Internationalisation Strategies for Islamic Financial Institutions

CIBAFI-IDB Roundtable Meeting
23-24 February 2015
Manama, Kingdom of Bahrain

General Council for Islamic Banks And Financial Institutions
CIBAFI

The views expressed in this publication are those of the speakers, participants, and contributors and not necessarily the views of the General Council for Islamic Banks and Financial Institutions and the Islamic Development Bank or Directors or Managers of these institutions or the governments they represent.

Published in 2015 by

General Council for Islamic Banks and Financial Institutions
Jeera III Tower, Office 51, Building No. 657, Road No. 2811, Block No. 428, Manama, Kingdom of Bahrain, P.O. Box No. 24456

ISBN 978-99901-26-10-5

Internationalisation Strategies for Islamic Financial Institutions

CIBAFI-IDB Roundtable Meeting
23-24 February 2015
Manama, Kingdom of Bahrain

CIBAFI

General Council for Islamic Banks and Financial Institutions
Islamic Development Bank
2015

ABOUT THE GENERAL COUNCIL FOR ISLAMIC BANKS AND FINANCIAL INSTITUTIONS (CIBAFI)

The General Council for Islamic Banks and Financial Institutions (CIBAFI) is a not-for-profit organisation that represents the interests of Islamic financial institutions worldwide. Founded in May 2001 in the Kingdom of Bahrain by the Islamic Development Bank (IDB) and a number of leading Islamic Financial Institutions, CIBAFI is recognised as a key institution within the international architecture of Islamic finance. CIBAI is affiliated with the Organisation of Islamic Cooperation (OIC).

CIBAFI was established with the objectives of developing the Islamic Financial Services Industry (IFSI) and promoting the industry in various fields through information sharing and financial analysis, raising of awareness of the IFSI, and the development of human capital.

ABOUT THE ISLAMIC DEVELOPMENT BANK (IDB)

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Q'adah 1393H, corresponding to December 1973. The Inaugural Meeting of the Board of Governors took place in Rajab 1395H, corresponding to July 1975, and the Bank was formally opened on 15 Shawwal 1395H corresponding to 20 October 1975.

Contents

Acronyms

ADB	Asian Development Bank
BCBS	Basel Committee on Banking Supervision
CIBAFI	General Council for Islamic Banks and Financial Institutions
GCC	Gulf Cooperation Council
ICD	Islamic Corporation for the Development of the Private Sector
IDB	Islamic Development Bank
IFI	Islamic Financial Institution
ITFC	Islamic Trade Finance Corporation
IOSCO	International Organisation of Securities Commissions
OIC	Organisation of Islamic Cooperation
UN	United Nations

Foreword

Islamic finance has been growing rapidly and consistently for several decades and it now occupies a significant position – and sometimes a dominant position – in the financial markets of Muslim countries. Islamic finance is also becoming a significant part of financial markets beyond the Muslim world, including some of the world's largest financial centres.

Despite this undoubted progress, there are still few Islamic Financial Institutions (IFIs) that have the scale to operate and compete at a global level. Even at a regional level, there are only a handful of IFIs that have a significant presence outside their home country. The need to internationalise IFIs is recognised by all those in the industry. Yet little work has been done to identify the steps that institutions, and the industry as a whole, must take to achieve greater internationalisation. The challenges lie in many areas: disparities in the level of Islamic finance development, a complex regulatory landscape that mixes both Islamic and conventional finance, lack of standard financial products and contracts, and differing Shari'ah interpretations. In addition, there is also the challenge of defining internationalisation strategies that will meet the extraordinarily diverse needs of those – both Muslims and non-Muslims – who seek to engage with Islamic finance, while also generating income and profits for the IFIs themselves, so that they will be able to maintain and grow sustainable businesses.

This situation prompted the General Council for Islamic Banks and Financial Institutions (CIBAFI) to lead a discussion to identify key themes for internationalisation strategies of IFIs. Recognising the importance for this issue, and the need for a coordinated approach, CIBAFI, together with the Islamic Development Bank (IDB) – Islamic Financial Services Department, organised a two-day Roundtable Meeting for executives and senior management of Islamic banks. The meeting was held in Manama, Kingdom of Bahrain, on 23 – 24 February 2015. The Roundtable aimed at facilitating discussions among industry experts and leaders on recent opportunities and challenges in the area of internationalisation of IFIs, and providing a common platform for sharing best practices and strategies in the area of international operations. The meeting was attended by senior Islamic finance practitioners and international industry experts from over 15 countries.

This Report on the Roundtable meeting has been prepared by the CIBAFI Secretariat, in coordination with the IDB. It summarises the key points made during the Roundtable and identifies priorities and action items that will enable IFIs to fulfil their desire to deepen and widen their international operations. The Report synthesises the presentations and the discussions among participants at the Roundtable and includes additional material subsequently submitted by the speakers.

Part I addresses how IFIs can identify suitable markets into which to expand and the key considerations that IFIs should keep in mind before venturing overseas. It also describes the different strategies that can be used to enter new markets. Part II considers how an IFI can leverage its brand to assist overseas expansion, while also cautioning on the danger that expansion may dilute an institution's core values. This section also describes the challenges that IFIs may face in maintaining and strengthening their governance and compliance functions as their operations become more complex and widely spread. Part III then describes how Islamic financing can be structured in a way that enables new players to participate, especially smaller players who may have limited financial resources and less experience of global financial markets. Specifically, this section considers how to structure Shariah-compliant syndications and trade finance. The final section draws general conclusions and identifies some takeaway points related to best practices and policy recommendations that will facilitate the global expansion of IFIs.

Foreword

CIBAFI and IDB would like to express their gratitude to H.E. Rasheed Mohammed Al Maraj, Governor Central Bank of Bahrain (CBB), H.E. Dr. Ahmed Mohammed Ali Al-Madani, President IDB and H.E. Shaikh Saleh Abdullah Kamel, Chairman CIBAFI, for the support extended for the organisation of the Roundtable meeting.

