mashreq المشرق

MEED-Mashreq Islamic Finance Business Leaders Forum

Facilitating Growth

April 2023

MEED
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Foreword

Experts emphasise the role Islamic finance can play in achieving business ambitions

As economies in the GCC regain their strength after the challenges of recent years, Islamic finance too is growing in tandem.

Benefitting from higher oil prices and limited inflationary impact, the sector is expected to continue its upward trajectory in the coming months. Credit analysts S&P Global Ratings forecast 10 per cent growth over the coming year.

Experts, however, argue that the industry is yet to achieve its full potential. Despite the strong growth witnessed in recent years, issues such as a lack of clarity on Shariah-compliance, limited innovation and slow evolution of financial instruments hinder the speed of growth.

At the same time, the prospect for change is enormous. The parallels between Shariah-compliant instruments and the emerging demand for ESG-focused finance serves as a substantial opportunity for the sector to embrace.

Moreover, there is appetite to embrace new age financial technology, or fintech, to improve accessibility to finance.

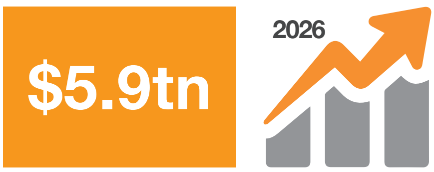
Even more significant is rising support from governments, compliance authorities and banking regulators to expand Islamic finance to broader sections of the economy. A key enabler in this case is financial technology or fintech, which is allowing Islamic finance solutions to reach a broader audience globally.

On 7 December 2022, MEED and Mashreq brought together leading experts in an exclusive, invite-only session to discuss how Islamic finance can support business growth, underpinned by ethical, equitable and sustainable lending values. This report captures high-level insights from the event.

Islamic finance presents $6tn opportunity

Digitalisation and alignment of Islamic products with sustainability is opening up new avenues for growth

GLOBAL ISLAMIC FINANCE INDUSTRY



EXPECTED GROWTH FROM $4TN IN 202

*Source:
Islamic Finance Development report 2021*

Islamic finance presents $6tn opportunity Increased digitalisation and emergence of Islamic products aligned with sustainability themes are opening up new avenues for growth

The global Islamic finance industry is expected to grow to $5.9tn by 2026 up from $4tn in 2021, according to an Islamic Finance Development (IFDI) 2021 report. By IFDI projections, this growth will be driven by the sector's biggest segments - Islamic banks and sukuks.

This sector has continued its growth momentum despite the challenges of a recovering economy, which has been affected in large part by energy prices, disruption in supply chain and rising inflation.

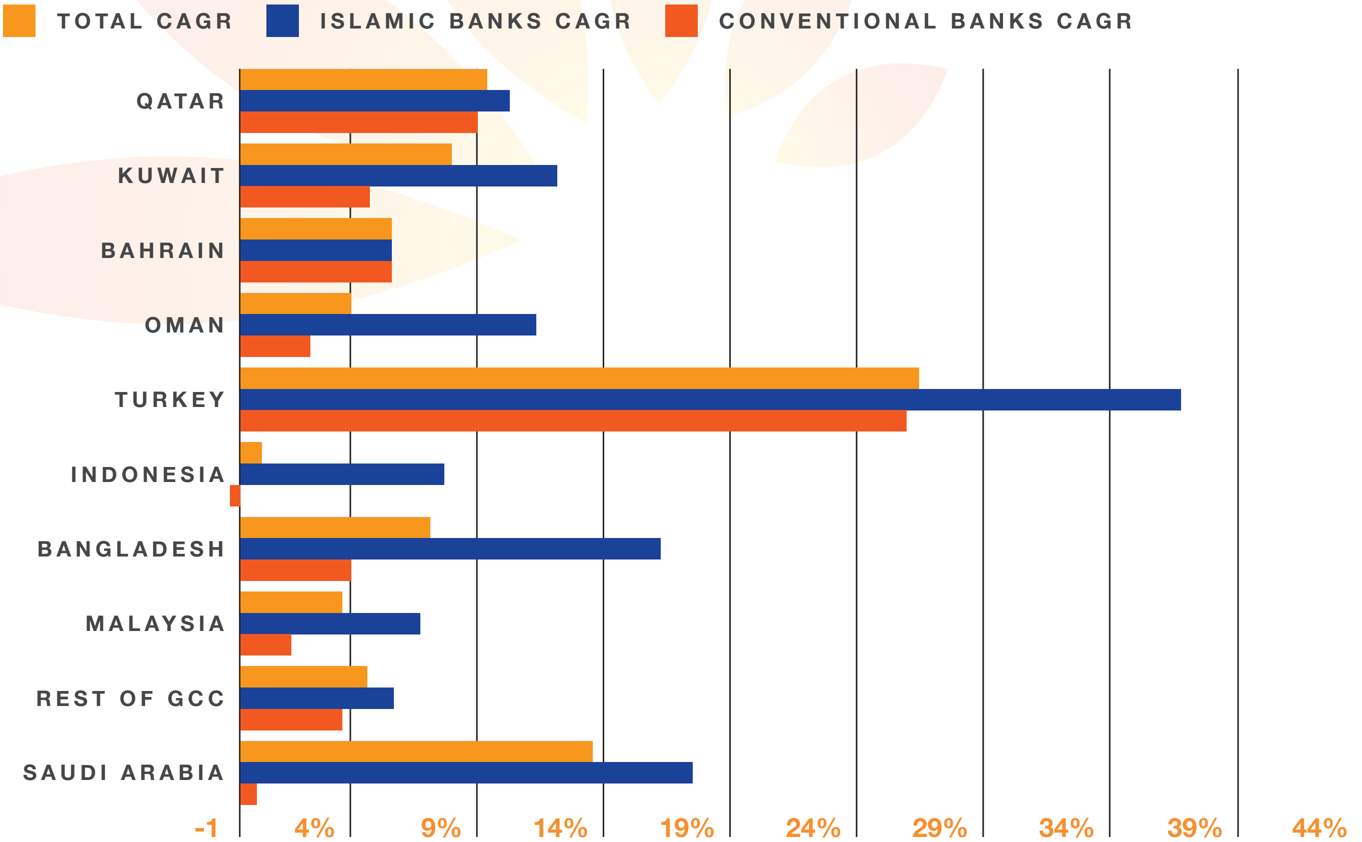
In fact, Islamic financing has expanded at a much faster rate in the past few years compared with conventional loan growth. Credit analyst Moody's Investors Service states that the two segments grew at an average compound rate of 10.5 per cent and 3.4 per cent respectively during the 2020-21 period.

