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Does nature trump nurture? As the Islamic Finance industry moves beyond the infancy stage of the last decade, we consider the neighborhood in which the industry has grown up to date and reflect on whether it may have contributed to the challenges, or 'growing pains,' namely lack of development and innovation, that the industry is experiencing today.

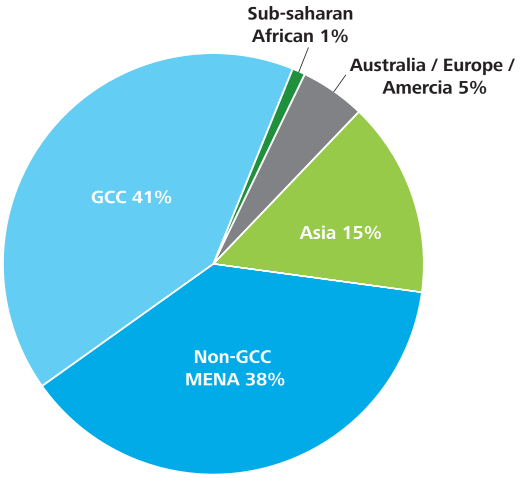
A child star

The Islamic Finance industry arguably receives a disproportionate amount of media attention relative to its size and activity, so it is often easy to forget that the advent of Islamic Finance as we know it today is a relatively new phenomenon dating back just a few decades.

The principles of Islamic Finance – its DNA so to speak – have remained unchanged since the dawn of Islam. The modern incarnation of Islamic Finance, however, has gone through a significant amount of 'growing up' and has done so, to a significant extent, within the environment of the financial sectors of developing economies, most notably in the Middle East.

In 2010 the Middle East North Africa (MENA) region accounted for almost 80% of total Sharia'a-compliant invested assets, with just over half of these in the Gulf Cooperation Council (GCC) countries. Consequently, the development of Islamic Finance has been impacted by the general state and stage of development of the financial sector in the Middle East.

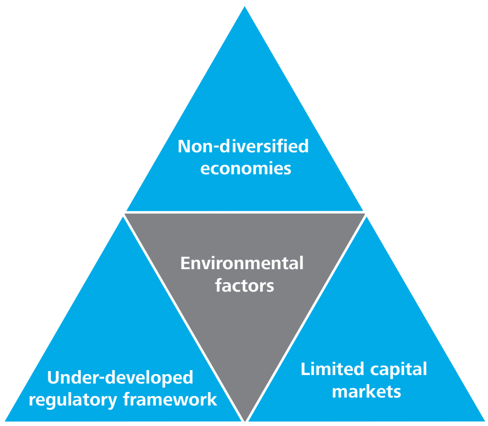
Breakdown of Islamic Finance Assets by Geographic region (2010)



Source: *The Banker* and Maris Strategies

Growing up in the GCC

The development, in recent years, of the financial sector in the GCC has been unprecedented, with the development of financial centers that have attracted global financial institutions. Despite this quantum leap in progress, there are still environmental factors that have affected development and constrained innovation and progress, of which three are highlighted below.

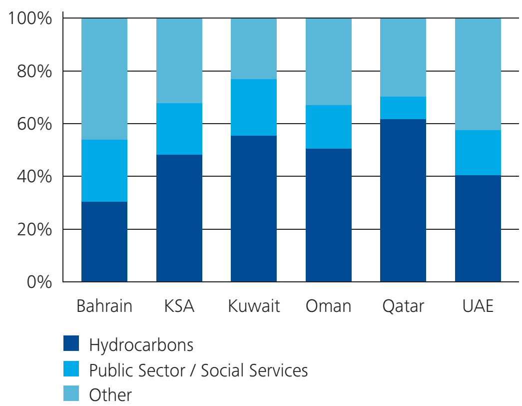


Source: Deloitte

1. Non-diversified economies – "Where can we play?"

The economies of the GCC region clearly have a strong leaning towards the hydrocarbon sector, resulting in non-diversified regional economies. As the chart below demonstrates, the hydrocarbon sector continues to be a key contributor to GDP in the region.