We are also grateful to the participants of the Roundtable for their efforts as well as to the contributors of this publication and significant comments and views shared during the Roundtable discussions. We also appreciate the contribution from Mr. Andrew Cunningham as the rapporteur, and Mr. Peter Casey as the reviewer of this publication. It is hoped that the Roundtable will lead to further engagements and collaborations between Islamic financial institutions across different countries to encourage the advancement of the Islamic finance industry.

Abdelilah Belatik
Secretary General
CIBAFI

Ahmed Al Gebali
Director
Islamic Financial
Services Department
IDB

IDB President Speech

بسم الله الرحمن الرحيم

Praises to Allah SWT and peace be upon the Prophet and his family and companions.

At the outset, I would like to express sincere thanks and appreciation to H.M. the King, to the people and to the Government of the Kingdom of Bahrain for hosting the Roundtable Meeting of Internationalization Strategies of Islamic Financial Institutions. I would like to also express my gratitude to his Excellency Dr. Rashid Al Maraj, the Governor of Central Bank of Bahrain, for the great efforts that the Central Bank of Bahrain has undertaken to support the Islamic financial services industry, and provide all the means required to make the industry successful in the local, regional and global context.

And I would like to thank his Excellency for appointing Mr. Khalid Hamad, the Executive Director of Banking Supervision of the Central Bank of Bahrain, for delivering an opening remarks in this meeting. I would like to also thank his Excellency Shaikh Saleh A. Kamel, Chairman of CIBAFI for its collaboration with the IDB to organize this meeting.

As you are aware, the first meeting of the Directors of Investment and Operation was held in 1983 in the IDB headquarters in Jeddah, with the objective to foster the syndicated financing among Islamic banks. In that meeting, a number of issues and challenges that the industry is facing were discussed, and a number of recommendations have served as the basis of the establishment of specialized institutions to support the Islamic finance industry.

I am looking forward to the revival of this meeting to become a platform for all interested parties within the Islamic financial services industry, to discuss the current challenges that keep evolving and are being complex in nature which are facing the industry at different levels. As you know, the industry faces a number of challenges. Some of them are from operational, products and system end, while the others come from the legal and the necessary enabling environment. Several problems are also relating to Shariah compliance, fatwa issues, and Shariah references. These increasing complicated challenges become more complicated in view of the expansion of the Islamic financial industry at different levels in the global markets In view of that, the topic that will be discussed in this meeting on expansion of the industry at the global level is considered as one of the most important and current issue in the industry.

From a general perspective, we can say that the industry today is in need to foster the ethical dimension in its activities and to focus on the real economy, as well as to limit trading financial assets without any alignment to the real sector, which further have adverse effects on the financial market in general.

By looking at the industry, we found out that most of the institutions still focus on limited products which do not reflect the real image of the Islamic financial system. In this regard, we must remember the call from Shaikh Saleh Al Hossain, mercy be upon his soul, which was delivered in a number of Islamic finance industry events, for the industry to put more efforts in innovations to create new products that combine profit generation and contribution to the social and economic development. I would urge your meeting here to focus on the operational issues that foster the cooperation, coordination, and joint development among Islamic financial institutions. I would also call for this meeting to be organized regularly, in order to strengthen the co-financing of projects. The IDB is glad to cooperate with you at best in this regard and to investigate the challenges that the industry faces in order to address them with the best means possible.

These challenges may be summarised are as follows:.

First, managing the liquidity in Islamic financial institutions professionally, which serves the industry and the national economy of the host country of the institutions.

Second, continuing development of financial products that both comply with Shariah principles and at the same time have positive impact on the economy of our member countries.

Third, to provide the enabling environment in legal, regulatory, supervisory and Shariah dimensions, in order to develop an Islamic finance support that is able to support the dynamic changes in economics and finance.

Fourth, the commitment to apply the Shariah, accounting, and supervisory standards issued by specialized institutions.

Fifth, encouragement of financing waqf project and the capacity building of waqf institutions. Specifically, I call upon all Islamic financial institutions to cooperate with Awqaf Properties Investment Fund that is managed by the IDB and a number of Ministries of Islamic Affairs as well as Islamic financial institutions, contributing to this fund, with the objective to revive the Prophetic tradition of waqf and to finance waqf projects.

Sixth, there is an issue of high importance which I would encourage this meeting to focus on: which is microfinance and poverty alleviation. There is a need for this meeting to be the point of transformation in this matter. The IDB is glad to share with you its experience in microfinance and its efforts towards poverty alleviation in member countries for more cooperation in this regard between Islamic financial institutions. As you know, microfinance has made significant contribution through some of the successful experiences such as the experience of Islami Bank Bangladesh. I take this opportunity to call for benefiting from these successful experiences in order to contribute to serve our member countries, especially in their efforts to fight unemployment and poverty, as well as to bank the underserved market segments and to establish a decent quality of life.

The concern of Islamic financial institutions with microfinance and poverty alleviation is a moral obligation, and it is a platform to introduce the industry to the public with its moral dimensions. That will contribute to mitigate the problems relating to unrest which is happening in the Muslim world in the last few years. With respect to the interest of the IDB towards the expansion of the Islamic financial services industry globally, the bank is recently coordinating with the Kingdom of Saudi Arabia, Indonesia, Turkey, and members of the G20 to put Islamic banking on the table of the G20, in order to explore the contributions that Islamic financial institutions can make towards serving and sustaining the global economy. The IDB is in a discussion with Turkey, as the Chair of the G20 in this year.

In conclusion, I would like to convey to you that the IDB welcomes to host your next meeting in its headquarters in Jeddah. And I am sure that your meeting will come up with practical results, and I want to emphasize that the IDB is more than happy to cooperate in implementing the recommendations.

I ask Allah SWT to grant success to this meeting for serving the Ummah.

Wassalamu'alaikum warahmatullahi wabarakatuh.

H. E. Dr Ahmad Mohamed Ali Al Madani
President
Islamic Development Bank (IDB)

Keynote Address by Central Bank of Bahrain

The topic "Internationalization Strategies of Islamic Financial Institutions" is highly relevant in today's world as Islamic finance moves to the next level of growth and maturity. Islamic finance has come a long way in the last four decades and it is important for us to understand the historical development in order to take stock of where we stand today. The growth has presented many challenges. It has not been uniform, either geographically or year-on-year. A handful of countries account for over 80% of today's total Islamic financial assets. Bahrain and Malaysia have continuously developed as global hubs of Islamic finance, and whilst they lead the way in terms of research into and the structure of both financial products and master documentation, together they account for only 5% of global Muslim population. As the debate moves forward and other major Islamic countries become more focused on Islamic finance the industry will benefit from a significantly increased intellectual capacity, and thereby develop at a greater speed.