The outlook for the Islamic financial system is optimistic as experts now regard it as one of the fastest growing segments of the global financial system, with a predicted average growth rate of 8 per cent until 2025.

New developments

Although the market is still at a maturing stage, considerable growth opportunities are emerging, particularly with the increased focus on aligning Islamic financial

Islamic finance growth outperformed conventional peers during the pandemic (% growth in financing between 2019 and Q3 2021



Source: Moody's Investors Service

products with environmental, social and governance (ESG) factors and the recent strides in digitalisation.

Green and sustainability sukuk are providing the additional impetus to the overall demand for the Islamic papers by the global investors as they are aligned with sustainability themes. The implementation of energy transition strategies and investments in clean energy are also boosting the opportunities for sustainable sukuk.

The Islamic banking sector holds the lion's share of the market, constituting 70 per cent of Islamic finance assets, as per Refinitiv Islamic finance data. Sukuk is the second-largest contributor to Islamic finance assets with over $74.5bn of issuances in the first half of 2022 according to S&P Global Ratings.

"Islamic finance has played a vital role in the UAE's national development with Islamic banking and finance assets estimated to be about 25 per cent of the total domestic banking assets, which stood at AED1.6tn in August 2022," said Sohail Zubairi, AAOIFI certified sharia advisor and auditor and IICRA accredited Islamic finance arbitration expert, speaking during the MEED-Mashreq Islamic Business Leaders Forum on 7 December 2022.

"We need a Sukuk insurer entity in the UAE on the lines of Danajamin in Malaysia that can help wean the private entities away from the banking sector and into the domestic capital market. This move will help reduce the burden on the UAE banks that can then spare greater funding at lower costs for the projects of national development," said Zubairi.

To capitalise on the rising demand and to keep pace with the developments in this segment, the industry must produce an emerging pool of talent that can integrate the knowledge of sharia and Islamic products with the technological advances in the industry.

However, existing training and qualifications may not provide the required levels of specialisation and sophistication.

"In many countries, especially ones with low awareness, Islamic finance practitioners are often inadequately equipped," said Bashar al-Natoor, global head of Islamic finance at Fitch Ratings. "There is a gap in understanding sharia products and the industry is looking to employ specialists.

Key characteristics of sharia-compliant or halal investing

- Profiting from debt is prohibited
- Interest payments are prohibited
- Investing in businesses that profit from alcohol, arms, tobacco and gambling is forbidden
- Earnings are generated through profit-sharing
- Islamic finance instruments must be backed by real assets

"Stakeholders, including customers, regulators and employees of Islamic financial institutions often view Islamic products to be similar to conventional interest-based products. This perception stems from the way Islamic products are marketed and priced."

A major contributor to this sector's continued growth will be making sharia-compliant products easily accessible and standardising compliance processes.

Furthermore, as digital banks and new payment methods such as 'buy now, pay later' emerge in the Islamic finance system, it is important that Islamic banks not only simplify and centralise their operating models but also work with the innovators and developers to deliver banking solutions without compromising sharia principles.

Citing collaboration as another key driver for the growth of Islamic finance, senior corporate and structured finance and banking leader and Islamic finance specialist Jawaad Chawla said, "From a very humble beginning, not more than 2 decades ago, Islamic finance has grown into a multi-trillion-dollar industry. And we got here through the collaborative efforts of bankers, lawyers, scholars, regulators and industry experts, who have all come together to bring innovation into Islamic finance and offer it to a wider audience."

Globalisation trend

Islamic finance is no longer exclusive to Islamic or Muslim-majority countries. Recent global developments such as the UK government's second issuance of sukuk in 2021 and the launch of Australia's first full-fledged Islamic bank in July 2022 are a testament to its increasing appeal.

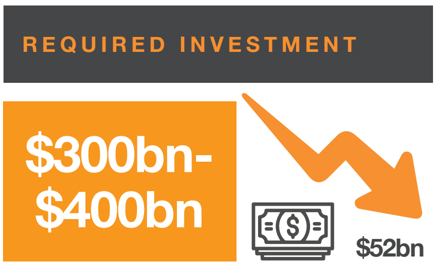
Zubairi explained that more and more countries are now keen to adopt Islamic finance options as governments move to diversify funding options and interest in sustainable and responsible investing peaks.