GCC hydrocarbon dependence (% of nominal GDP)



Source: National Authorities and Deloitte analysis

Hydrocarbon dependence, coupled with a large public sector, leads to a limitation of the areas investors and financiers can seek exposure to. When the region was awash with liquidity in the pre-financial crisis days, the Islamic Finance industry followed the general trend of participating in the asset price bubble that manifested itself in the real estate markets of the region.

With the financial crisis ending that chapter, the call for Islamic financial institutions to diversify away from real estate is not one that has an easy solution. As other sectors and industries, though present locally, lack depth and are relatively crowded out by the state and the energy sector, investors cannot help but question 'diversify into what?'

2. Underdeveloped legislative framework – "Do we have the kit?"

The regulatory frameworks of many GCC countries continue to pose considerable impediments to the development of the Islamic Finance industry. If regulatory outcomes are uncertain or if there is an absence of essential legal frameworks such as bankruptcy laws and the ability to enforce contracts, market participants will be hindered in their ability to innovate. This void is increased when considering the additional features that Sharia'a-compliant contracts and arrangements require and that are different to conventional financial arrangements.

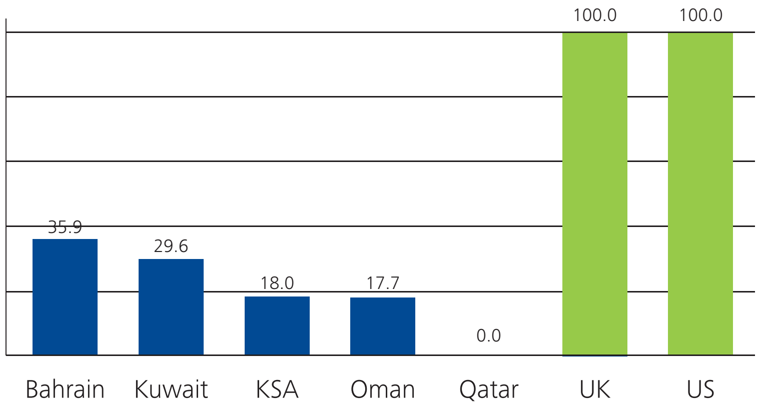
Of the 183 countries ranked in the "Doing Business" index conducted by the World Bank in 2011, only Qatar from the GCC was ranked within the top 100 as regards the enforcing of contracts.

GCC Economy	World Ranking for enforcing contracts (out of 183)
Qatar	95
Oman	104
Kuwait	114
Bahrain	117
United Arab Emirates	134
Saudi Arabia	140

Source: Doing Business 2011 Rankings, IFC and World Bank

Only in the recent past have institutions such as credit bureaus begun to emerge. Such institutions are vital for the finance sector as they enable increased operational sophistication and help companies to adequately assess risk. The following graph shows the private credit bureau coverage in the GCC and highlights the percentage of individuals and/or firms already assessed by a private credit bureau.

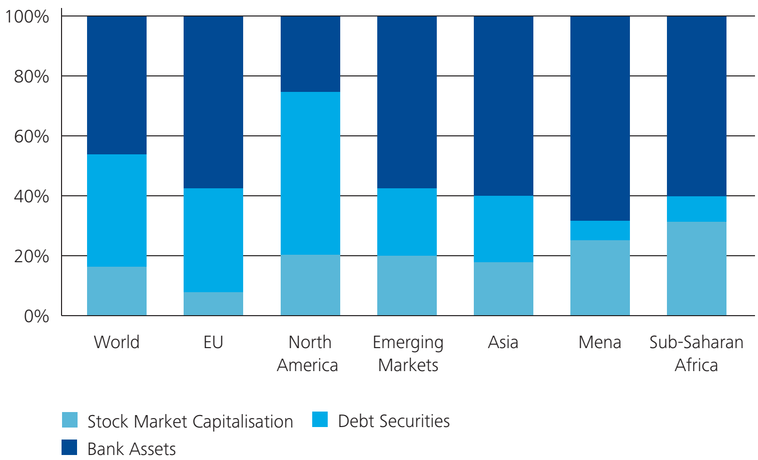
Percentage of adult population listed by a private credit bureau 2010



