified. This type of musharaka is more suited for the financing of longer-term projects. The second type of musharaka contract is the diminishing musharaka, which also consists of equity participation and sharing of profits on a pro rata basis, however, it allows for the bank to reduce its equity in the project and ultimately transfer the ownership of the assets onto the other parties to the contract on a gradual basis.

While musharaka contracts are viewed as the purest form of Islamic finance, in practice, however, because both parties bear the risks of the project, banks tend to participate in musharaka projects rather infrequently.

Musharaka is viewed as the purest form of Islamic finance

On the liabilities side, Islamic banks offer current, savings, investment and special investment accounts. Current accounts, like in conventional banks, offer no return on the funds. Depositors are permitted to withdraw their funds at any time, and they allow the bank to utilise the deposits while in the bank. Savings accounts are also operated in the same way as the current accounts. However, the bank may, at its sole discretion, pay a positive return on the funds in the savings accounts. While similar to the concept of paying interest on deposits, this is permitted under the Shari'a, as the return is not predetermined or a condition for depositing funds in the bank. In both of these types of accounts (or Wadi'a), the amounts deposited are guaranteed.

Investment accounts, as mentioned, are a form of equity investments, which are generally based on mudaraba contracts. Investment accounts generally do not guarantee the repayment of the invested amount. Special investment accounts are also based on mudaraba but tend to be customised to

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the requirements of customers. In practice, however, Islamic banks tend to receive only a small proportion of their total deposits from profit and loss sharing agreements, favouring the non-remunerated deposits.

Islamic banks tend to favour non-remunerated deposits in terms of obtaining deposits...

On the assets side of an Islamic bank's balance sheet, there are a wide variety of financing products offered, including relatively short-term asset-backed securities and low-risk financing products. Mudaraba contracts can also be used as methods of financing, whereby the bank functions as the financier (the rab al mal), offering capital to the entrepreneur who manages the business, in return for a share in the profits. However, since the bank plays no role in the management of the project, and provided that no negligence or misconduct by the entrepreneur arises, any losses from the project are borne by the bank, this type of financing is seldom used.

For investment or financing purposes, Islamic banks tend to prefer other modes of financing over mudaraba and musharaka, with the most common type of financing arguably being murabaha, where the bank purchases an asset on behalf of the customer, and sells it back to the customer at a mark-up or cost-plus basis. This differs to the charging of interest by conventional bank in that the Islamic bank actually purchases the assets, and therefore assumes the risks for the duration between the time of purchase and the resale to the customer. The murabaha contract has been extended further to a commodity murabaha (tawarruq). Here, the customer of depositor requests that the bank purchase a specified commodity from a supplier on a cash basis. The bank receives the cash for the price of the commodity from the customer, which represents a deposit made in the bank's accounts. The bank then purchases the commodity on a deferred sale at a cost price plus a profit margin, in accordance with murabaha terms. The commodity is then sold to another buyer at the equivalent price at which the bank purchased the commodity. The bank therefore assumes the liability, equivalent to the cost price of the commodity plus the mark-up, to be paid to the customer (depositor) at maturity.

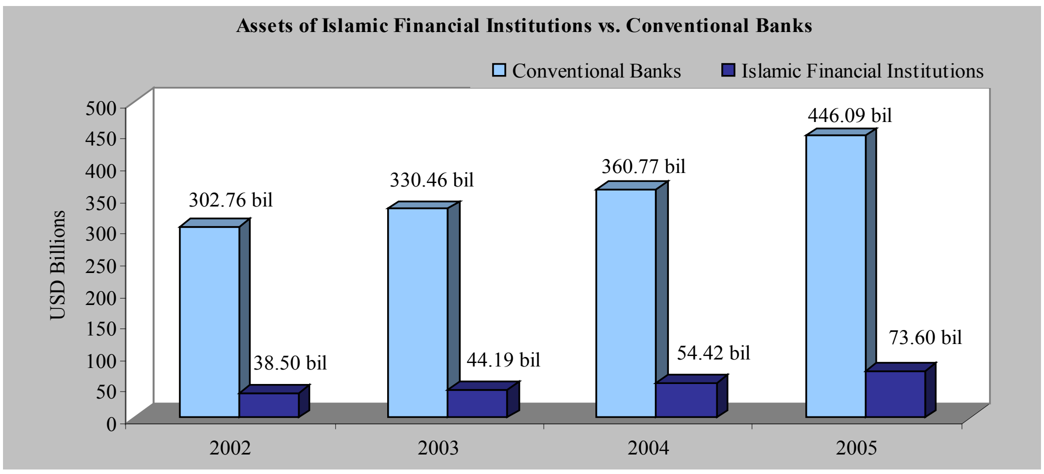
...and murabaha and other types of asset-backed financing over mudaraba and musharaka financing

Other financing products include; bai' mu'ajjal, the purchase and resale of assets on a deferred payment method; ijara, the purchase of an asset by the bank and leasing it out to customers; and bai' salam, the pre-payment for the purchase of goods.

A consideration of the growth in the assets of Islamic financial institutions in the GCC countries as compared to that of conventional banks highlights the rapid growth in Islamic banking compared to conventional banking. Islamic financial institution assets grew by a substantial 91.2% over the period 2002-2005, while the growth in conventional banking assets grew by 47.3% over the same period.

Growth in assets of Islamic banks surpasses the growth in assets of conventional banks

**Growth of Assets of GCC Islamic Financial Institutions vs. GCC Conventional Banks**



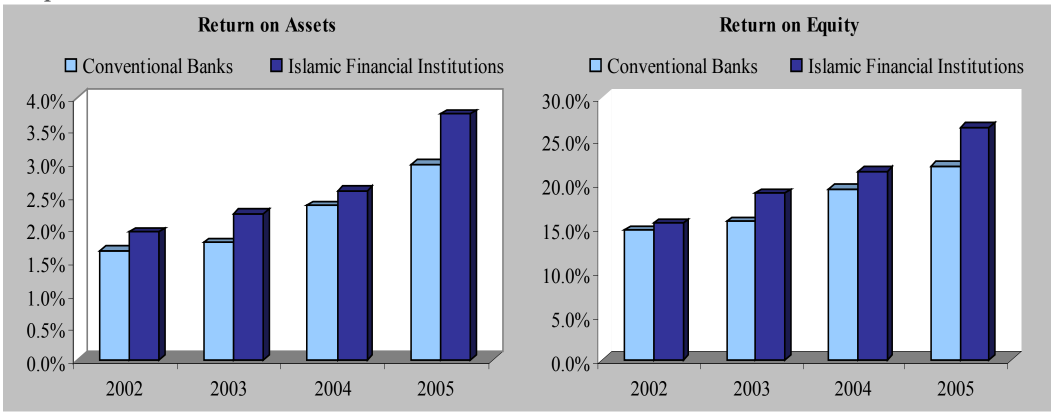

Source: Institute of Banking Studies

While this growth is impressive, the penetration of Islamic banking is still very low, with Islamic banking assets comprising only around 14% of total assets in the GCC countries, with the largest penetration rates arising in Saudi Arabia, United Arab Emirates and Qatar.

Low Islamic banking penetration

The Return on Assets (ROA) and Return on Equity (ROE) show that the Islamic financial institutions have consistently produced higher returns than conventional banks. In 2005, the ROA and ROE for Islamic institutions in the GCC amounted to 3.74% and 26.54% respectively, compared to 2.98% and 22.10% for conventional banks.

**Comparison of ROA and ROE for Islamic Financial Institutions and Conventional Banks in the GCC**




ROA and ROE for Islamic banks have consistently outperformed those of conventional banks...

Source: Institute of Banking Studies

Islamic financial institutions possess a competitive advantage over conventional banks through their low cost of funds since the institutions are mainly funded through interest-free current accounts, which are non-remunerated. Furthermore, Islamic banking often features highly profitable consumer-lending facilities and the ability to profit from returns on higher yielding assets.

...due to Islamic banks having a lower cost of funds and highly profitable financing services

Islamic financial institutions thus far have tended to be domestic players of a relatively small size. In the Gulf countries, only three Islamic banks rank within the largest 30 financial institutions in the region; and these are the Al Rajhi Banking & Investment Corporation, the Kuwait Finance House, and the Dubai Islamic Bank.

**Key Regional Islamic Banking Institutions**

| (USD Millions) | Country | Assets | Deposits | Net Profits |
|---|---|---|---|---|
| Al Rajhi Bank | Saudi Arabia | 28,053 | 19,492 | 1,946 |
| Kuwait Finance House | Kuwait | 21,724 | 12,836 | 662 |
| Dubai Islamic Bank* | UAE | 17,548 | 13,000 | 430 |
| Abu Dhabi Islamic Bank | UAE | 9,799 | 6,533 | 155 |
| Bank Aljazira | Saudi Arabia | 4,190 | 2,911 | 526 |
| Qatar Islamic Bank | Qatar | 4,072 | 960 | 278 |
| Bank Al-Bilad | Saudi Arabia | 3,008 | 2,121 | 47 |
| Qatar International Islamic Bank | Qatar | 2,297 | 1,859 | 110 |
| Jordan Islamic Bank | Jordan | 1,821 | 1,737 | 22 |
| Shamil Bank | Bahrain | 1,693 | 112 | 62 |
| Boubyan Bank | Kuwait | 504 | 168 | 10 |

* Calculated based on an exchange rate of USD 1 : AED 3.672
Source: Grail Research and Company Annual Reports (FY 2006)

However, many banks and investment companies in the region have or are planning to convert to Islamic Banks, including the Kuwait International Bank, the Industrial Development Bank of Jordan, and Amlak Company in the UAE.