"We are seeing countries such as Hong Kong and South Africa adopting Islamic finance and a rise in investments from countries that do not necessarily have a Muslim dominated population," he said. He further opined that the growth in Islamic finance assets is reaching saturation point in the Islamic world and that next generation push can only come from non-OIC countries provided "we are able to develop a global Islamic finance law which provides legal protection to the parties entering into an Islamic finance contract and also serves as a global benchmark for dispute resolution".

This globalisation trend is expected to continue with the application of ESG principles and digitalisation and a higher degree of standardisation within the Islamic finance sector.

Green prospects pave way for Islamic finance

Shariah-compliant lending can help narrow the investment gap necessary to achieve the UN SDGs



FOR PRESERVING AND RESTORING BIODIVERSE ECOSYSTEMS

The gathering of global leaders, policymakers and business entities at Cop27 in Sharm al-Shaikh saw the spotlight shine firmly on climate finance. Channeling investments to fight climate change and other issues facing humanity were stated by many to the number one priority, with the 'loss and damage' fund seen as a watershed moment for climate-risk nations.

It is estimated that the world is facing an annual investment gap of $2.5tn when it comes to achieving the UN Sustainable Development Goals (SDGs) by 2030. The pandemic is said to have further widened this gap to $4.3tn, as per UNCTAD estimates, with the ongoing Ukraine-Russia conflict set to exacerbate the issue.

For preserving and restoring biodiverse ecosystems alone, the required investment is estimated to be between $300bn-$400bn. However, only $52bn is currently being directed into these projects.

"We shall never be able to fill the funding gap with the money contributed by just governments and philanthropy," said Adnan Aziz, director of the Centre for Excellence in Islamic Finance at Ajman University (AU-CEIF).

"Private sector could close more than half of this funding gap by setting up profitable enterprises with a positive impact."

Aziz and other industry speakers at the MEED-Mashreq Islamic Business Leaders Forum strongly advocated the role of Islamic finance in improving the bankability of nature-based solutions and the wider UN SDGs.

As one of the fastest growing global financial segments, the Islamic finance market is well-placed to help narrow the investment gap. An annual report by S&P Ratings valued the global Islamic finance market at $2.2tn in 2021; experts at the forum estimate this figure to have surpassed $3tn at the end of 2022.

Sharia-compliant financing principles, encompassing the wellbeing of the society and environment, naturally align with the guidelines of ethical investing – more commonly known as ESG investing.

Given the substantial level of funding required to realise these goals, Islamic finance can become a crucial non-traditional finance source. However, it remains an under-utilised avenue, limited by challenges including low awareness and depth of knowledge, and the complexity of instruments, explained Michael Grifferty, president of regional trade-association Gulf Capital Market Association (GCMA).

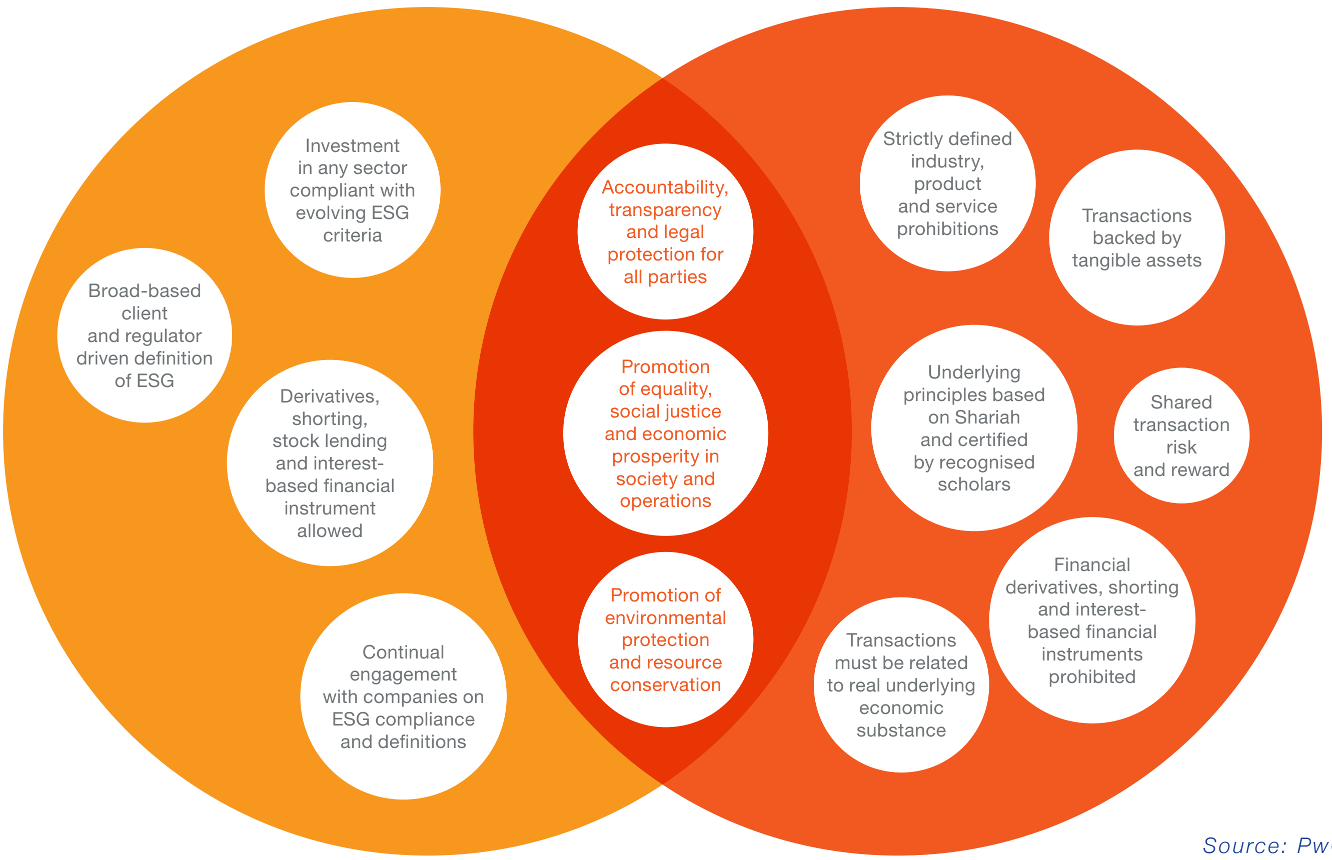
"There is also a dichotomy to bear in mind," said Grifferty. "Typically, proceeds from green bonds, sukuk and loans are directed into green projects. Something that is becoming more important are sustainability-linked bonds and sukuk, where the proceeds might not be used for a green-labelled project but the return on the instrument depend upon the environmental and sustainability performance of the issuing entity."