Islamic banking itself has less than a 2% share of the global banking market, while Islamic fund management and Takaful are even less. There are a number of new and emerging markets for Islamic finance, especially in African countries, Kazakhstan and Azerbaijan. Non-Muslim countries like Russia, China and India are also actively considering how to integrate Islamic finance into their economies, while the likes of the UK, Hong Kong and Luxembourg have already entered the arena with their Sukuk offerings. The opportunities are immense, but there are equally compelling challenges facing the industry.

So we need to ask ourselves, what is needed to establish Islamic finance as an integral and critical mainstream player in the global economy? There are a number of important pre-requisites. These include the convergence of Shari'a standards, the adoption of international best practices, the need for unwavering support by the industry to the Islamic standards setting bodies and other infrastructure entities, a focus upon more effective human resource development, improved and increased solutions to liquidity management, significant improvement in the quality of services and products, and a greater focus towards industry-led developmental efforts and leadership with vision, competence and integrity.

This Roundtable is an excellent start; we need more such events and perhaps even a permanent platform may be considered to provide practical assistance to Islamic banks in their global expansion efforts. The IDB and CIBAFI deserve our thanks for organizing this Roundtable and are the right platform to take the discussion forward.

Mr. Khalid Hamad Abdulrahman
Executive Director of Banking Supervision
Central Bank of Bahrain

Part One
Identifying Target Overseas Markets and Penetration Strategies

Part One. Identifying target overseas markets and penetration strategies

The arguments in favour of greater internationalisation by Islamic banks are compelling. Not only will greater internationalisation provide Muslim companies and consumers with greater choice as they conduct their financial activities, but internationalisation also offers benefits to banks, both in terms of diversification of risk away from their home markets, and through exposure to the some of the fastest growing economies in the world. But an internationalisation strategy needs to be well thought through in order to identify opportunities that are both appropriate and attractive. This Roundtable has suggested some of the key factors that IFIs should take into account when considering expansion overseas.

1. Focusing on economic fundamentals: Core drivers to ensure sustainability

Economic growth in the 56 countries of the OIC has consistently outstripped that seen in countries that are economically more developed. While real economic growth for the whole world and developed countries averaged 3.8% and 1.6% respectively in the ten years to 2013, real economic growth in the 56 countries of the OIC averaged 5.4%. In terms of population, again it is in developing countries, including those of the OIC, that growth can be seen. World population is expected to rise from about 7.2 billion in 2013 to about 7.7 billion in 2020, but during this time the population of developed countries will be almost unchanged at 1.3 billion. In contrast, the population of the OIC countries is expected to rise by more than 200 million to about 2.1 billion. We should not underestimate the significance of such a rise in population. One way to look at it is that that the addition of 200 million more people within the OIC by 2020 is equivalent to adding the entire populations of Egypt, Libya, Tunisia, Algeria, Morocco and Saudi Arabia.

Combining the figures on Gross Domestic Product (GDP) and population presents an even clearer picture of the likely trajectory for OIC economies in the years ahead. The OIC countries accounted for 9% of global nominal GDP in 2013, but they accounted for 24% of world population. Average per capita GDP of IDB countries was $2,414 in 2012, 31% of the global average.

The discrepancy between OIC countries (and developing countries as a whole) and global averages can be seen in many areas, such as health, education, and technology. Discrepancies can also be seen in financial markets. For example, private sector credit represents a much smaller percentage of GDP in developing countries than in developed countries, stock market capitalisation is smaller in relation to GDP and fewer adults have bank accounts.

Selected Human Development Indicators*				
	OIC 56	World	Developed Countries	Developing Countries
Real GDP Growth, avg 2004-2013	5.4%	3.8%	1.6%	6.5%
Population, 2013 (million)	1,863.4	7,716.7	1,274.9	6,441.8
Per capita GDP, 2012 (constant 2005 USD)	2,414.1	7,732.1	31,372,7	2,391.3
Annual growth in labour force, 2012	2.4%	1.5%	0.8%	1.7%
Adult literacy rate, 2008-2012	72.3	59.2	80.2	n/a
% households with a computer, 2012	20.4%	40.3%	77.7%	26.4%
Physicians per 1,000 people (2003-2012)	0.8	1.4	2.9	1.0
Internet users per 100 people 2012	22.3	35.6	75.3	26.6
Trade mark applications files, 2011 (million)	n/a	3.8	1.4	2.5

Source: Data taken from Mr. Oosthuizen's presentation to the CIBAFI Roundtable. Mr. Oosthuizen's data was taken from the Islamic Development Bank.

The above facts demonstrate the potential for the OIC countries to achieve strong rates of development over the medium and long term. As a supporting fact, the 2014 United Nations Human Development Report shows how countries have advanced to higher levels of human development. For example, of the 47 countries classified in the UN's "Low Human Development" range in 1990, 17 had advanced to higher classifications by 2014. Similarly, of the 45 countries in the "Medium Human Development Range" in 1990, all except 12 had graduated to higher levels by 2014.

It is therefore very likely that developing countries will become more attractive economies over the medium and long terms: GDP and population growth will be faster than in developed countries, and developing countries will start to converge with developed countries in terms of human development indicators such as education and literacy, health care, mobile phone and internet usage, and scientific innovation. However, the countries of the OIC are a heterogeneous group displaying different characteristics in almost every area of human and economic development. IFIs pursuing internationalisation strategies therefore face the challenge of deciding where to focus their efforts for best results.

