THE FINANCING CHALLENGE

The financing challenge

Islamic finance could provide much-needed stability in the banking sector

There is a view that, had the world banking system operated on the principles of Islamic finance, the meltdown would not have occurred; financial instruments based on toxic sub-prime mortgages would not have been allowed. David Testa, CEO of Islamic finance group Gatehouse Bank, explains to Nigel Ash the opportunities that Shari'ah law can offer to corporate finance and how it can help leaders cope in a recession.

The $800 billion volume of Islamic finance is a fraction of global financial activity and the sector has its own complexities as Islamic scholars debate the legitimacy of proposed products. However, as London bids to become the international centre for Islamic finance, mainstream banks including Standard Chartered, HSBC and Deutsche Bank have set up their own Shari'ah operations.

'The global banking scene will not be recognisable over the next decade from what we've just been through over the last 15 years,' says David Testa of Gatehouse Bank. 'In my view it is going to be completely different and will be much more conservative. This is why I see a bright future for Islamic finance.'

Despite the perceived limitations of Shari'ah-compliant financial structures, he believes Islamic products will resonate

Essentials

- Businesses and regulators are beginning to offer a better reception to Islamic finance.
- The challenge facing the sector is the consistency of funding structures and the general acceptance of their legitimacy.
- A large investor base, predominantly in the Gulf region, beginning to look for new opportunities, and corporates across the West anxiously looking for new funding sources present opportunities for Islamic finance.

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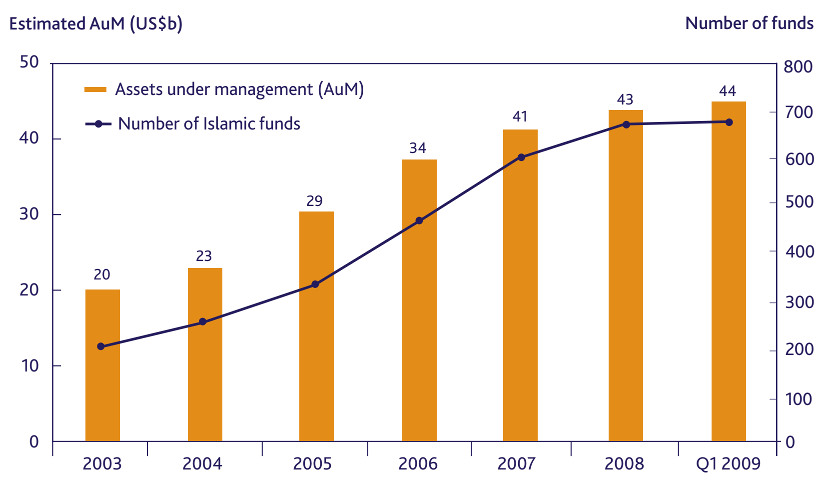
The sovereign UK sukuk that never was

When he was chancellor, Gordon Brown was looking seriously at a benchmark sukuk (bond) issue of between £500,000 and £2 billion. Testa says that, like many sukuk deals, half of the investors would probably have been non-Islamic. Though disappointed, he was not surprised that the idea was abandoned when Brown became premier. 'I suspected a year before that it was not going to work. When Brown succeeded Blair and Ed Balls moved up from the treasury, a lot of the impetus went away. I think the civil servants in the treasury never liked the idea.'

Testa believes that the Debt Management Office should have been looking at all options and should not have put the sukuk in the "too difficult" box. Had the first UK sukuk succeded, it would probably have secured London's position as the new Islamic Finance market, upstaging the claims made chiefly by Malaysia, whose sukuk business has suffered in the recession.

The UK remains the only country in Europe or North American to license Islamic banks. Changes are being made in French law and Testa says that three applications from Islamic finance houses are awaiting legislation. Post 9/11, the US recoiled from tentative moves to license Islamic banks but President Obama's Cairo speech, reaching out to the Muslim world this June, may provoke attitudes in Washington to change.

FIGURE 1. GLOBAL ISLAMIC FUNDS INDUSTRY



Source: *Eurekahedge, Zawya, Ernst & Young analysis*

in the new financial and regulatory environment: 'The key factors in their favour are that there will be no complex derivative structures and no short selling, simply investing in real economy assets.'