Nature conservation

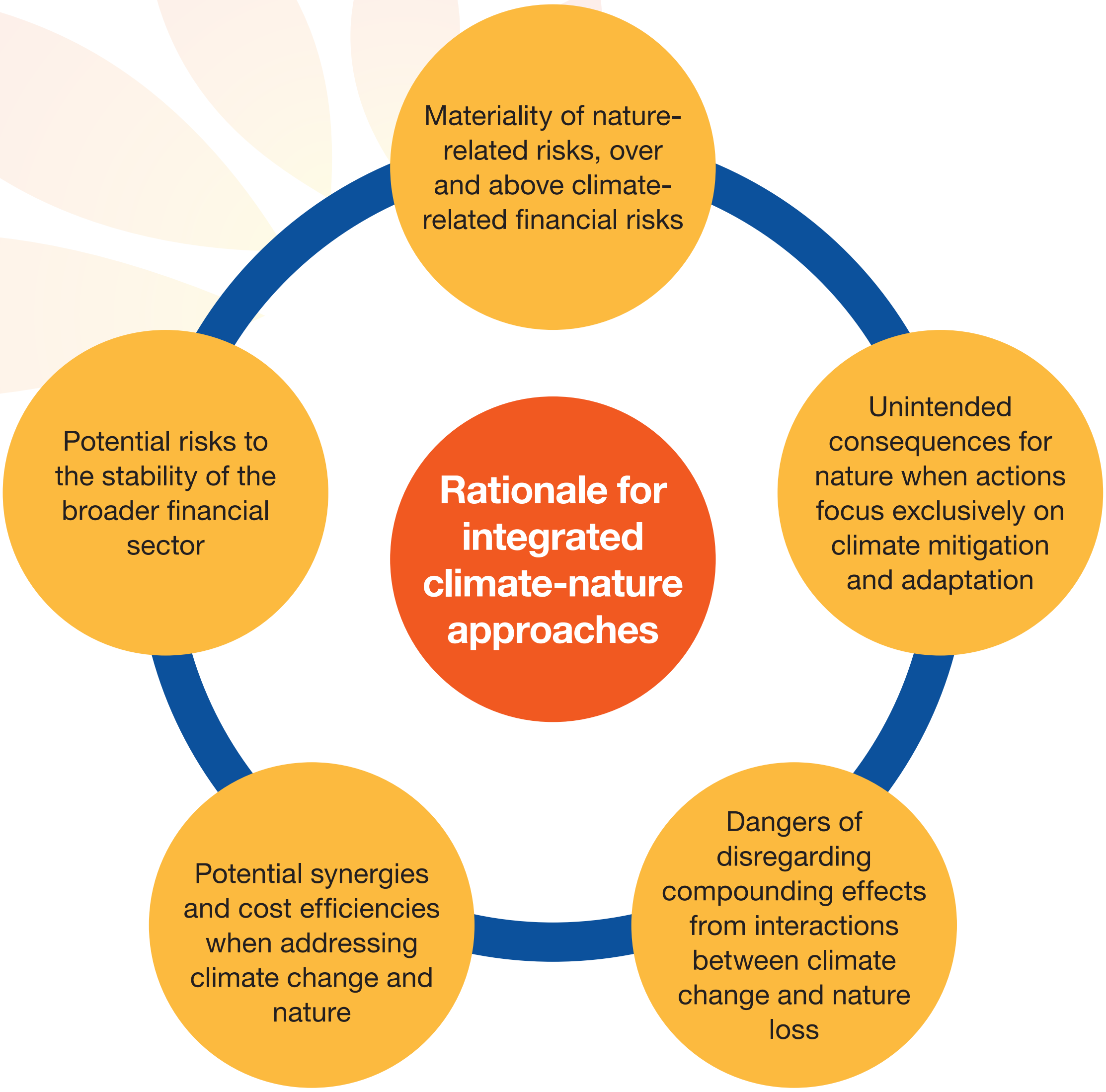
Launched in 2015, the 17 SDGs serve as guidelines for governments and organisations around the world to reduce poverty and hunger, fight inequality, and ultimately achieve a more sustainable future.

Intrinsically tied to each of the goals are efforts to mitigate climate change and prevent nature loss. A report published by September 2022 by the Cambridge Institute for Sustainability Leadership emphasises the interconnectivity between climate change and nature loss, driving home the need for financial institutions to support both in equal measure.