### 3.2.2 Islamic Insurance (Takaful)

Insurance in the Middle East and the North Africa region has a very low penetration rate compared to other areas in the world. While this may be attributed to a number of factors including a low household income and lack of awareness and understanding of the importance of insurance, a primary reason for this is due to insurance being viewed by Muslims as including uncertainty and interest, which conflicts with the Shari'a. Furthermore, Muslims are influenced by their belief in fate or Qadar.

Islamic insurance, or takaful, is based on cooperation and mutual help for the good of society. It is based on a collective sharing of risk by a group of individuals, the policyholders, whereby funds contributed by policyholders are combined and used to help those in need.

Takaful is based on collective sharing of risk

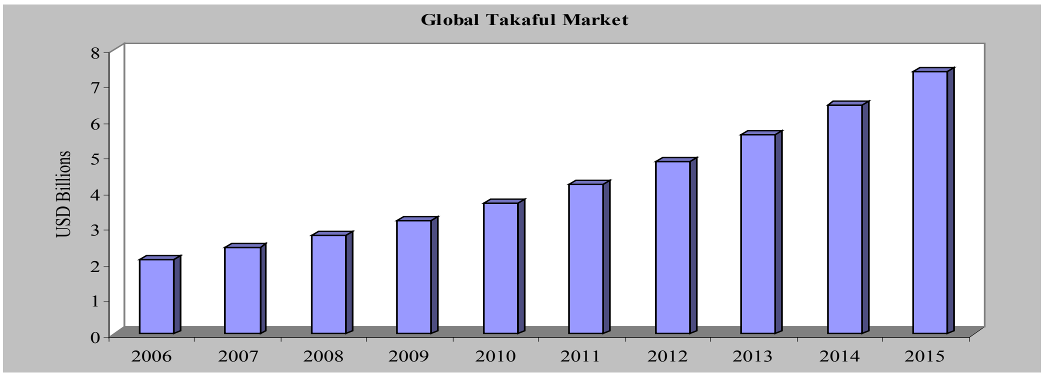
Contracts underlying the takaful process in practice most commonly include the modes of mudaraba, wakalah and waqf.

The emergence of takaful allows the mitigation and management of risks in Islamic finance. The first takaful company was established in 1979 and there are now in excess of 250 companies present globally. Takaful's major markets are Malaysia, Iran, Pakistan, Saudi Arabia and other GCC countries. Despite the growth, however, the takaful industry is still in its formative years, lacking the proper regulatory frameworks, standards and codes of practice.

Major takaful markets are Malaysia, Iran, Pakistan and the GCC

However, takaful has been receiving a lot of attention as an integral part of Islamic finance, and is expected to grow at an exponential rate to reach almost USD 7.5 billion by 2015.

**Projection of Growth in Global Takaful Market**




Source: Celent

Growth in takaful has been impressive and is expected to reach USD 7.5 billion in 2015

Takaful has a vital role to play in the Islamic financial services industry, due to its ability to mobilise long-term funds, whereby the contributions or "donations" made by policyholders are invested by takaful companies in other Shari'a compliant products.

### 3.2.3 Islamic Capital Markets

The growth and development of Islamic banking and Takaful products has emphasised the vital requirement for Islamic capital market instruments through which balance sheet liquidity may be managed. The Islamic capital market functions as a parallel market to the conventional capital market, facilitating the deepening of the Islamic financial services industry and acting as a tool for resource mobilisation and allocation.

Today, there are a variety of capital market products available for investment, including Islamic funds, sukuk, Shari'a-compliant securities and indices.

Wide variety of capital market products, to include funds, sukuk, securities and indices

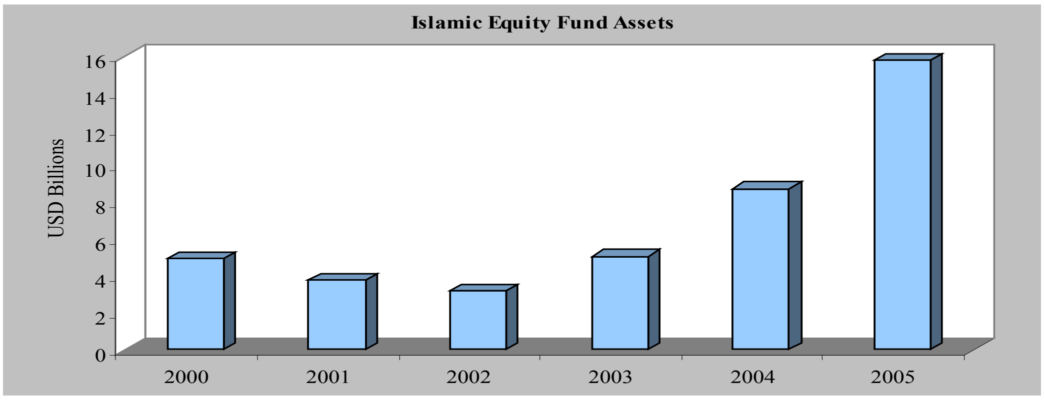
## Islamic Funds

The Islamic funds segment is a segment of the Islamic financial services industry that is experiencing substantial growth. Estimates place around 400 funds globally as compared to around 150 back in year 2000. The development of the industry suggests that many more funds will be launched with additional interest from international players.

Estimates of 400 Islamic funds globally

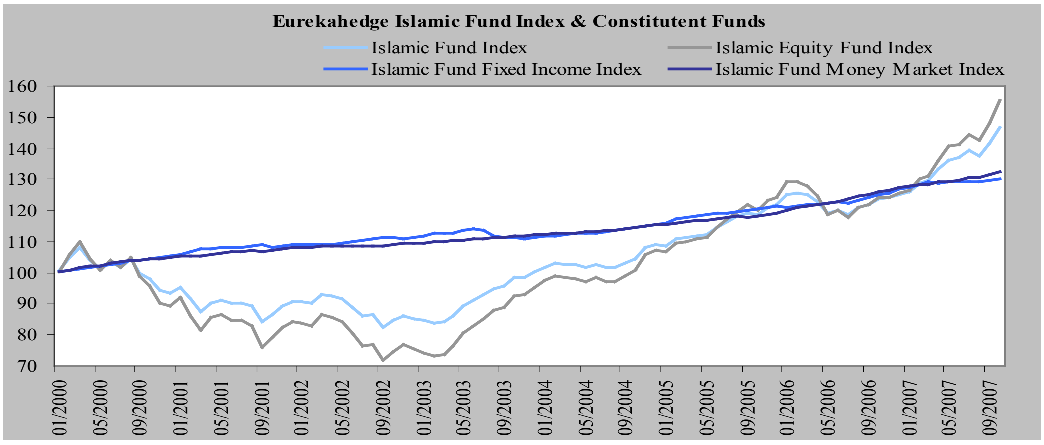
The Islamic funds are concentrated in the MENA region and the Asia Pacific, claiming the lion's share, at over 60%.

The size of the Islamic equity fund assets has been undergoing an exponential growth trend over the past few years, reaching around USD 16 billion in 2005.




Source: KPMG "Making the Transition from Niche to Mainstream" Sector Outlook

A consideration of the performance of the Eurekahedge Islamic Fund Index and its constituent funds in recent years highlights a rapid increase primarily since the start of 2003.



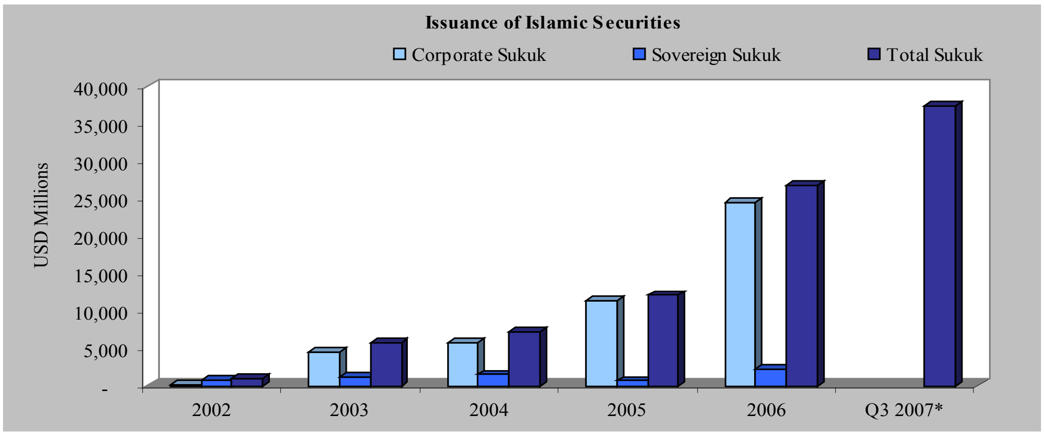

Source: Eurekahedge

Sharp rise in the Islamic fund index and its constituent, the Islamic equity fund index

## Sukuk

The need for management of liquidity, due to the prohibition of a variety of interest-earning instruments, led many countries to introduce Islamic bonds (sukuk), with the first international sukuk issued by the Government of Malaysia in 2002.

Sukuks are looking promising as a mechanism for enhancing liquidity in the Islamic Financial Services Industry. This is because they provide a regular stream of income, and, unlike many other Islamic financial products, they can be traded in secondary markets due to their backing by tangible assets.