The first step is to identify those countries that are most likely to achieve rapid rates of economic and human development – clearly not all will; and some countries will outperform others. Subsequently, the focus narrows to countries with financial systems that offer the greatest opportunities for IFIs. In judging this, commercial factors such as those described in the next section will be important. Also important will be the broad policy environment for Islamic finance, where key issues are as follows:

- The legal and regulatory framework governing the conduct of Islamic Finance as a whole and the operations of IFIs in particular
- The supervisory framework that governs the oversight of Islamic Finance and IFIs
- The nature of any financial sector safety net provided by the national authorities (for example, lender of last resort facilities and a Shari'ah-compliant deposit insurance schemes)
- Standards governing Shari'ah governance; and level of adherence to such standards.

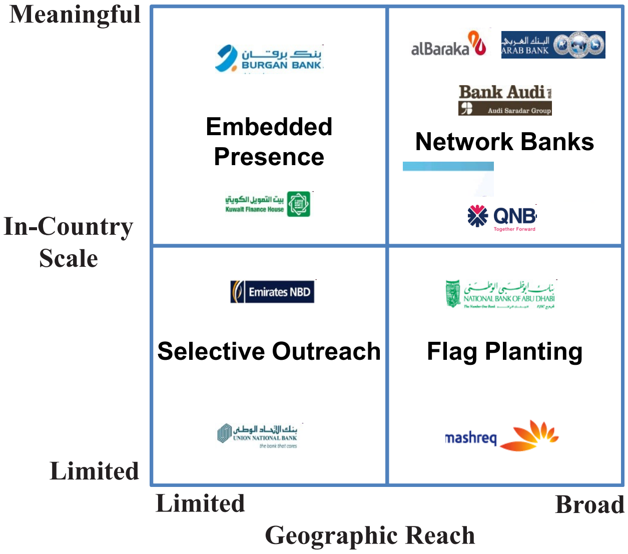
A more detailed listing of factors to consider when assessing the viability of a financial system, from the perspective of an IFI, is given in in the following table.

Practical Considerations when Assessing the Viability of a Financial System, from the perspective of an Islamic Financial Institution*
Does this country promote equal opportunities ("level playing field") for Islamic Finance and Conventional Finance; and in practice do equal opportunities exist (e.g. tax equivalence for financial transactions that are economically equivalent)?
Does the country's legal system accommodate Shari'ah compliant contracts?
Do the country's banking regulations and accounting standards permit the creation of profit equalisation reserves and investment risk reserves?
Do the country's banking regulations accommodate risk-sharing accounts on the liabilities side of Islamic banks' balance sheets?
Does the government or the financial authorities have a formal liquidity facility that can be made available to IFIs suffering from temporary illiquidity; do the regulators have powers to intervene in IFIs that are facing fundamental problems; and does this country have formal procedures for resolving or winding up failed IFIs?
Does this country have a Shari'ah-compliant deposit protection scheme?
Do this country's banking standards accommodate the specific features of IFIs, in particular in relation to liquidity and capital?
Do the financial regulators recognise AAOIFI and IFSB standards and, if so, have they been incorporated into domestic regulations?
What regulations and standards does this country have on Shari'ah governance? (For example, are the responsibilities of Shari'ah boards defined by regulation/banking standards?) Does this country have a national Shari'ah Board and, if it does, what is the relationship between the national Board and the Shari'ah boards of individual banks?

* Based on the paper presented by Carel Oosthuizen.

2. Structured approach to overseas market selection

IFIs that are planning to expand overseas need to consider the strength and opportunities within entire financial systems and not only the Shari'ah-compliant sector. Many internationalisation efforts by IFIs have been opportunistic and in some cases executed despite having no clear business case. Other than "network banks", with broad geographical reach, only a few Islamic banks have made significant and synergistic international moves that lead them to become fully embedded in their target markets. Many have indulged in "flag planting" as a pre-emptive strategy in new markets and to avoid late entry costs. There have also been some opportunistic moves such as purchasing licenses in mature markets. Even network banks have not fully succeeded in making internationalisation work because of complex management models, difficulty in capturing market share, and challenges in achieving group synergies (shown in areas such as uncoordinated strategies, different platforms for operations, etc.) An analysis of some attempts at internationalisation is shown in the following chart.



Source: Internationalization of Islamic Banks – Ways to Play for the Future, Dr Philipp Wackerbeck, Strategy&

In addition, the challenge of finding attractive markets for internationalisation, for Middle Eastern banks in particular, should not be underestimated. The lack of harmonised supervisory frameworks within the GCC creates high barriers to entry in what is already a heavily banked region that is saturated with Islamic banking services. Beyond the GCC, different but equally difficult challenges exist: high political risk in North Africa, the strength of local IFIs in South East Asia and high regulatory hurdles in Europe and the U.S.

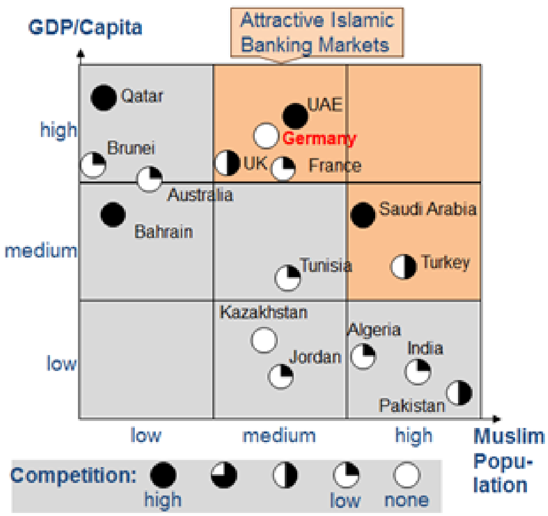
Six key criteria are identified for market selection, in addition to the policy and regulatory framework discussed in the previous session. The following table sets these out, along with questions that banks should ask themselves as part of the assessment process. Some of these questions relate to broad macro-economic and policy factors but others, such as the competitive environment and the compatibility of the target market's financial system with the products and strategy of the bank, address factors that are more specific to the objectives and abilities of individual banks.

Key Criteria for Target Market Selection		
	General Questions	**Key Indicators for Islamic Banks**
Market Size	How large is this target market? Is it worth pursuing?	Size of Muslim population; GDP per capita, etc.
Expected Growth	What is the outlook for the financial sector and for the economy in general?	GDP growth, growth of Muslim population, etc.
Competition	What is the level of competition that a new entrant would face?	Existing market shares/footprint of Islamic banks and conventional banks with an ethical offering.
Market Access	Is this market accessible to our bank? Are there any barriers that would prevent our bank entering this market?	Regulation, saturation, political will, etc.
Compatibility	How aligned is this market to our corporate objectives?	Homogeneity of customers, fit of existing products, etc.
Sustainability	Are there any risks that we should take into account?	Political/economic stability, forthcoming regulation, etc.