ESG VS. ISLAMIC FINANCE AT A GLANCE



Source: PwC



Source: Integrating climate and nature: The rationale for financial institutions

"Building conservation and nature-based solutions into projects represents a massive opportunity," said Aziz. "When it comes to Islamic finance, there is a natural synergy with nature-based solutions. As Islamic finance stakeholders, there is a clear opportunity for us to reach the objective of sustainability and not just focus on business value proposition or fiscal threat alone."

In a report published in September 2021, UNDP estimates that $30bn-$50bn can be chanelled through green sukuk alone by 2025. Despite the synergy however, Islamic climate finance remains a seldom used tool.

"Nature-based solutions are necessary but are seen as "unattractive" by Islamic finance stakeholders due to reasons including a lack of availability of large-scale opportunities, relatively low returns and the unconventional nature of risks.

"We need to work with companies, financial institutions and local stakeholders to develop bankable nature solutions. This way we can reduce pressure on ecosystems, drive resilience and sustainability, while generating positive financial returns for communities and investors."

Bankable nature-based solutions combine characteristics including cashflow generation, a higher probability of success and an acceptable risk-adjusted rate of return, while providing sufficient collateral and a clear exit strategy for investors.

"Bankable solutions create positive environmental returns, which in turns lead to positive biodiversity impacts and thus aid in climate change mitigation," said Aziz.

He further emphasised that the creation of bankable nature-based solutions can help create an asset class that provides both the necessary financial dividends, "but also gives back to the society".

Industry players gathered at the Islamic Finance Business Leaders Forum held by MEED and Mashreq on 7 December

New age tech supports sector expansion

Islamic fintech platforms enhance and improve the reach and effectiveness of Islamic banking instruments

The rapid digitalisation of our world has fundamentally changed how the banking industry operates and delivers its services. Today, banks are competing beyond financial services. Seamless and instant digital banking has become an essential business offering.

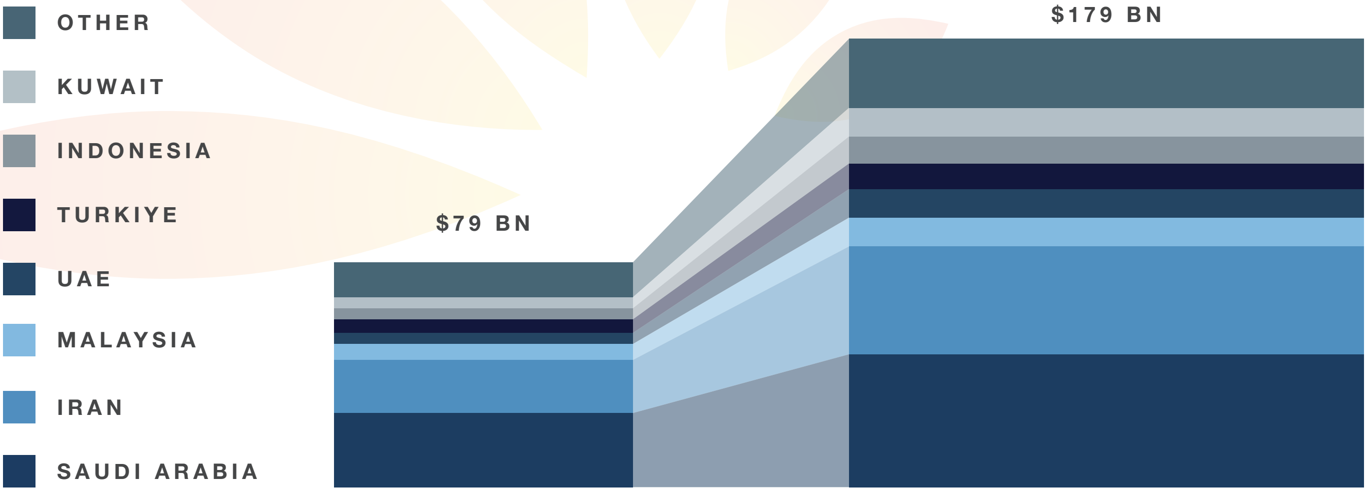
A similar disruption has been observed in the Islamic finance sector, which has turned to financial technology or fintech to expand its market reach.

Experts at the MEED-Mashreq Islamic Finance Business Leaders Forum strongly advocated the role of fintechs in enhancing the inclusivity and accessibility of Islamic finance instruments.

"Fintech is an integral part of the overall development story," said panellist Jawaad Chawla, a UAE-based senior corporate and structured finance and banking leader, and an Islamic finance specialist. "Given the pace at which fintech is growing, Islamic finance does have a lot to align with, in terms of increasing awareness as well as speeding up their digital adoption processes. The demographics, the connectivity and the ever-growing financial inclusion are all key drivers of this growth."

The global Islamic fintech market saw transaction volumes of $79bn in 2021, and is expected to reach $179bn by 2026, according to a report by research firm DinarStandard and ethical advisory and investment firm Elipses.