* Estimate figure obtained from AMEinfo.com
Source: International Islamic Financial Market

Impressive growth in sukuk market, particularly for corporate sukuk issuances

The sukuk market has grown substantially in recent years, reaching over USD 35 billion at the end of the third quarter of this year. The bulk of the growth in sukuk issuance comes from corporate issuances in a bid to raise money, although there have been several countries issuing sovereign sukuk in recent years, to include the UAE, Qatar, Pakistan, Malaysia, to name a few. Demand for sukuk has so far exceeded the supply, with offerings being typically oversubscribed.

Moreover, a benchmark index for sukuk has recently been launched by Dow Jones Citigroup, including the following sukuk issuances. The Dow Jones Citigroup Sukuk Index is the first index that measures the performance of global sukuk.

| Name | Coupon | Maturity | Par ($MM) | Quality | Country | Stated Coupon |
|---|---|---|---|---|---|---|
| Islamic Development Bank | 3.625 | 12/08/2008 | 400 | AAA | Supranational | Fixed-rate |
| Kingdom of Bahrain | 5.83 | 30/06/2009 | 250 | A | Bahrain | Floating-rate |
| Government of Dubai | 5.808 | 04/11/2009 | 1,000 | A+ | UAE | Floating-rate |
| Sarawak International | 6.493 | 22/12/2009 | 350 | A- | Malaysia | Floating-rate |
| Islamic Development Bank | 5.513 | 22/06/2010 | 500 | AAA | Supranational | Floating-rate |
| State of Qatar | 5.736 | 09/10/2010 | 560 | AA- | Qatar | Floating-rate |
| Abu Dhabi Islamic Bank | 5.76 | 12/12/2011 | 800 | A | UAE | Floating-rate |
| DIB Sukuk | 5.69 | 22/03/2012 | 750 | A | UAE | Floating-rate |
| Emirates Islamic Bank | 5.66 | 12/06/2012 | 350 | A | UAE | Floating-rate |
| Dubai Int'l Financial Center | 5.735 | 13/06/2012 | 1,250 | A+ | UAE | Floating-rate |
| DP World Sukuk Ltd. | 6.25 | 02/07/2017 | 1,500 | A+ | UAE | Fixed-rate |

Source: Dow Jones

Despite this growth, however, the sukuk market does still suffer from lack of liquidity, with those investing in sukuk generally holding them till maturity, due to the low number of issuances and the limited number of alternative investment avenues. They also tend to be held by larger institutions, thereby excluding individual private investors from the market.

Most popular structures of sukuk are based on ijara and salam contracts

The most popular structures of sukuk are based on ijara and salam contracts. Ijara sukuk are sukuk that represent ownership of equal shares in a leased asset. For the issuance of an ijara sukuk, the owner of the asset (the lessee) sells the asset to a Special Purpose Vehicle (SPV), which issues sukuk to investors to raise the required financing to pay for the purchase of the asset. The asset is then leased to the lessee for its use, who then makes periodic rental payments to the SPV. These rent proceeds are then distributed to the sukuk holders. At maturity, the SPV sells back the assets to the lessee at a predetermined price, equal to the amounts still owed under the ijara sukuk, which is distributed to the sukuk holders. An important property of the ijara sukuk is that the owner of the sukuk has the right to dispose of the sukuk at any time, without affecting the rights of the lessee, which means that they are tradeable and theoretically easily convertible into cash. This means that ijara sukuk will pose as a potential solution to the liquidity problems faced in the Islamic financial industry.

Salam sukuk are based on salam contracts, where the issuer of a salam sukuk is the seller of goods that are to be delivered at a future date in return for an advance payment, received on the spot. The holders of the salam sukuk therefore become the buyers of the goods, and are entitled to the sale price of the certificates or the sale price of the salam goods. The price paid for the salam sukuk represents the purchase price of the goods. An SPV collects the proceeds of the sukuk issued and passes them on to the seller of the goods in return for a commitment to deliver the goods at a future date. The goods are then marketed at the time of delivery for sale. The difference between the purchase price and the sales price represents the profits that are distributed to the holders of sukuk. However, because the underlying asset of salam sukuk is a debt resulting from the advance payment of the sales price, salam sukuk are not tradeable.

The bulk of the sukuk issuances have so far been sovereign issuances or issuances by companies with sovereign backing. Furthermore, sukuk issuances have predominantly taken place in Malaysia, which claims over 80% of the total sukuk market. Bahrain is the second country in line, with a share of less than 5%. However, the interest shown by the Gulf countries has only very recently been sparked, and they are therefore expected to be the driving force of the growth of the sukuk market in the future.

An important point to make is that sukuk are attracting a lot of international and non-Muslim attention. Of the Global Malaysian Sukuk issue of 2002, 70% is said to have been taken up by non-Muslim investors, while for the Qatar Global Sukuk issue, the non-Muslim contribution amounted to 65%.

Non-Muslim attention received on Sukuk issuances

A point worth mentioning is that, in Islamic capital markets, conventional derivative instruments, such as interest rate swaps and options are not permissible. Therefore, the need for competitiveness of the industry and risk management and liquidity needs will help drive sukuk further, creating other alternatives.

**Islamic Stock Markets**

For stocks to be listed on Shari'a-compliant indices, companies are screened on a number of quantitative measures, such as their debt-to-equity ratios, liquidity-to-asset ratios, in addition to compliance of the underlying business with the Shari'a. Companies involved in gambling, the production and/or sale of alcohol and pork, and providers of conventional financial services, are some examples of companies that are excluded from the Islamic indices.

Stocks listed on Shari'a-compliant indices are screened on a number of factors

Some of the major Islamic indices are listed below:

| Index | # Stocks Listed | Market Capitalisation (USD Billions) |
|---|---|---|
| Dow Jones Islamic Market Index | 2,460 | 21,148.7 |
| MSCI World Islamic Index | 1,128 | 14,640.0 |
| FTSE Shari'a Global Equity Index Series | 677 | 10,752.1 |
| S&P 500 Shari'a Index | 276* | 8,077.4* |
| Global's GCC Islamic Index | 70** | 144.8 |

* As of June 30th 2007
** As of October 30th 2006

### 3.3 Market Trends

As mentioned in section 3.2 above, banking is the most dominant segment of Islamic financial services. While in some countries it is required by the State that the banking system be fully compliant with Islamic law, many other countries accept a dual banking environment where Islamic finance operates in parallel with conventional finance, either as specialised Islamic banks or as Islamic windows of conventional banks.

The specialised Islamic banks are banks structured based entirely on Shari'a-compliant principles. Islamic windows, on the other hand, are Islamic products and services offered by conventional banks to customers that require Shari'a-compliant products.

The Islamic market structure is evolving with the rising demand for Islamic products. By setting their standards on a par with conventional financial products in terms of benefits, pricing, transparency and service, Islamic products are gaining the support of non-Muslims.

Regional Islamic financial institutions are gradually expanding their reach and acquiring a global presence. Meanwhile, western financial institutions are also fighting for a share of the growing pool of investors attracted to Shari'a-compliant products, initially by offering Islamic services through existing Islamic banks of windows of banks in Muslim countries, and more recently, by creating their own Islamic bank subsidiaries.

Entrance of new players to the market has forced the diversification of products offered

The entrance of new and international financial institutions to the market has forced existing institutions to diversify their products away from commercial banking, bringing about the emergence of investment banking, equity capital markets, debt capital markets and private banking, all of which are expected to be the key drivers of the sector growth from now on.

This need for diversification is accentuated by requirements of capital adequacy and liquidity levels, cultivating the development of the sukuk market, which is growing exponentially, estimated by the Islamic Finance Information Services to have reached USD 27 billion in 2006 compared to USD 7.2 billion just two years prior. Other emerging areas in Islamic finance are hedge funds, Islamic insurance, and Shari'a-compliant investments.

Attempts are being made to replicate conventional structured products to increase the variety of shari'a-compliant products

Islamic securitisation should begin to play an important role in the development of the sukuk market. Players in the market are also attempting to replicate conventional structured products in a bid to increase the range of Shari'a-compliant products available. Support for such attempts are being provided by the International Swaps and Derivatives Association, who in collaboration with the International Islamic Financial Market of Bahrain, is producing a Shari'a-compliant Master Agreement, which is hoped to facilitate the development of the Islamic derivatives market.

### 3.4 Regulations and Standards

Expansion of industry is unmatched by development of the regulatory system

The wide-spread expansion of the Islamic financial services industry has, according to many, been unmatched by the development of the industry's regulatory and supervisory systems. A major challenge is to develop a framework for governing, supervising and regulating Islamic financial service providers, due to there being no common approach among countries in which Islamic finance exists. Many countries have enacted Islamic banking laws, such as Malaysia, Pakistan and Turkey, while others have no laws regulating Islamic institutions.

This had led efforts being made to establish standards and regulations for the industry. One of the major initiatives is the Islamic Financial Services Board (IFSB). The IFSB was established in Malaysia in 2002 in response to efforts by central banks of Islamic countries, the Islamic Development

Bank, the International Monetary Fund, and the Accounting and Auditing Organisation for Islamic Financial Institutions.

The IFSB's role is to develop international standards relevant to Islamic financial institutions to ensure the stability, transparency, prudence, and soundness of the Islamic financial industry. The IFSB introduces standards for adoption, consistent with the principles of Shari'a. It has developed two prudential standards relating to risk management and capital adequacy, and more recently, standards on corporate governance, transparency and market discipline.