Source: Internationalisation of Islamic Banks – Ways to Play for the Future, Dr Philipp Wackerbeck, Strategy&

Case Study

The meeting considered a case study showing how an analysis of this kind had been applied, for a particular bank, to Germany.



Source: Internationalisation of Islamic Banks – Ways to Play for the Future, Dr Philipp Wackerbeck, Strategy&

Germany emerged as an attractive market as a result of the following attributes:

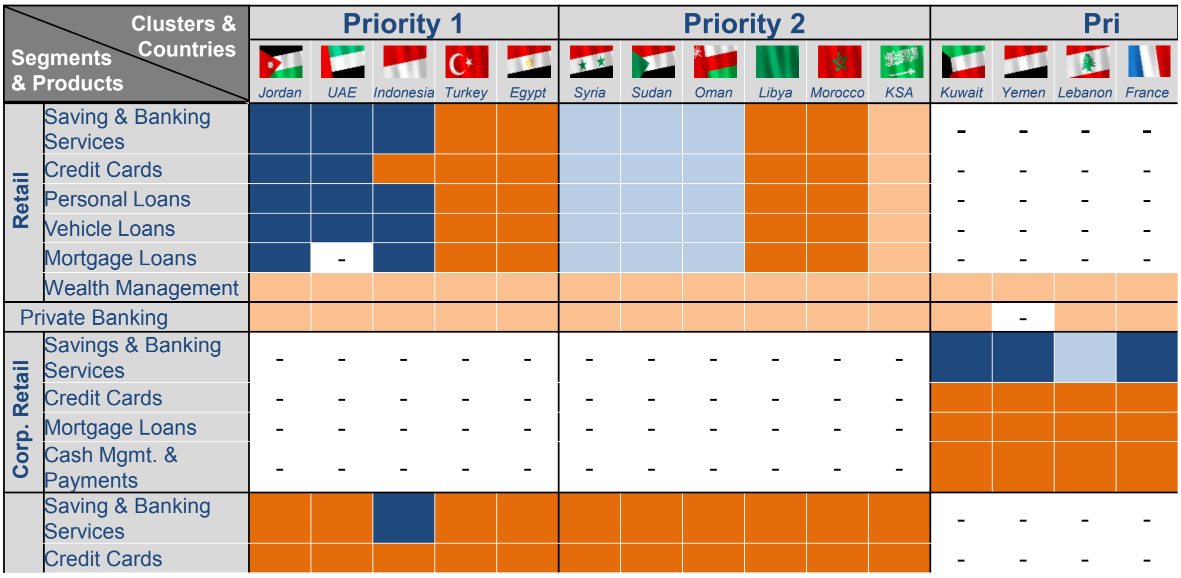
High GDP per capita: The German market offers attractive opportunities due to relatively high GDP/ capita, homogeneous structure and large size of Muslim population.

Low competition: At the time of writing there was no domestically licensed full-fledged Islamic bank in Germany

Homogeneous Muslim population: The Muslim population in Germany is homogeneous, since it is mainly of Turkish origin. As a result, it is easier for banks to design financial products that will appeal to a large proportion of that population.

Licensing: Receipt of a banking licence in Germany would enable a bank to operate in other EU countries, such as Austria, which is also German speaking.

Greater differentiation can also be achieved by analysing product segments in individual countries. For example, a bank could identify its principal product lines such as "savings and loans", "credit cards", "personal loans", with a further broad distinction between retail, SME and corporate customers. The bank can then identify countries where it is currently present with these products and countries that it wants to target. The potential target markets need to be prioritised to plan market entry strategies. A holistic target market planning can be shown as follows.



Source: Internationalisation of Islamic Banks – Ways to Play for the Future, Dr Philipp Wackerbeck, Strategy&

3. Different methods of entering new markets

Expansion into overseas markets can take many forms. The most common can be described as greenfield, mergers and acquisitions, and partnership.

Greenfield	M & A	Partnerships
A bank builds a new operation from scratch	A bank buys an existing operation that belongs to someone else	A bank enters into an agreement with a local partner

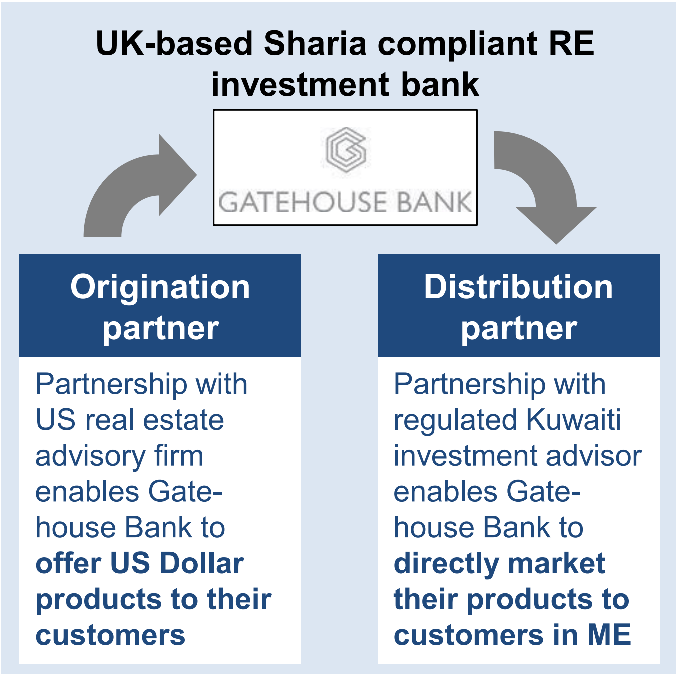
Within these three categories, different routes can be taken. For example, the "greenfield" approach may involve capitalising a newly licensed subsidiary or establishing a branch or a representative office. "Partnerships" could entail jointly capitalising a new operation entity or an agreement for a local bank to distribute some of the home bank's products.