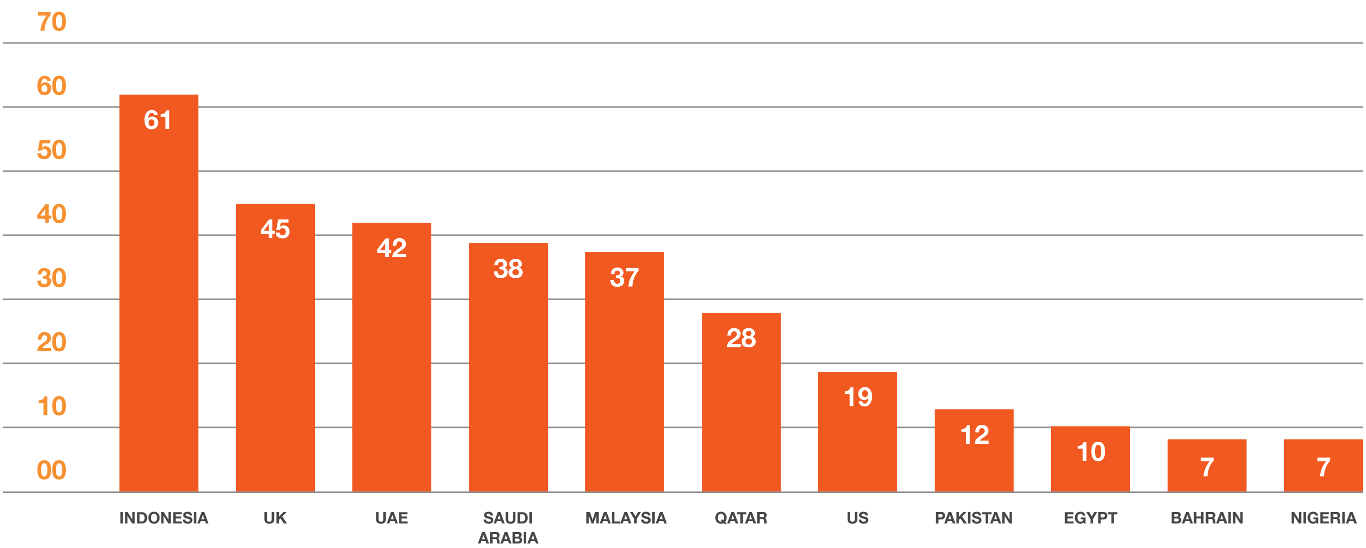
MARKET SIZE: OIC COUNTRIES ARE EXPECTED TO CONTINUE TO GROW THE ISLAMIC FINTECH SECTOR AT 17.9% CAGR THROUGH 2026



Source: Global Islamic Fintech (GIFT) report 2022

VOLUME OF ISLAMIC FINTECH BY COUNTRIES (TOP 10):

NOTE: 10 countries house nearly 82 per cent of the 375 Islamic fintechs globally



Source: Global Islamic Fintech (GIFT) report 2022

Saudi Arabia and the UAE rank in the top six markets by transaction volumes, and are seen as leading hubs for digital innovation.

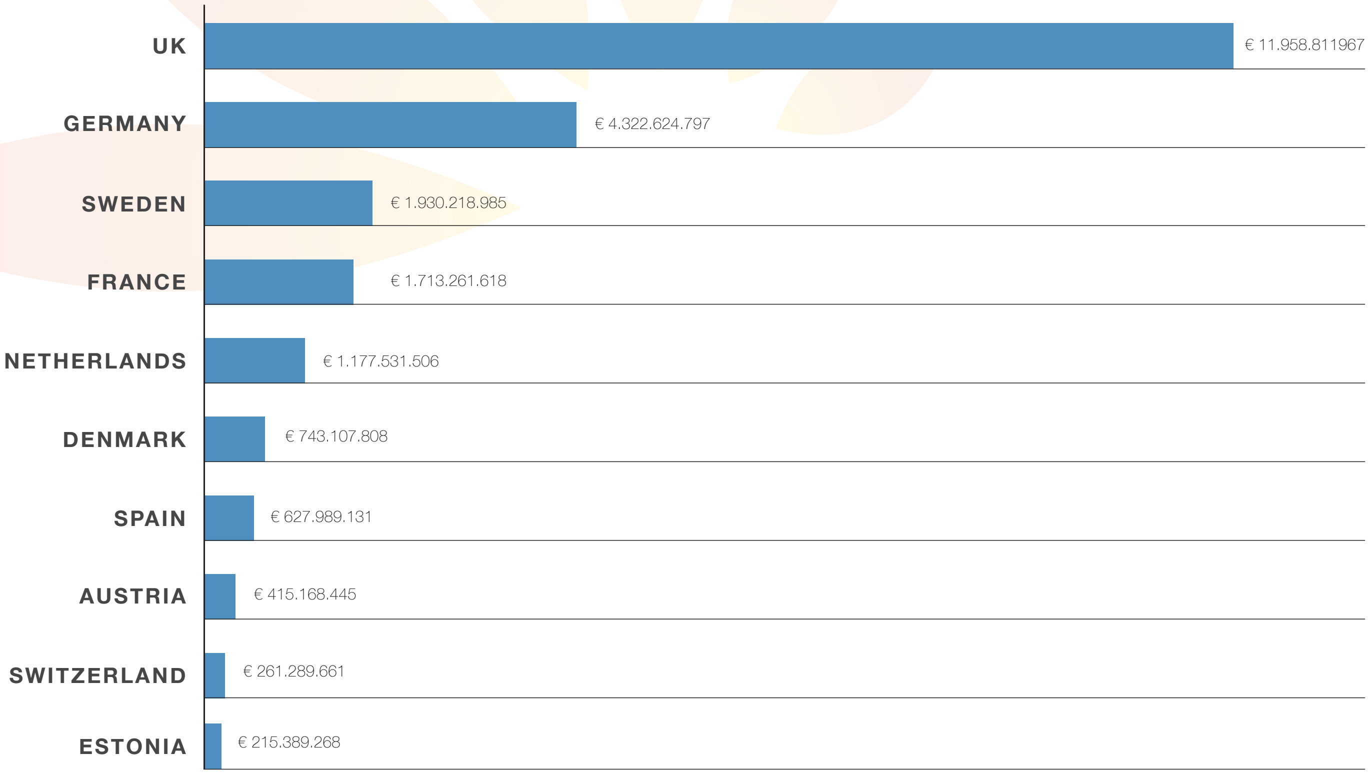
The report further notes that 10 countries house nearly 82 per cent of the 375 Islamic fintechs globally.