IFSB is developing international standards to promote stability, transparency and prudence

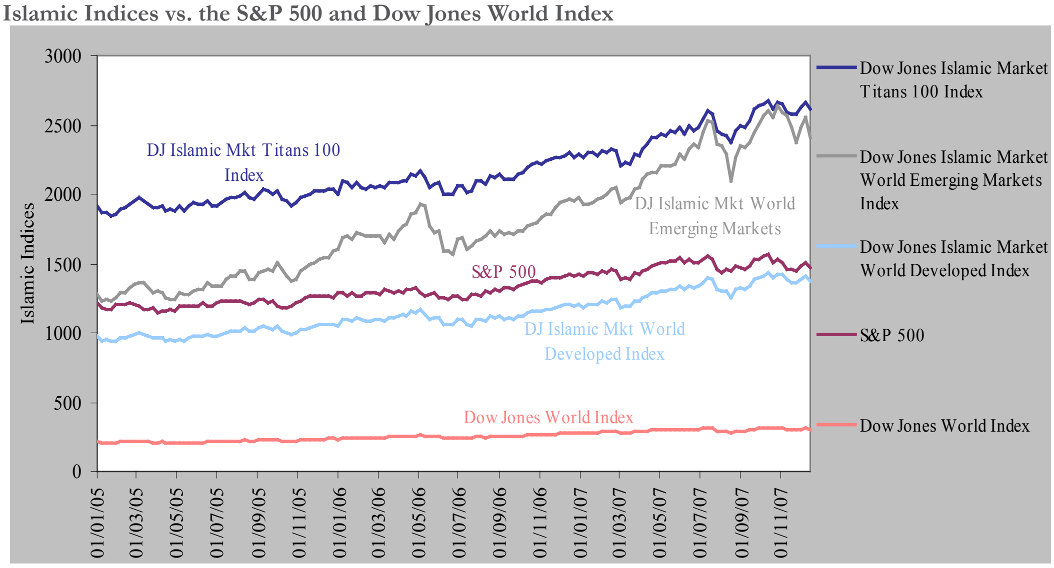
Another important player in the role of development of the Industry is the Islamic Development Bank (IDB), which is developing internationally acceptable procedures and standards. The IDB has collaborated with the IFSB to create a ten-year blueprint on the development of the Islamic Finance Service Industry, which lays down guidelines on the steps to be taken to achieve this.

Other institutions in the industry include the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market created to promote an active international market according to Shari'a, the Liquidity Management Centre of Bahrain (LMC) to meet the liquidity requirements of Islamic financial institutions, and the Council of Islamic Banks and Financial Institutions.

### 3.5 Global Islamic Index Performance

A sample of the Dow Jones Islamic Market Indices have been included below for illustration purposes of the performance of Shari'a-compliant indices, against the performance of the S&P 500 over the same period. All three Islamic indices have shown substantial increases over the past couple of years, with the rise in the Dow Jones Islamic Market Titans 100 Index and the Dow Jones Islamic Market World Emerging Markets Index outperforming the S&P 500, and that of the Dow Jones Islamic Market World Developed Index shadowing the movement of the S&P 500. Moreover, all three indices outperformed the performance of the Dow Jones World Index.

**Islamic Indices vs. the S&P 500 and Dow Jones World Index**



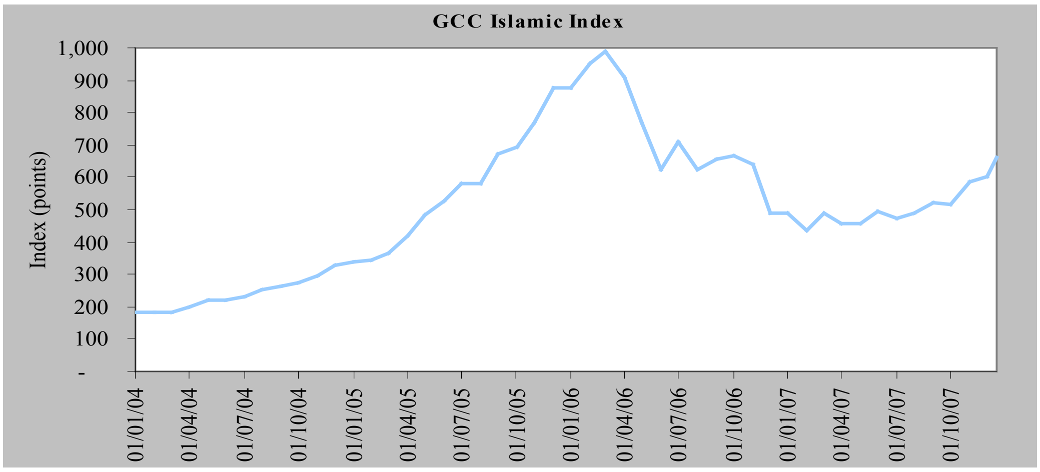

Source: Google Finance, Yahoo Finance

Overall rising trend for the Islamic indices, outperforming the S&P 500 and Dow Jones World Index...

In contrast, the GCC Islamic Index shown on the following page indicates a sharp rise in the index until the start of 2006, where it began an almost constant decline for the entirety of the year. The GCC Islamic Index consists of all Shari'a-compliant stocks listed across the GCC stock exchanges.

ABC Investments

The decline in the GCC Islamic index was mirrored across the region, where the capital markets experienced a sharp correction that commenced towards the end of 2005, and carried on through 2006. The start of 2007 showed signs of recovery, and this is evident in the GCC Islamic Index.




Source: Global Investment House

...although the GCC Islamic index followed the regional indices performances, experiencing a significant correction in 2006

### 3.6 SWOT Analysis

| Strengths | Weaknesses |
|---|---|
| Increased attention in the sector by multinational financial leaders | Limited number of Shari'a scholars with an understanding of banking and financial services |
| Fast pace of product innovation due to conventional financial institutions entering the Islamic market | Shortage of qualified human resources to offer and develop Islamic products and services |
| Rising demand for Islamic products | Lack of a uniform regulatory and legal framework |
| Fast growth and increasing market share of the sector | Existing banking regulations are based on Western banking models |
| Increasing partiality towards Islamic products | Secondary market for Islamic products is illiquid and lacks depth |
| High profitability and low cost of funds | Lack of money markets that are compliant with Shari'a, and no lender of last resort |
| Improved pricing competitiveness for customers compared to conventional products | Lack of research into the industry needed to create new innovative products and determine segments of the market to target |
| Increasing variety of products available | Islamic Banks seen as being linked to Islamic political parties |
| | Comparatively small number of participants |
| | Different Shari'a interpretation leading to a loss of confidence in the industry |
| **Opportunities** | **Threats** |
| Strong macroeconomic fundamentals | Increasing competition leading smaller Islamic financial institutions to lose out to larger multinational institutions |
| Growth in products will attract new investors | Government regulations |
| Growing Islamic population | |
| Increasing awareness of Islamic financial products and services available | |

## 4.0 FACTORS IMPACTING THE PERFORMANCE OF ISLAMIC INSTITUTIONS

### 4.1 Customer Characteristics

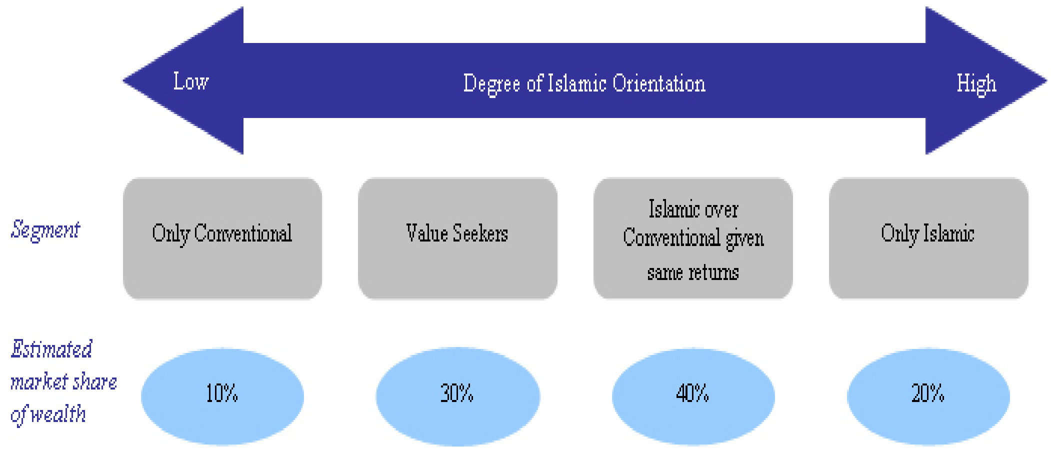
#### 4.1.1 Religious Conformity

Islamic finance is evolving as the global Muslim population expands; The global Islamic population has been rising over the years and is said to be the fastest growing religion. In 1970, the Islamic demographics stood at around half a billion capita, comprising around 15% of the global population. In 2007, this figure had more than trebled to reach 1.6 billion capita. Estimates by Barrett and Johnson state that the Muslim population will reach 1.9 billion by 2025.

Islam said to be the fastest growing religion and Muslim population is expected to reach 1.9 billion by 2025

The Muslim population can be divided into four main market segments. The first are those that are religiously motivated - i.e. they are attracted to the products simply because they are Shari'a-compliant and are willing to sacrifice returns for this purpose. The second segment are those who prefer to comply with the Shari'a, but expect returns at least equal to conventional financial institutions. The third segment are those indifferent to Shari'a-compliant products, but seek performance and returns. The fourth segment are those that will only consider conventional products.

**Illustration of market segments of Muslim population**




Source: Ernst & Young

The growth potential of the industry depends on winning over the "value seekers", those that prefer Islamic over conventional given the same returns, and those interested solely in conventional products. This can be achieved as follows; for the conventional-oriented segment, efforts should be made at marketing to develop awareness of Islamic products, while for the value seekers and Islamic over conventional, emphasis should be placed on improving the performance of the Islamic products and the quality of service provided.