Greenfield strategies give banks the greatest control over their expansion. There are no legacy issues (corporate culture, IT systems, long standing employees) that can constrain the bank's vision for its new operations. But greenfield expansion does present challenges: the bank has to appoint managers to implement its vision. Many of these managers, including the senior staff, have to be locally recruited; yet the bank also needs to provide some form of representation from headquarters.

Mergers and acquisitions allow fast market entry and bring new capabilities and networks, as well as the potential benefits of an established brand. However, they depend on the availability of a suitable target, and the challenges and expense of integrating corporate structures, culture and systems are often underestimated.

Partnerships offer more flexibility than greenfield approaches and lower risks. By working with a foreign partner that distributes products in its own country, a bank is able to gain access to a new pool of clients, and perhaps even follow its existing clients into new markets. Partnerships can be implemented by investing in the foreign firm or by coming to a contractual arrangement, without any investment taking place.

The meeting considered a case study of Gatehouse Bank, a UK-based Shari'ah-compliant real estate investment bank, which uses a partnership with a U.S. real estate advisory firm to source U.S. dollar products to be offered to its customers, and a partnership with a regulated Kuwaiti investment advisor to directly market products to customers in the Middle East.



Source: Internationalisation of Islamic Banks – Ways to Play for the Future, Dr Philipp Wackerbeck, Strategy&

Whichever approach a bank takes to internationalisation, it should only embark on international expansion if it has a strong domestic base of operations. Nothing should be done that will compromise the bank's core domestic business – after all, it is this domestic business that is creating the revenues, and the stability, that enables the bank to spread its wings abroad.

Finally, any bank should be aware that internationalisation can have a significant impact on a bank's business. The business becomes more complex; risk management more difficult; governance structures may have to be adjusted; and IT systems become harder to manage. As banks consider which countries to target, and identify their strategies for entry, they must also reflect on the effect that internationalisation will have on the existing business. Managed well, internationalisation brings new ideas, new dynamism and greater revenue to the bank. Managed badly, it can suck up management time and resources and increase the bank's risk profile, while contributing little to the bank's franchise or revenues.

Part Two
Branding and Governance Practices Revisited

Part Two. Branding and governance practices revisited

Branding and governance are important issues for IFIs to consider as part of their internationalization strategies. While the former is related to the emerging issue on rebranding of IFIs in order to broaden their customer base, the latter remains one of the most crucial issues in global financial markets.

1. Leveraging the brand and maintaining core activities

Branding is important to any institution that is expanding overseas, but it is particularly important to the internationalisation strategies of IFIs. IFIs are targeting a particular segment of the financial community – the segment that wants to conduct its financial affairs in accordance with the Shari'ah and with ethical principles. Not all customers of Islamic banks are Muslims – some non-Muslims use Islamic banks in order to fulfil their desire to conduct their financial affairs in an explicitly ethical manner.

A study by Ogilvynoor presented at the Roundtable noted that more than 90% of Muslims say that their faith and religious views affect which goods they chose to consume. As a result, potential customers of IFIs need to know that their bank is trustworthy and is committed to conducting genuinely Shari'ah-compliant banking. This is particularly true when banks are trying to attract customers outside their home market, where they are less well known.

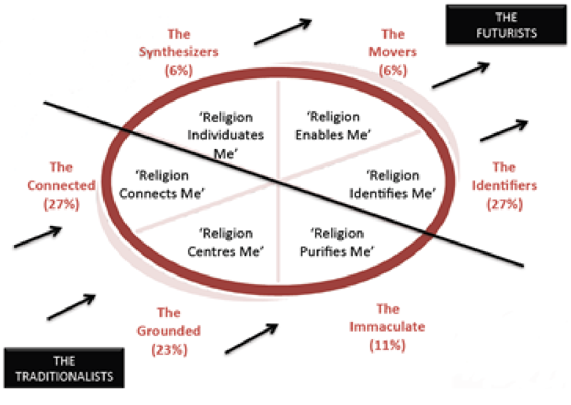
The issue of branding goes beyond the narrow view of Shari'ah compliance as it is often understood within Islamic Finance circles. Too often, IFIs see Shari'ah compliance solely in terms of whether their financial products conform to Shari'ah rules governing financial transactions (for example, the avoidance of riba; the avoidance of gharar and maysir; the correct use of investment account reserves).

This narrow Shari'ah-compliance approach currently seems insufficient to attract a wide range of Muslim and non-Muslim consumers. In some regions, there are many Islamic banks, all of which are operating in conformity with Shari'ah financial principles. If an IFI is trying to enter a new market, it will be difficult to distinguish itself purely in terms of financial Shari'ah compliance. That is why a broader approach of branding is needed.

If an IFI is to project itself internationally and compete with all players – both Shari'ah-compliant and conventional – it has to make emotional connections with consumers. Successful global brands respect their customers and are trusted by them; they are loyal to their customers and evoke loyalty from them; and they are transparent about their business practices and objectives. These principles have been followed by mainstream global brands such as Adidas, McDonalds, Apple, Nike and Coca-Cola, etc .

In other words, it was argued, there is no such thing as a 'Muslim brand': all brands have the potential to appeal to Muslim consumers. Good Shari'ah practice is good business practice universally. What IFIs need to do is to build a brand that is empathetic to values in order to appeal to non-Muslims in general and Muslims in particular, and the brand's principles need to be reflected in all aspects of the brand's identity, behaviour and communications. If Shari'ah compliant brands are to beat the conventional brands, they have first to connect with consumers at the emotional level. This implies focusing on the consumer and his or her needs above all else, maintaining values at all costs, and also acting like a "normal" brand rather than a specifically Islamic one.

Ogilvynoor uses a model which segments religiously-inclined consumers as follows.