Testa believes that businesses are already starting to offer a better reception to Islamic finance mechanisms and so too are regulators. 'This is because our products are innately conservative and avoid the infinite leverage model, which has got us all into so much trouble. They avoid the multi-layered synthetic structures of derivatives, in this case collaterised debt obligations (CDOs) and collaterised loan obligations (CLOs), that have caused so much difficulty because they are so non-transparent.' CDOs and CLOs are asset-backed securities contracts traded between private parties and are therefore not subject to the same scrutiny as exchange-traded derivatives.

Testa is not, however, among those who believe absolutely that a far wider application of Shari'ah finance would have headed off the banking collapse. Indeed banks run on Islamic principles have not been without their own troubles. In the Gulf in particular, these institutions took their investors into property, either directly through loans or indirectly via private equity for property companies. With the popping of the property price bubble throughout the region investors are facing substantial losses. The Shari'ah-based principles of shared risk, the upside and downside are, however, sometimes honoured in the breach. Many banks keep 'profit equalisation reserves' to compensate depositors, at least to a certain extent. These reserves are likely to come under closer scrutiny in the light of recent protests by scholars that a bank's guarantee to pay out the face value of a sukuk (Islamic bond – see box, right), even if the issuer defaulted, was not acceptable, because it ignored the requirement that risk must be shared.

'Islamic commentators would all say that equity investment is really the only true Shari'ah compliant investment,' says Testa, 'but I don't fully go along with that. What I would say is that equity investment is the easiest to fit into Shari'ah principles. However, if Islamic banks and Islamic finance want to play a significant part in the global economy, they do have to create fixed income or debt-equivalent products because the world economy cannot be sustained by equity alone.

'Businesses and entrepreneurs are not going to want to share all of the up-side with the financiers. It's as simple as that. Moreover there are a lot of deals where equity is simply not going to work for a very wide audience. So you do have to work hard. The dynamic in Islamic finance has been to get the leverage equivalent product to be Shari'ah compliant and that is an on-going process.'

'If Islamic banks and Islamic finance want to play a significant part in the global economy, they do have to create fixed income or debt-equivalent products.'

Because the sukuk is generally held by the original investors, there is no liquid secondary market and therefore no reference generated for corporate debt. Testa accepts that, for the finance function in multinational companies, this reduces the attraction of tapping the Islamic market. 'I would imagine that international companies wanting to do a benchmark deal in Europe would find that a disadvantage. Islamic finance is not a solution for such businesses unless it is something like a small private placement that fits in a particular piece of a larger jigsaw puzzle.'

Private equity is indeed, he says, a key area, especially for smaller Islamic institutions like Gatehouse: 'There's huge interest at present. It is something we're very active in.

'You have got to keep to the demands of the market and play to the strengths of the more innately conservative principles of Islamic finance.'

Skills and training

There may not yet be a shortage of investment bankers with the skills and knowledge to structure Sukuk deals. However, if the market takes off, as Gatehouse and the other four UK Islamic houses believe it will, there may be a skills problem.

With this potential shortfall in mind, in 2007 CIMA, supported by HSBC Amanah, became the first international chartered accountancy body to offer a global Islamic finance qualification.

For more information, visit www.cimaglobal.com/islamicfinance

We have a lot of investors who are very keen to do direct investments. They are not being aggressive right now but we all know that the private equity world is under a huge amount of stress. Deals are going to go under. There's going to be quite a lot of bargain hunting in the second half of the year and then you may see more activity.'

So where does Testa believe that Islamic finance can contribute to leading us out of the downturn? There is, he says, a large investor base, predominantly from the Gulf, which is beginning to look for new opportunities. Meanwhile corporates are anxiously looking for new funding sources.

'My view,' says Testa, 'is you have got to keep to the demands of the market and play to the strengths of the more innately conservative principles of Islamic finance – the asset-based and asset-backed nature of the financing structures, the resilience of the Gulf investors, the improvement in the oil price and the fact that now it's beginning to be a little bit above where most people had budgeted. All of these things are good news for the Gulf and Islamic finance.'

He adds: 'What I am seeing; which I don't particularly like very much, is some people seeking the moral high ground and saying, "Well of course with Islamic finance in place we'd never have been in the global meltdown that we're in". I don't like it being put in that way; I just think the time is right for Islamic finance to really show what it can do. A lot of what it is based on is sustainable and viable for getting us through these current problems and putting us in a more sustainable basis for the future.'

David Testa

David Testa worked for WestLB from June 1997 until joining Gatehouse as CEO in July 2007. He has had extensive experience since 1999 of originating and arranging a wide variety of conventional and Islamic transactions in the Gulf Cooperation Council.