Marketing and increased added value needed to drive industry growth

#### 4.1.2 Wealth and Liquidity

Global wealth is estimated to have growth by 7.5% in 2006 to reach USD 97.9 trillion, according to the Boston Consulting Group. This is particularly true in the Gulf region, where demand for suitable investments is soaring due to the growing oil wealth.

Increased wealth and liquidity in the GCC countries due to soaring oil prices creating demand for suitable investment avenues

This growth in wealth and liquidity is driving demand for alternative forms of investment, and this demand is not restricted to the Muslim population of investors.

#### 4.1.3 Awareness and Understanding

The extent of the penetration that will be achieved by the Islamic financial institutions in the global market, and the speed at which it will grow depends on how well-informed investors are about the opportunities and products available, as well as whether the industry is viewed as being transparent and well-regulated.

Need for public awareness and understanding of products available

The industry needs to partake in aggressive marketing campaigns to raise awareness of Islamic products and services available on the market. Focus should be made on targeting non-muslims, highlighting Islamic products as other diversified investment products instead of a religious alternative to conventional products. Furthermore, research and development should lead to an increased variety of products and a deeper understanding of the market requirements in order to be able to deal with the evolving needs of customers, to compete in the global financial market.

### 4.2 Number of Islamic Banks and their Integration with the Existing Financial System

A growth in the number of Islamic banks will enlarge the number of players in the Islamic financial market. This will increase the level of competition, sparking a need for innovation to create new products and services. The large interest of international players in the industry is also heightening the attention of the global financial market, drawing in an ever-growing number of customers.

### 4.3 Variety of Products

In order for the Islamic markets to remain competitive, products must be introduced that meet the risk/return requirements of investors, fulfil the requirements of the Shari'a, offer opportunities of diversification, and remain cost-effective as competitive as compared to conventional products.

To be able to compete with conventional financial service providers, a wide variety of products need to be provided

In order to facilitate the expansion of the industry, products offered should be at least on a par with conventional products in terms of value and cost. By creating products in the Islamic financial services industry that are mere adaptations of products offered in the conventional financial market, the Islamic market will always come in second place. Reliance on the knowledge and expertise within the conventional market may inhibit innovation, creativity in the creation of new products, and the ability to draw customers away from the conventional market to the Islamic financial services industry.

### 4.4 Increased acceptance of Takaful

A key area of development of the Islamic financial services industry is Takaful. Insurance penetration (measured as insurance premiums as a percentage of GDP) in Muslim countries, and in the Middle Eastern and North Africa region as a whole, is very low. The World penetration rate is 7.5% while for Arab countries, the penetration falls below 4%, with the bulk of the countries registering a penetration rate of less than 2%. While a low per-household income and lack of awareness contribute to this low level of penetration, insurance, particularly in the form of life insurance, is hindered by the acknowledgement that conventional insurance products do not comply with Shari'a. The emergence and growth of takaful providers and services, accompanied by rising awareness of the importance of insurance, will create a demand, with ample room to expand. The effect of this will trickle over to other forms of Islamic services, boosting the industry further.

Expansion of takaful industry will spill over to other forms of Islamic services

## 5.0 INDUSTRY HURDLES AND BARRIERS TO GROWTH

### 5.1 Lack of Liquidity

Shari's-compliant instruments often revolve around financial contracts supported by physical assets. This makes the instruments highly illiquid and difficult to trade. Islamic financial institutions have little or no access to shari'a-compliant liquid short-term investment markets of any depth, making it difficult for them to manage any temporary excesses or shortages in liquidity. In the case of Murabaha contracts, for example, customers can make purchases without having to take out a loan and pay interest as the bank makes the purchase and resells the goods to the customer at an agreed upon mark-up. Thus the debt as an asset remains illiquid and non-tradeable.

Lack of vehicles through which to manage liquidity

Sukuks are also long-term in nature, despite the belief of the market that sukuk will in the future offer the way forward in terms of managing liquidity through a range of maturity profiles. Holders of sukuk often feel obliged to retain sukuk until maturity, which limits their secondary trading market. Furthermore, because sukuk issuances are often not rated, this negatively impacts liquidity too.

For banks, a key challenge is management of liquidity to maintain a balance between their short-term liabilities composed of deposits, and their long-term assets. Conventional banks use inter-bank money markets to resolve this issue; however, since these money markets are interest-based, Islamic banks cannot use them. This leaves Islamic banks predisposed to hold substantial amounts of liquid assets and excess reserves, exposing them to higher levels of market risk, and at a disadvantage to conventional banks in terms of long-term returns from investment portfolios. Furthermore, this impedes the deepening of the financial market and reduces profitability. The implementation of Basel II will introduce further challenges as it requires banks to provide capital according to the risk weighting of their assets.

Therefore, there is a definite need in the market for a 'last resort' lender, interbank instruments that may be actively traded, and the creation of Islamic hedging and risk management instruments.

Attempts have been made by Malaysia and Bahrain to overcome these hurdles; Mayalsia established the Malaysian Interbank Islamic Money Market in 1994, while the Bahrain Monetary Authority established the Liquidity Management Centre in 2002. Moreover, the International Islamic Financial Market was created to promote an international market endorsing global investment activities that are compliant with the Shari'a.

Efforts to enhance liquidity management have been made

### 5.2 Lack of Scale

Islamic financial service providers have yet to reach the scale needed to compete with conventional service providers and international companies and banks. In order to achieve economies of scale, a growth in the size of the industry is vital. The number of available Shari'a-compliant products has to increase in both size and variety to form a critical mass that will attract large numbers of investors, thereby creating a much needed breadth and depth for the industry that will make Islamic finance more attractive.

Achieving economies of scale necessitates the growth in size of the industry

Until this critical mass is reached, awareness in the global financial market regarding Islamic financial services will remain constrained, which will prohibit the growth of the industry. Increased awareness will create a demand for a broader range of Islamic products and services that are more suited to requirements at more competitive prices and via more convenient channels. This will impact further on the number of Islamic financial service providers that exist in the market, and will therefore enhance competition and the need to innovate.

In terms of equities, while these are traded on a number of global Islamic indices, because they will always be a segment of the wider market, the investor in Islamic equities will be at a disadvantage compared to conventional investors in terms of range of choice and associated risks and rewards.

### 5.3 Human Capital and Shari'a Scholars

Shortage of expertise in the industry and the number of shari'a scholars with an understanding of finance will hinder the sector's development

The fast rate of development and innovation in the Islamic financial services industry is applying pressure on the industry to develop a pool of expertise and talent in the market in order to cope with the rising demand for Islamic services, and the corresponding requirement for excellence in performance and productivity.

For the organic growth of the industry, alongside the requirement for innovation and creativity, qualified human capital is required. The shortage of such human capital operating in the Islamic financial services sector will hinder the progress of development of the sector.

Shari'a scholars in Islamic finance need to have a thorough understanding and knowledge of Shari'a principles in addition to a background in finance. Growth in the Islamic financial industry has far outpaced the increase in the number of experienced Shari'a scholars. Furthermore, the ever increasing sophistication and complexity of products that are emerging mean that very few Shari'a scholars have the technical background to understand and ensure compliance with the Shari'a.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has attempted to remedy this by offering various professional qualification programs, which include the Certified Shari'a Advisor and Auditor program and the Certified Islamic Professional Accountant program. Many other initiatives are also underway, including University courses specialising in Islamic finance, and conferences and workshops being offered across the glob.

### 5.4 Lack of Harmonisation in Shari'a Rulings

Lack of concurrence in what complies with the Shari'a negatively impacts the trust and confidence felt in the market

Shari'a is based on interpretation of the Quran rather than specified laws, meaning that the rulings of scholars on the methodology are affected by their own personal beliefs and understanding, in addition to culture influences. A lack of harmonisation in Shari'a rulings creates doubt and uncertainty in the industry which will negatively affect the trust and confidence needed within the market. Furthermore, disagreements between scholars on what complies with Shari'a and what does not suppresses progress. The recent efforts of the AAOIFI to resolve this by preparing Financial Accounting Standards and Shari'a standards should provide a vital resource on which judgements of compliance may be based. It is hoped that this encourage consistency and clarity in the sector. A standard of reference will facilitate the fast resolution of any issues of implementation.

### 5.5 Regulatory Issues

For the Islamic financial services industries to continue to flourish, the trust and confidence of the market in the Islamic system and the organisations offering such services will be a primary facet. Efficiency, reliability and transparency within the market, governance structures, and regulatory and supervisory factors all contribute to achieving that.

While efforts are being made by a variety of regulatory bodies, such as the IFSB and the Accounting and Auditing Organisation for Islamic Financial Institutions, a vital component of the regulatory environment of the industry is standardisation of regulations. A major impediment is that the regulators are frequently inexperienced and lacking in knowledge about Islamic finance.

Moreover, the laws governing Islamic products and services generally differ between countries, necessitating the need for cooperation and coordination between regulatory bodies. This will enhance the integration of the Islamic financial services industry into the global financial market.

## 6.0 ISLAMIC FINANCIAL SERVICES IN JORDAN

### 6.1 Sector Overview

Islamic financial services have, up until recently, been confined to Islamic banking. Islamic banking in Jordan first emerged on the scene with the establishment of the Jordan Islamic Bank in 1978. Since then, the Arab International Islamic Bank was established, and Islamic windows of conventional banks have appeared on the scene.

Islamic finance first appeared in Jordan in 1978 with the establishment of the Jordan Islamic Bank

The banking system of Jordan is governed by the Central Bank of Jordan, and the Islamic banking sector currently must comply with the Islamic banking regulations included as part of the overall Banking Law No. 28 of 2000. In accordance with the Banking Law, Islamic banks are required to appoint a board to be designated as the "Islamic Juriprudence Supervision Board" separate to the regular board.