Source: The Power of Branding, Vaquas Alvi, Ogilvynoor

The firm's analysis also suggests that the religious sensitivity of a product or service depends on how intimately personal it is to the consumer. Three tiers are identiefied as follows:

Tier 1	It relates to areas of bodily consumption such as food products, beverages and items such as oral care. Here Shari'ah compliance is absolutely essential.
Tier 2	It relates to areas that are close to the body or in regular contact, such as skin and hair care products, fashion apparel, and to non-tangible areas where a customer has frequent interactions, such as consumer finance. Here, Shari'ah compliance is important but marginally less so than is true for Tier 2 products.
Tier 3	It relates to areas that are consumed infrequently, such as hotels, travel packages, loans, financing, and insurance. Here, there is some room for flexibility in Shari'ah compliance in which the brands can appeal beyond the Muslim community.

Source: The Power of Branding, Vaquas Alvi, Ogilvynoor

Interestingly, in this analysis, financial services is an area where Shari'ah brands have some room for manoeuvre to be able to appeal to consumers' emotion and also to appeal beyond the Muslim community.

Case Study: Al Baraka

The meeting considered the case of Al Baraka, which has successfully transformed its diverse group of international banks into a single, well-recognised Islamic banking brand. It noted that to continue expanding, IFIs have two options. Option one is to compete for the mass of consumers - by some estimates, 60 or 70 percent of the population even in a mainly Muslim country - who base their choice of banking services on non-religious factors. The other is to move into new markets in Asia, Europe or Africa, in countries which have Muslim minorities but where establishing a profitable presence will require attracting large numbers of non-Muslims. Either will require coherent corporate branding, across time and across stakeholders.

Firstly, Al Baraka stressed that building a strong brand entails creating customer experiences that are rooted in customers' lifestyles, their relationships – both personal and professional – and their broader social connections. The growth will be driven by customers. In particular, digital banking will be the focus of the future, and Islamic banking needs to evolve towards technology-based service-driven value propositions. A mere digital presence is not sufficient; the presence needs to be tailored to consumers' lifestyles, relationships and emotional connections. This kind of new experience will cause sizeable shifts of customers between brands. When Al Baraka was considering how to strengthen its international position, it began by identifying its existing strengths. It identified four areas of strength:

- **Islamic Finance:** commitment to the principles of Islamic finance was the main driver of customer loyalty throughout the group, although the group believed that, 30 years since it began operations, this commitment should be re-affirmed and re-invigorated.
- **Customer Loyalty:** the group believed that the connection between customers, bank employees and the way in which the group was managed was particularly strong and went beyond a purely commercial relationship. Al Baraka believes that this strong relationship exists between all banks in the group – wherever in the world they may be – and their customers.
- **Strong Commercial Brand:** the brand was based on commitment to Shari'ah principles; strong financial position; and an international footprint.
- **Strong local presence:** this leads to greater international opportunities. Al Baraka bank believed that its focus on local banking was a distinguishing feature and gave it an advantage over other international groups when competing for local business.

In practical terms, these observations led the Al Baraka Group to further strengthen the ties between the Group and its subsidiaries, to present a modernised Islamic finance proposition, and to enhance its presence in local markets while also injecting an international image to local operations through the standardisation of products and marketing. The Group also redefined its vision, mission and values to ensure that its operations are focussed primarily on customers and society as a whole.

Finally, Islamic banking needs to start looking at its future differentiation through a suitable business model that emphasises strengthening relationships and enhancing engagement with different groups of stakeholders. In other words, it needs a shift of business model from satisfying shareholders into meeting stakeholders' values and well-being, which has a **broader concept of customer centricity** accounting for consumers, society, inclusion, environment, etc.

2. Upgrading governance and compliance

An unavoidable consequence of internationalisation is that corporate governance becomes more complex and the burden of compliance becomes greater. It is easy to see how the compliance burden increases: not only do local regulators have their own standards and regulatory culture that need to be incorporated into a bank's existing compliance function, but home regulators want to be assured that a bank is not engaging in activities overseas that could weaken it or bring it into disrepute.

As for corporate governance, challenges arise from the need to define a more extensive strategy, to include representatives from overseas operations in a bank's top decision-making bodies; and to set policies and procedures (such as risk guidelines and internal audit policies) that are relevant, appropriate and practicable in all areas of the expanded group.

These challenges apply to any bank that is expanding its operations overseas but there are particular and additional issues that need to be addressed by IFIs. For any bank, an integrated risk and compliance framework unifies a bank's approach to risk, and it facilitates good governance, an effective risk strategy and compliance. Increasingly common in major banks, the approach is often known as "GRC" (Governance, Risk, Compliance). IFIs, however, face additional layers of governance, risk and compliance arising from their status as Shari'ah-compliant institutions.

Governance	An IFI is not a profit maximising institution but rather an institution that must combine a social mission with the need to earn sufficient profits to remain in business and reward shareholders. An IFI also has to recognise different ownership structures from those of a conventional bank: investment account holders have rights that are different to those of depositors in a conventional bank.
Risk	An IFI faces risks that are different from those of conventional banks (as well as many risks that are the same) and so it may not be able to configure its risk function in the same way as a conventional bank. For example, "credit risk" may be an inappropriate designation for many of an IFI's exposures, whereas "credit risk" represents the majority of risk taken by a conventional bank. Legal risk may be greater for Islamic banks if they are working in financial systems where the laws and regulations governing the conduct of Islamic finance have only recently been created.
Compliance	Most obviously, Islamic banks must comply with the tenets of the Shari'ah. This is not something that affects conventional banks.

There has been a trend towards silo-based approaches in banks that have pursued international strategies. For example, banks with multiple lines of business in different countries may react to regulatory requirements on a case-by-case basis rather than on a firm-wide basis. While it is easy to see how such siloed approaches arise – for example, as banks focus on complying with regulations in new markets, while disregarding the need to maintain group-wide policies and procedures – in practice they lead to inefficiencies and gaps in coverage.

The following types of issues need to be addressed at Group level:

- Prudential standards: These are likely to be implemented differently at national level in the different jurisdictions in which the IFI operates
- Accounting presentation: Some jurisdictions recognise AAOIFI standards and permit or require IFIs to report on the basis of AAOIFI standards, while others do not; and different jurisdictions take different approaches to the implementation of IFRS
- Compliance with Fatwas: Acceptance of a fatwa issued in one region does not necessarily lead to its acceptance in other regions
- National regulations with international reach: For example, FATCA which is a U.S. law that the U.S. applies internationally, with the result that affected banks need to collect data in a consistent manner from all areas where they operate.