Islamic finance readily lends itself to various structures within the fintech space, added Chawla.

"Peer-to-peer, crowdfunding, profit-sharing – all of these align with the fundamentals of Islamic finance. This also democratises the potential for funding and financing, which is again aligned with equitable financing and Islamic principles. I see a very bright future for Islamic banking and sukuk in the fintech arena."

Typically targeting a younger population segment, Islamic fintechs find that high internet and mobile penetration enables them to disrupt typically siloed processes. It adheres to the same principles as Islamic finance – prohibiting profits from debt, interest charges and businesses related to alcohol, tobacco and gambling, besides stocks of conventional banks, insurance companies and other types of financial institutions.

TOP 10 COUNTRIES FOR FINTECH INVESTMENT IN 2021



Source: TechEU

Islamic finance is also well-placed to drive the adoption of ESG and sustainable development goals (SDGs), with their shared principles of equitable investments for the environment and society. Experts rally that fintech can provide an added layer of ease and innovation to this process.

"I see ESG and fintech as the two rocket ships that can help Islamic finance sustain its growth trajectory," said Michael Grifferty, president of the Gulf Capital Market Association (GCMA), a regional trade association focused on the Arabian Gulf debt and equity markets.

Islamic fintech remains in the early stages of development, lagging behind conventional fintech firms. A challenge limiting growth is the lack of Sharia-compliant funding, as most funds available are traditional and based in non-Muslim countries such as the UK, Germany and Sweden. Only a small number of investors in the Middle East meet the requirements.

This is, however, changing. For example, Wa'ed Ventures, the venture capital arm of the Saudi Aramco Entrepreneurship Centre, led the $50m Series B funding round of New York-based Islamic fintech start-up Wahed in June 2022.

Regulations promoting innovation are further necessary to ensure Islamic fintechs can scale up and compete with regional and global financial players. Specific Islamic fintech regulations can help create a more distinct identity from conventional fintech. Enabling a competitive environment will allow for the further proliferation of Islamic finance products.

Looking ahead, Sohail Zubairi, AAOIFI certified sharia advisor and auditor and IICRA accredited Islamic finance arbitration expert, said that "security token will be the next big thing when it comes to digitalisation in Islamic finance", emphasising the importance of fast emerging security token through which substantial liquidity absorbed by the real estate assets can be released by way of fractionalisation of the ownership and its sale through tokens which could be structured as the asset-based or asset-backed, similar to a sukuk.

Having mentored over 30 Islamic fintech start-ups for DIFC Fintech Hive, Zubairi added: "Islamic security tokens will allow internationalisation of local ownership with round the clock global trading and could be an ideal savings tool for retail household investors for whom not much is currently offered by the markets".

Green demand drives sukuk traction

Islamic finance experts regard sukuk as an important route to achieving global green goals

First Abu Dhabi Bank made headlines recently when it announced of a five-year $500m sukuk or Islamic bond. Citing strong investor interest even in the face of a looming global economic downturn, it was the first global sukuk issuance of 2023.

The growing use of sukuk was a key discussion point among Islamic finance experts gathered at the Islamic Finance Business Leaders Forum.

In its latest report, credit analyst Fitch Ratings stated that while sukuk issuance in core markets in 2022 fell 7.9 per cent to $244.3bn compared with 2021, the medium-to-long term outlook is positive given investor demand, issuer refinancing needs and government support.

Moreover, the sukuk market is experiencing a directional change due to a growing number of sustainable sukuk issuances. In 2021, ESG sukuk issuances reached $6.1bn, led by Indonesia and the GCC, according to a report by financial data provider Refinitiv.

ESG sukuk has steadily increased its

Source: Refinitiv

share within the global sukuk space, growing from 0.4 per cent of total sukuk volumes issued to 4.3 per cent in the first half of 2022.

The GCC has marked a stable rise in the volume of issuances and structural frameworks to scale ESG-linked sukuk. In May 2019, Dubai-based real estate developer Majid al-Futtaim (MAF) launched the region's first corporate green sukuk, following it up with a second offering in October 2019.

Saudi Arabia's Islamic Development Bank, meanwhile, raised $2.5bn with its green sukuk in March 2021, while the kingdom's Riyad Bank closed a $750m green Islamic bond in February 2022. A month later, Bahrain-based infrastructure fund Infracorp issued a $900m green sukuk on the London Stock Exchange.

Meanwhile, Dubai Islamic Bank (DIB) priced its first sustainable sukuk in November 2022, a $750m issuance with a tenor of five years.

The green opportunity

Long-established sukuk are Islamic finance capital market instruments that provide returns like conventional fixed-income products such as bonds but whose terms and structures are Shariah-compliant.

Upon the issuance of sukuk, the issuer sells certificates to investors and uses the proceeds to purchase the asset. Investors thus receive partial ownership of the asset, as well as part of the profits generated, as interest is forbidden under Shariah law.