Prior to this law, a Shari'a Law of 1978 had been created for the purpose of establishing Islamic Banks, and as a consequence, the Jordan Islamic Bank was established. In 1985, the Central Bank of Jordan issued a Jordan Islamic Bank for Finance and Investment Law of 1985 to govern the operations of the Jordan Islamic Bank, and to support Islamic banking in Jordan.

Jordan operates a dual banking system, with 2 fully-fledged Islamic banks; the Jordan Islamic Bank for Finance and Investment and the Islamic International Arab Bank (a wholly owned subsidiary of the Arab Bank Group). These two Islamic banks have succeeded in mobilising large amounts of funds that were previously hoarded by individuals that did not want to do business with conventional banks. Moreover, the banks have succeeded in claiming a sizeable share of the direct facilities and customer deposits in Jordan.. The Jordan Islamic Bank claimed a 10.1% share of the direct facilities in 2006 while the Islamic International Arab Bank claimed 3.2%.

Jordan operates a dual banking system

As compared to 2002, the Islamic banking sector assets increased by an impressive 80% from JD 1.14 billion to JD 2.04 billion in 2006, compared to a 60.3% growth in the consolidated assets of the licensed banks in Jordan, highlighting the growth in the sector. The level of customer deposits also soared by 115.9%, reaching JD 444.13 million compared to JD 205.68 million in 2002, compared to a growth in the sector of 68.8%. Furthermore, profits have risen exponentially over the same period reaching JD 23.46 million in 2006 compared to JD 3.84 million five years prior. This impressive performance of the sector has spurred the Industrial Development Bank of Jordan to begin the process of converting to an Islamic bank.

In 1996, the first Islamic insurance provider was established, the Islamic Insurance Company. However, despite this long-standing Islamic presence in the Jordanian market, it was only in the last few years that the market has witnessed a divergence towards Islamic finance. In 2005, the Arab American Insurance Company altered its purposes to become compliant with the Shari'a, while in 2007, the First Insurance Company was established as a takaful insurance provider, taking up the number of takaful operators in the market to three.

The number of takaful providers have increased in recent years...

In terms of the financial investment services sector, this has also seen new companies arrive in the market, including First Finance and Al-Sanabel International. Tamweelcom, a Jordanian company offering microfinance has announced plans to open a new branch that will offer loans to finance small projects in accordance with the Shari'a.

...as have investment service providers

## 6.2 Key Players in the Market

### 6.2.1 Islamic Banks

#### Jordan Islamic Bank for Finance and Investment (JOIB)

The Jordan Islamic Bank for Finance and Investment was established in 1978 as a public shareholding company with the purpose of offering financing, banking and investment services in accordance with Shari'a principles. The Bank's paid-up capital was increased numerous times to reach a current level of JD 35 million.

The Bank offers a number of services through its 66 branches and offices, including the acceptance of deposits in current and demand accounts, and joint investment accounts such as savings, notice, fixed accounts, Mudaraba, and restricted investment accounts. It also offers direct financing though Mudaraba, Musharaka, Murabaha, direct investment, Istisna, and leasing resulting in the transfer of ownership.

Since its establishment, Jordan Islamic Bank has succeeded in positioning itself amongst the largest banks in Jordan in terms of asset size, with the total assets in 2006 reaching JD 1.46 billion.

| | |
|---|---|
| Net Income (2006) | JD 15,472,506 |
| Net Income (Q3 2007) | JD 17,629,085 |
| Share Price (31st December 2007) | JD 5.75 |
| EPS (2006) | JD 0.241 |
| EPS (Q3 2007) | JD 0.271 |
| Forward P/E (times) | 15.91x |
| Trailing P/E (times) | 23.86x |
| Trailing P/BV (times) | 3.20x |

#### Islamic International Arab Bank

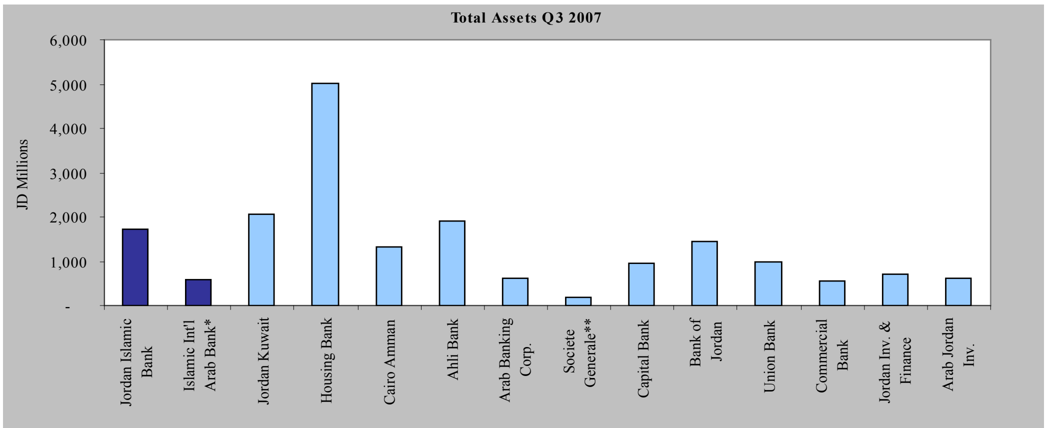
The Islamic International Arab Bank was established in 1997 as a public limited shareholding company, and commenced operations in 1998 in accordance with Islamic Shari'a. Through its 11 branches in Jordan, the Bank offers a number of services including the acceptance of deposits in current and savings accounts, share investment accounts, specialised investment accounts and Nama' Al-Aqari accounts (a type of savings account, with a minimum investment requirement of JD 3 thousand, and a one year investment period) .

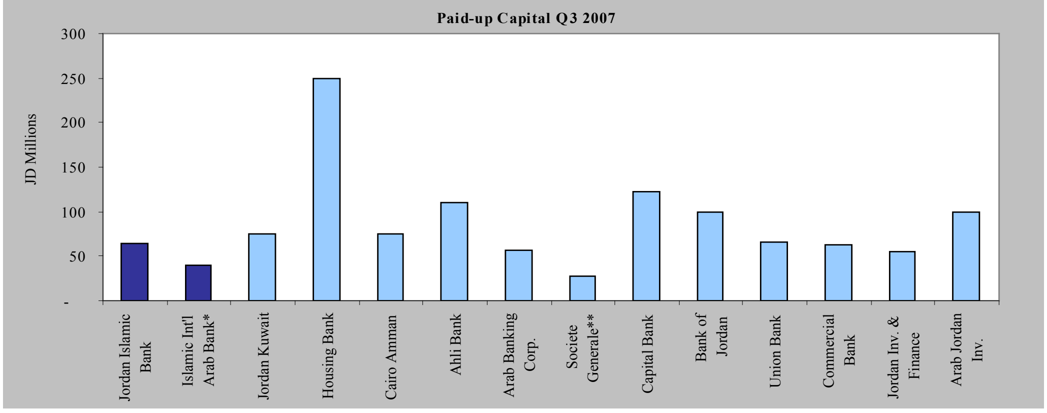
The Bank also offers direct financing through Murabaha, leasing (Ijara), Mudaraba, Musharaka and Istisna.

| | |
|---|---|
| Net Income (2006) | JD 7,990,691 |
| Net Income (Q3 2007) | N/A |
| Share Price (31st Dece,ber 2007) | N/A |
| EPS (2006) | JD 0.200 |
| EPS (Q3 2007) | N/A |
| Forward P/E (times) | N/A |
| Trailing P/E (times) | N/A |
| Trailing P/BV (times) | N/A |

#### 6.2.1_1 Market Share

A consideration of the share of the total assets and paid-up capital of the banks in the Jordanian market indicates that in terms of total assets, the Jordan Islamic Bank ranked amongst the largest five banks in the sector - the Arab Bank has been excluded from the below graphs due to its size being substantially larger than the remaining banks in the sector, in order to enable a clearer illustration. The Islamic International Arab Bank, on the other hand, is one of the smallest banks in the sector, with only the Jordan Commercial Bank and Societe Generale Banque ranking lower.



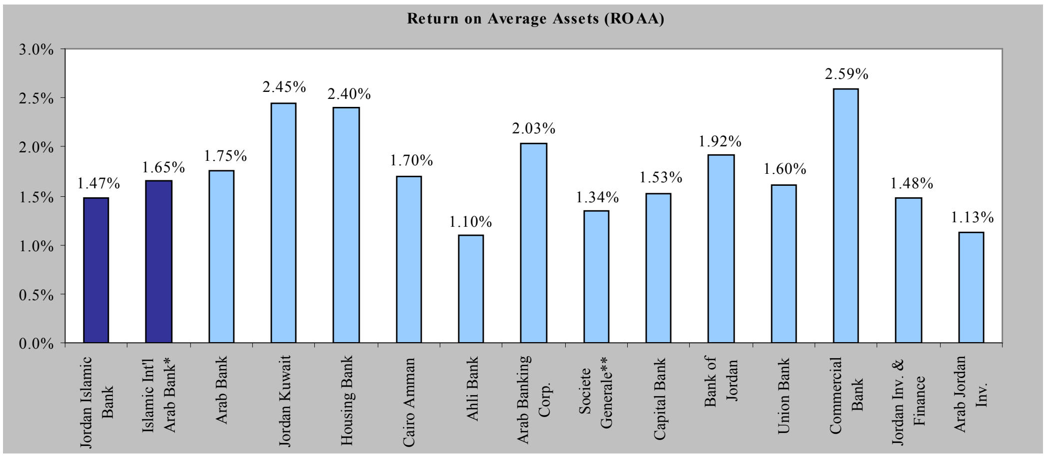




* Total assets and paid-up capital for the Islamic International Arab Bank are as of December 31st 2006
** Total assets and paid-up capital for Societe Generale are as of June 30th 2007

In terms of the paid-up capital, both Islamic banks fall below the average paid-up capital for the sector.