Source: Doing Business 2011 Rankings, IFC and World Bank

In the absence of meaningful market activity in debt capital markets, the banking sector clearly rules

Breakdown of capital markets by geographical region



Source: IMF and Deloitte Analysis

Encouragingly, the situation is continuing to improve year on year with increased coverage throughout the region and more countries enhancing their frameworks, such as the Qatari Central Bank that launched the "Qatar Credit Bureau" in March 2011.

3. Underdeveloped capital markets – "What is there to do?!"

The under-development of regional debt capital markets relative to other sources of finance has had a profound ripple effect on the Islamic Finance industry. The extent of the gap is best demonstrated by the graph on left, which shows debt securities in the MENA region accounting for approximately 6% of total capital funding sources compared to a world average of approximately 35%.

In the absence of meaningful market activity in debt capital markets, the banking sector clearly rules. The banking sector, stifled by the environmental factors illustrated, has adopted a relatively conservative approach to banking, with collateralized lending featuring heavily.

Amongst the resultant outcomes is that the human capital within the financial sector of the region adopts a particular mindset and approach, not generally conducive to innovation, which the Islamic Finance industry badly needs. Furthermore, corporate entities have limited opportunities to explore different funding sources. For example, despite all the hype surrounding Sukuk (Sharia'a-compliant bonds), there has been relatively little in the way of non-sovereign related entities issuing fixed income securities in the region.

The graph also shows that equity capital markets continue to dominate in the MENA region, even if they lack the scale and maturity of other stock markets around the world. The World Bank estimated that at the end of 2009, the combined market capitalization of all the companies listed on all the stock exchanges in the GCC, at USD 640 billon, was just one quarter of the size of the combined capitalization of companies listed on the UK stock exchange alone (USD 2,796 billion).

Impact on the Islamic Finance industry – "The company they keep"

Some of the consequences on the Islamic Finance industry being nurtured in such an environment have already been described. One of the biggest challenges facing the industry today continues to be the lack of suitable asset classes that truly meet the needs of industry participants, such as Takaful companies and fund managers. It is reasonable to conclude that a factor of why a large proportion of Sharia'a-compliant funds are currently invested on a Murabaha/Tawarruq basis between financial institutions is also due to the combination of factors highlighted.

The inference is that the lack of product innovation within the industry is significantly attributable to the environment in which it has evolved, which has limited the potential for the creation of viable Sharia'a-compliant alternatives.

Lessons from abroad – An (overseas) education

The Islamic Finance industry has already benefited from taking lessons from outside the region, with London and Luxembourg being two key conventional financial centers where much activity has taken place. Within its own fraternity, Islamic Finance has also achieved much progress in Malaysia.

In the same way that students studying abroad deepen their experience and skill sets, the Islamic Finance industry has flourished in more conducive financial and regulatory environments that have helped foster innovation and development. However, like all students, there is a time to return home and transfer newly-acquired skills to the local market.

Neighborhood regeneration

The Islamic Finance industry will benefit from reform in its home territories that address general environmental challenges. The panacea for structural challenges will differ and have different lead times to achieve. The positive outlook is that the GCC countries have acknowledged the issues hindering progress and are, encouragingly, seeking to implement measures in this regard.

The Islamic Finance industry will undoubtedly benefit as the neighborhood in which it predominantly resides experiences the fruits of such measures.

by **Dawood Ahmedji**, Islamic Financial Advisory Services leader, Deloitte in the Middle East