Sukuk is the second-largest contributor to the Islamic finance sector behind the banking segment, with over $74.5bn of issuances in the first half of 2022, according to S&P Global Ratings.

"You'll be surprised to note that whenever a sukuk is issued, the typical investor profile consists of institutional investors from the West and the Far East, given their interest in the fixed income stream," said Sohail Zubairi, AAOIFI certified sharia advisor and auditor and IICRA accredited Islamic finance arbitration expert. "They're confident this is the correct way to invest."

Because of the sector's fundamental alignment with ethical investing, Islamic finance and its instruments are well suited to driving socially and environmentally responsible investing. Sukuks cannot be used to finance impermissible activities and are structured to avoid high degrees of

leverage and speculation.

With ESG rising to the top of companies' agendas, green sukuk is growing in importance. According to estimates from the UKIFC, $30bn to $50bn of capital dedicated to sustainable development goals (SDGs) could be raised through green and sustainability sukuk by 2025.

In the GCC, governments are heavily investing in sectors such as clean energy and vehicles, while businesses are incorporating ESG principles in their operations and financial models. This provides a significant opportunity for green investors to tap into.

"The misunderstanding is that green financing is not attractive because it does not have good returns. This is false," said Zubairi. "Green bonds are performing well – the global market has crossed $2tn already. But the real issue is the lack of proper criteria to measure green sukuk."

Zubairi emphasised the need to develop parameters similar to conventional green bonds based on standards such as the Climate Bonds Initiative (CBI).

Furthermore, the ESG maturity model requires a rating system to see how various sukuk issuances are performing and how the proceeds are utilised. This, said Zubairi, will help convince investors that their investments are being deployed effectively.

"In my opinion, green sukuk should not be limited to the large government-related entities or sovereigns or private institutions," said Jawaad Chawla, a UAE-based senior corporate and structured finance and banking leader, and an Islamic finance specialist.

"We need to promote the capital market at the mid-corporate level, and then possibly trickle it down to the SME level."

Chawla highlighted that while 80-85 per cent of companies registered with UAE banks are SMEs, they only constitute about 15 per cent of banking balance sheets, showing "tremendous opportunity on the capital market front".

"If we create a sukuk market in the mid-corporate space, it will firstly enhance the local capital market industry. And it will improve access to capital for these corporates by bringing them directly to high-net worth individuals or institutions.

"Further, if developed in a green format, these sukuks could further support both the corporates as well as the environment by deploying the capital for sustainable purposes. It will help create strong synergy and harmony."

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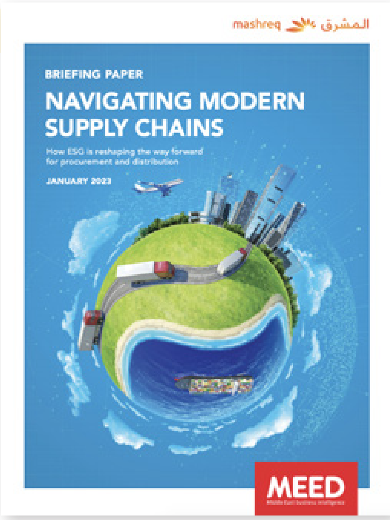

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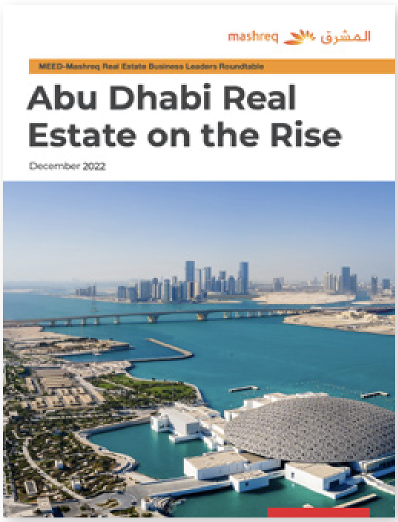

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Ibrahim al-Mheiri
EVP, Head of Islamic Banking at Mashreq

About Mashreq

Established in 1967, Mashreq is the oldest privately-owned bank in the UAE, with award-winning financial solutions and services. Through its 50 year history, Mashreq has differentiated itself through innovative financial solutions, making it possible for its customers to achieve their aspirations.

Today, Mashreq has a significant presence in 11 countries outside the UAE, with 21 overseas branches and offices across Europe, the US, Asia and Africa. Mashreq launched its new Vision and Mission recently, outlining its commitment towards its clients, colleagues and the community.

In line with its vision to be the region's most progressive bank, Mashreq leverages its leadership position in the banking industry to enable innovative possibilities and solutions for its customers across corporate, retail, international, treasury and Islamic banking.

Mashreq is proud to be the first financial institution in the UAE to be awarded the Gallup Great Workplace Award for four consecutive years from 2014-17. Mashreq also continues to invest in recruiting, training and developing future generations of UAE national bankers.

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About MEED

MEED has been integral to delivering business information, news, intelligence and analysis on the Middle East economies and activities for over 65 years.

Attracting a key senior management audience through its content and activities, MEED is a media brand, publication and data business that covers a spectrum of services which inform, engage, connect and ultimately support our subscribers and partners in their business development and strategic growth.

Acquired by GlobalData Plc in 2017, MEED is now part of one of the largest data and insights solution providers in the world with the capacity to build global communities for our clients.

Our purpose is to support the region's companies make better and more timely decisions through our innovative data solutions and grow through our comprehensive and worldclass marketing solutions. To find out more, email: info@meed.com