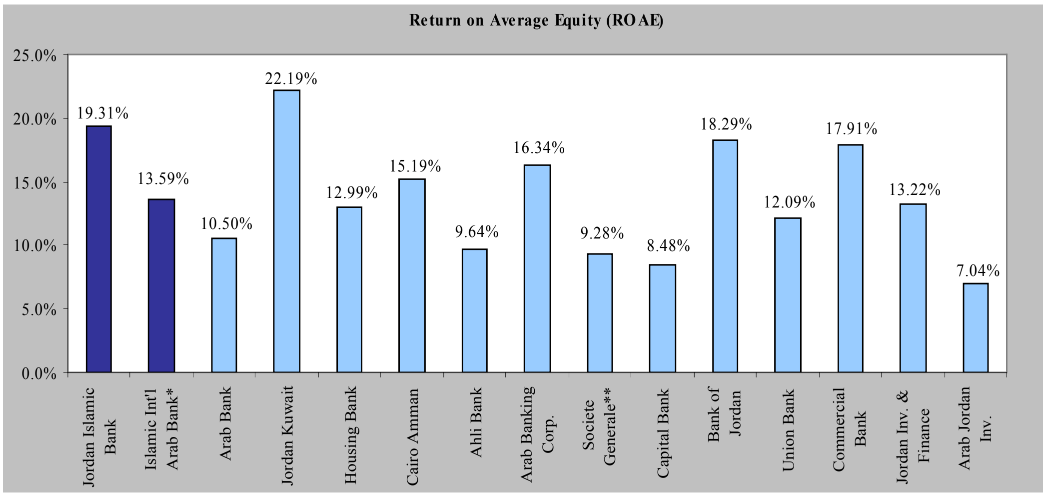
### 6.2.1_2 Profitability

In terms of profitability, a look at the Return on Average Assets (ROAA) of the Jordan Islamic Bank and the Islamic International Arab Bank indicates a below average performance for both banks, with their ROAA falling below the sector average ROAA of 1.74%.




Returns based on Q3 annualised earnings
* Average assets based on December 31st 2006 and 2005 average, and returns based on December 31st 2006 figures.
** Assets and returns for 2007 are based on June 30th 2007 figures

The Return on Average Equity paints a different story for the Jordan Islamic Bank which ranked second after the Jordan Kuwait Bank, with an ROAE of 19.37%, far above the sector average of 13.74%. The International Islamic Arab Bank achieved an ROAE of 13.59%, just slightly below the sector average.




Returns based on Q3 annualised earnings
* Average equity based on December 31st 2006 and 2005 average, and returns based on December 31st 2006 figures.
** Equity and returns for 2007 are based on June 30th 2007 figures

A key point to highlight with regards the Return on Average Equity, however, is that of the banks included in the sector average, seven increased their paid-up capital during 2007. This increase will have the effect of reducing their ROAE due to the increase in the shareholders' equity as a result of the raised capital, but an unmatched rise in the profits, due to insufficient time for the additional capital to take effect on the banks' operations. Therefore, the ROAE of these banks may be substantially understated compared to reality, meaning that the sector average is likely to be much higher than the 13.74% recorded above.

### 6.2.2 Takaful Insurance

#### The Islamic Insurance Company (TIIC)

The Islamic Insurance Company was established in 1996 as a public shareholding company. Its purpose is to participate in insurance and investment activities in accordance with the Shari'a. The Company offers both general insurance and life insurance.

The Islamic Insurance Company has raised its capital gradually over the years to reach JD 8 million in the third quarter of 2007.

| | |
|---|---|
| Net Income (2006) | JD 421,520 |
| Net Income (Q3 2007) | JD 627,586 |
| Share Price (31st December 2007) | JD 1.54 |
| EPS (2006) | JD 0.053 |
| EPS (Q3 2007) | JD 0.078 |
| Forward P/E (times) | 14.81x |
| Trailing P/E (times) | 29.06x |
| Trailing P/BV (times) | 1.19x |

#### Arab American Takaful Insurance Company (Baraka Takaful) (ARAI)

Established as the Arab American Insurance Company, a public shareholding company, in 1996. In 2005, the Company changed its name to the Arab American Takaful Insurance Company, and the purposes of the Company were altered to become compliant with the Shari'a, offering takaful insurance under its new trade name "Baraka Takaful". The Baraka Takaful offers non-life insurance and reinsurance services. The Baraka Takaful raised its capital over the years to reach JD 6 million as of June 30th 2007.

| | |
|---|---|
| Net Income (2006) | JD (1,076,693) |
| Net Income (H1 2007) | JD 1,396,291 |
| Share Price (31st December 2007) | JD 1.73 |
| EPS (2006) | JD (0.181) |
| EPS (H1 2007) | JD 0.235 |
| Forward P/E (times) | 3.68x |
| Trailing P/E (times) | Negative |
| Trailing P/BV (times) | 2.59x |

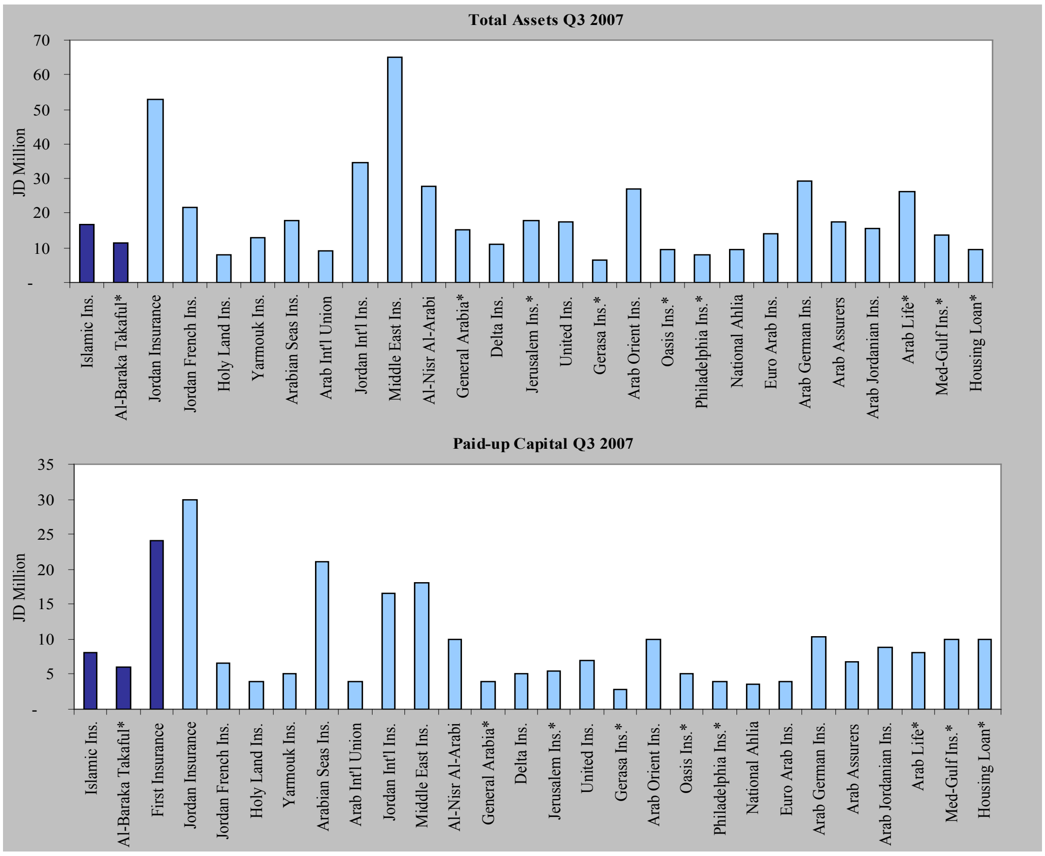
### First Insurance (FINS)

First Insurance was established on December 28th 2006 with a paid up capital of JD 24 million. The initial public offering of the Company took place in May 2007 offering 6 million shares to the public for subscription. The purpose of the Company is to offer general Islamic 'sharing' insurance in accordance with the Shari'a principals.

To date, there are no financial statements issued for the Company.

### 6.2.2_1 Market Share

A consideration of the share of the total assets and paid-up capital of the insurance companies in the Jordanian market indicates that in terms of total assets, the takaful providers are relatively small, falling below the sector average.

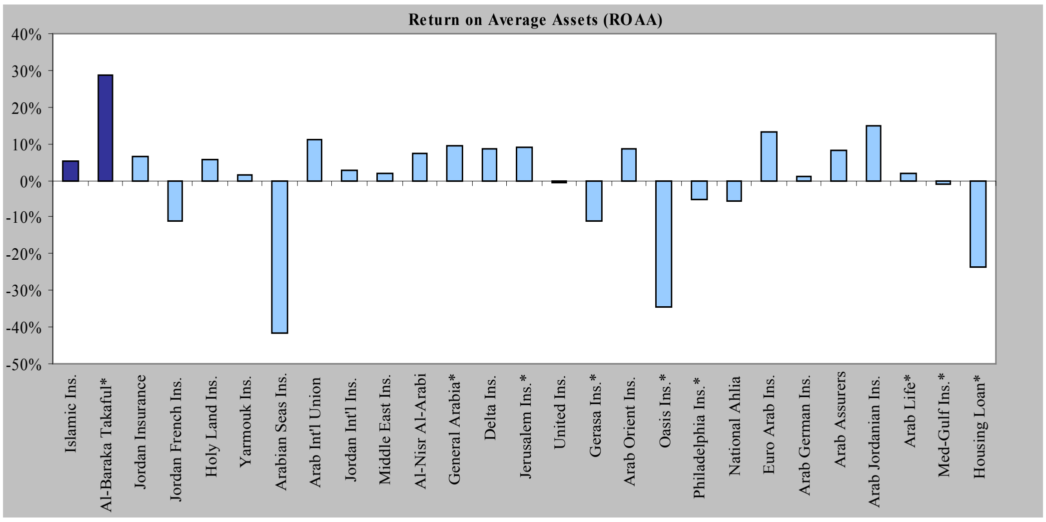



* Total assets and paid-up capital are as of June 30th 2007

The case was much the same for the paid-up capital, with the Islamic Insurance Company and Al-Baraka Takaful having a paid-up capital less than the sector average. First Finance, however, a new company established in 2007 offering takaful products, ranked as the second largest in terms of capital, with JD 24 million. A lack of reported financials means that we cannot compare the company's assets to the sector, however, we would expect that First Finance would claim a sizeable share of the assets.

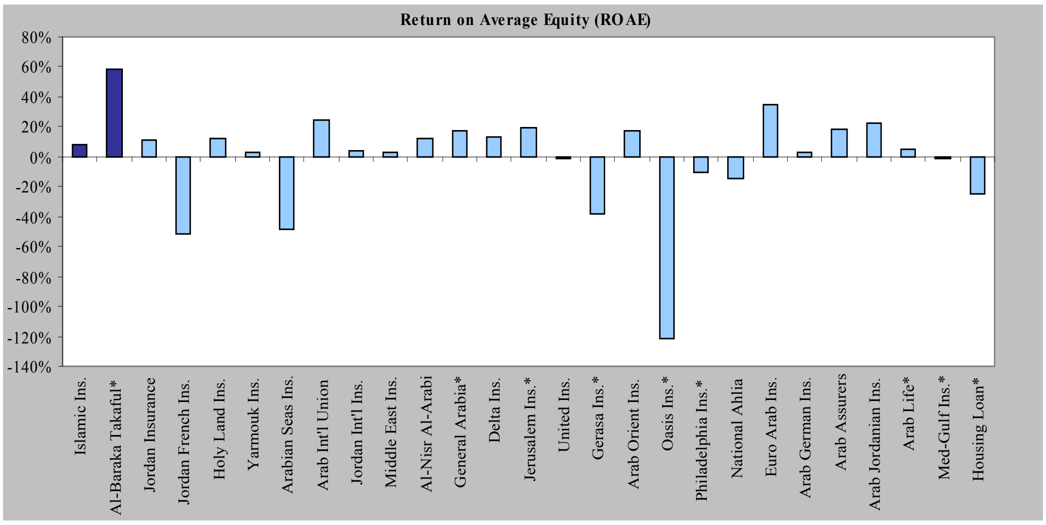
### 6.2.2_2 Profitability

In terms of profitability, a consideration of the Return on Average Assets reveals the Al-Baraka Takaful as having the highest ratio in the sector at almost 30%. Worth noting, however, is that the technical profitability of Al-Baraka Takaful is negative, which means that the company actually incurred losses from its core operations. The high returns, however, were made from returns on their investment portfolios.




In the insurance industry in recent years, this is not unusual, with many of the insurance companies in the market incurring losses overall, or from certain parts of the insurance.

In terms of Return on Average Equity, the case was much the same, with the Al-Baraka Takaful being the market leader, and the Islamic Insurance incurring positive returns.



### 6.2.3 Other Financial Services

### Al-Amin Company for Investment (AAFI)

Al-Amin Company for Investment was established as a public shareholding company in 1995. Its activities include investing in stocks, bonds and financial securities, in addition to investing in a variety of sectors in accordance with the Shari'a.

| | |
|---|---|
| Net Income (2006) | JD (1,962,444) |
| Net Income (Q3 2007) | JD 791,321 |
| Share Price (31st December 2007) | JD 2.16 |
| EPS (2006) | JD (0.219) |
| EPS (Q3 2007) | JD 0.089 |
| Forward P/E (times) | 18.20x |
| Trailing P/E (times) | Negative |
| Trailing P/BV (times) | 1.49x |

### Al-Sanabel International for Islamic Financial Investment (SANA)

Al-Sanabel International was established in 2006 as a public shareholding company with a paid-up capital of JD 20 million. The company is a financial services company providing financial products and services in compliance with the Shari'a, including corporate finance, asset management, direct investment, brokerage and financial advisory services.

| | |
|---|---|
| Net Income (2006) | JD (117,713) |
| Net Income (H1 2007) | JD (85,616) |
| Share Price (31st December 2007) | JD 1.24 |
| EPS (2006) | JD (0.006) |
| EPS (H1 2007) | JD (0.004) |
| Forward P/E (times) | Negative |
| Trailing P/E (times) | Negative |
| Trailing P/BV (times) | 1.25x |

### First Finance Company (FIFI)

First Finance Company was established in 2006 as a public shareholding company with a paid-up capital of JD 50 million. Its primary activities include financing in accordance with the Shari'a, to include direct financing, real estate financing and project financing. The company also offers financial management and consultancy services, in addition to management of property and real estate services.

| | |
|---|---|
| Net Income (2006) | N/A |
| Net Income (H1 2007) | JD 2,248,354 * |
| Share Price (31st December 2007) | JD 1.29 |
| EPS (2006) | N/A |
| EPS (H1 2007) | JD 0.045 * |
| Forward P/E (times) | 21.50x * |
| Trailing P/E (times) | N/A |
| Trailing P/BV (times) | 1.23x ** |

* Based on earnings from date of establishment (March 2006) to June 30th 2007
** Based on Book Value as of June 30th 2007

## 7.0 OUR PERSPECTIVE ON THE MARKET

The astounding growth of the Islamic financial services industry highlights the huge potential of the sector, with a large untapped market globally and burgeoning liquidity levels, particularly in the gulf states. The excess petro-dollars resulting from soaring oil prices in Muslim countries, alongside a recent predilection towards expression of Islamic identity, are helping to fuel the demand for Shari'a-compliant investment channels.

Competition is heating up in the industry with global players entering the market, fighting for a share of the pie. The interest shown by reputable financial institutions alongside the hype in the market regarding Islamic finance has also drawn in a sizeable portion of non-muslim investors, who found in the industry an array of products through which to diversity their investment portfolios.

While the performance of Islamic finance has been impressive thus far, the challenges faced by the industry must be met directly and swiftly if it is to have a sustainable chance of survival alongside conventional finance in the long run. The characteristic of being Shari'a-compliant alone will be insufficient to uphold the interest of global investors and attract investment. Customers demand competitive, sound, and profitable investment avenues. To achieve this, research into Islamic finance must be emphasised for the continual development of new products and services at competitive prices. Moreover, market analysis must be carried out to monitor the changing demands of the customers in order for the industry to evolve and cater to them.

Calls are being made for the standardization of products and services on a global front, in addition to fiqh convergence. As the industry continues to grow, efforts into designing a suitable infrastructure to support the growth and development of the industry must be made. Fairness and trust are vital components in the success of the Islamic financial system, and steps must be taken to ensure the transparency of the industry.

A variety of regulators and institutions already have plans and initiatives under way to ensure the smooth and efficient functioning of the industry as a whole, and standardization of regulations and reporting standards.

Going forward, marketing campaigns will be a key component of the strategies of Islamic financial service providers, raising awareness and knowledge of the products and services available. Financial institutions will have to work hard on building and maintaining customer relationships and gaining their loyalty. Moreover, products must be developed to create a wider range of diverse products with varying maturities and risk levels.

In terms of Islamic banking, it is likely that we will begin to see mergers and acquisitions taking place between banks, as Islamic banks fight to maintain and increase their market share and resist against the competition posed by the world leaders in finance, such as Citigroup, HSBC, Deutsche Bank and Standard Chartered who have entered the Islamic financial services market. While the increased competition may force smaller and less competitive local players out of the market, these experienced leaders will benefit the industry through their experience and innovation in creating new products, in addition to transfer of know-how and knowledge to local players, in addition to gaining the confidence of customers in the industry.

In Jordan in particular, awareness and interest in Islamic finance is still minimal. While the population of Jordan stands at almost 6 million capita, with the majority comprising of muslims, the Kingdom tends to have a slightly less affiliation to Shari'a compliance comparing to some of the neighbouring countries and the GCC. However, the recent announcement of the conversion of the Industrial Development Bank to an Islamic bank suggests expected high demand for Islamic products in the market. The strong performance of the two existing Islamic banks in recent years indicate that Islamic banking has located a niche in the market where it can grow, although it is expected that the growth will be slower than in other neighbouring countries.

Due to the low penetration rate of insurance in Jordan, takaful has vast opportunity to grow. The rising awareness of the importance of insurance, and the increasing per-household income should lead to a gradual uptake of takaful.

In the short term, we would expect the Islamic financial services sector to grow at a slow pace, with the bulk of the growth arising in the banking segment. In the longer term, we would expect the Islamic financial service providers to capture an increasing portion of the market share, while maintaining a dual system of conventional and Islamic services for both banking and takaful.

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