As banks internationalise their businesses, issues of governance, risk and compliance become more important, while simultaneously becoming more complex. As a result, the need for cohesive strategies, policies and procedures becomes more clear; as does the need for senior executives to be involved.

An integrated risk and compliance framework unifies the institution's approach to risk services and reflects the importance of having a comprehensive and integrated regulatory compliance function. Using this approach will help institutions offering Islamic financial services (IFIs) facilitate communication and delivery of good governance, empower an effective risk strategy, and ensure total compliance management with emphasis on the importance of Shari'ah stipulations. The remainder of this section sets out a high level discussion on the key elements and value proposition of an integrated risk and compliance approach – the total compliance management framework.

Do Risk Infrastructure & Management differ in Islamic finance?

The risk function of an IFI has an extra layer of Shariah non-compliance risk whether in the operational, management or market risk positions. Effectively the difference in the business model and supporting units and functions adds more elements to risk functions and infrastructure in the IFI. However, a common risk management infrastructure is used to support the business units and functions in the performance of their risk responsibilities. Executive management is charged with designing, implementing and maintaining an effective risk program. Other functions (e.g., internal audit, risk management, compliance, etc.) provide objective assurance as well as monitor and report on the effectiveness of an IFI's risk program to governing bodies and executive management.

Aligning risk to regulatory compliance

A review of the regulatory landscape and the emerging compliance trends reveals a number of alarming patterns that worries industry executives and regulators alike. This boils down to two main issues: the regulatory compliance risk and the rising costs of compliance-related processes. A number of points worth noting here include:

- Several IFIs, especially those with multi-country operations conduct compliance-related activities in silos. This creates gaps, redundancy, and overlap.
- IFIs as well as other institutions experience challenges with resource allocation and this creates an increased cost burden on the business and inefficiencies. This may also lead to potential failure to comply with critical Shari'ah and regulatory requirements in particular as a result of heterogeneous regulation that arises within the industry.
- A number of large IFIs with multiple lines of businesses continue to react individually to jurisdictional regulatory mandates as opposed to coordinating and integrating regulatory compliance.

Total Compliance Management (TCM)

TCM consists of addressing regulatory compliance in conjunction with risk. More precisely, IFIs should try to develop a risk-based approach and leverage the business value of a Total Compliance Management (TCM) framework. This framework requires building capabilities in the following practices and processes:

- Improving good corporate governance
- Developing effective risk-based corporate compliance
- Emphasizing strengthening coordination between governance, risk and compliance
- Developing a single compliance program to manage compliance against different regulatory and Shari'ah requirements
- Incorporating existing IT, business and security regulations, standards, and frameworks while introducing new requirements
- Instilling confidence through public pronouncement of compliance
- Promote a culture of best practice environment in the organization.

Total Compliance Management function

Source: Integrated Risk & Compliance : An Approach to Homogenous Compliance Framework, Dr. Hatim El-Tahir, Deloitte & Touche

History and experience have shown us that as IFIs grow and expand, the compliance function moves away from a centralised role to a decentralised one. However, the TCM approach   emphasises the need for a single compliance function aligning risk to regulatory compliance. It further supports the core enterprise risk management, operations risk management, and functional risk management activities (e.g. product and services, contracts and structures, information security, financial reporting and transparency, etc.).

2. Syndicated finance refers to a form of financing where two or more banks or financial institutions decide to group together to participate in a deal and each provides an agreed portion of the principal to a borrower/an obligor.

Part Three

Structuring Cross-border Shariah-compliant Financing

Part Three. Structuring cross-border Shariah-compliant financing

For many Islamic banks, structural expansion overseas, even in the form of partnerships rather than the creation or acquisition of new subsidiaries or branches, is not possible. Many Islamic banks are small and do not have the financial resources or the management time to develop an overseas presence. However, overseas business remains attractive for small IFIs, since it provides diversification of their business, an ability to offer cross-border products to clients, and may represent the first stage in a long-term strategy that, later on, will result in the establishment of a branch or subsidiary overseas. The Roundtable considered two ways in which Islamic banks can extend their reach internationally without creating a physical overseas presence: syndicated financing and trade financing.

1. Cross-border syndications

The concept of syndicated finance [2] from a Shariah perspective works in similar ways to that of conventional syndicated finance except that it uses structures and processes which are acceptable to the Shari'ah. Like conventional transactions, an Islamic financing transaction may be syndicated before the financial close, simultaneously with it or after the financial close. Many of the commercial considerations are also the same.

1.1. Evolution of Islamic syndicated financing

Shari'ah-compliant syndicated financing is emerging as a major tool to maximize the investor base, which has been growing both in terms of asset classes and geography. Companies from countries such as Morocco, Nigeria and Sierra Leone have been able to access Shariah compliant funding from other parts of the world for the first time.

Shari'ah-compliant syndicated financing is used mainly on three types of transactions: project financings, construction financings and general corporate financings. The key sector to which cross-border Islamic syndicated financing has extended its reach is infrastructure projects. Services and facilities following the completion of infrastructure projects have a genuinely positive effect on communities; something which is at the very heart of Islamic finance. In fact, the Islamic Corporation for the Development of the Private Sector (ICD) and the IDB have led and pioneered many such projects across the globe.

Over the last decade, sizable project financings in the GCC have seen one or more syndicated Islamic tranches in a single project along with a mixture of conventional tranches and Export Credit Agency / Export-Import funding. Real estate was the key asset class during the early 2000s until 2008. During that period construction and development of various types of real estate assets across the GCC – mostly in the UAE – were financed by IFIs in syndicates of various sizes. Several of these projects needed restructuring because the anticipated cash flows were adversely affected by the global financial crisis.

1.2. Factors impeding growth of Shari'ah-compliant syndicated financing

Cross-border syndications are now sufficiently common and diverse to enable IFIs of all sizes to participate. They present an easy route for IFIs to extend their businesses overseas. In doing so, IFIs not only diversify their businesses but also contribute to the international development of Islamic financial activity. However, there remain some key structuring issues which are affecting the growth of cross-border Islamic syndicated financing as follow.

Identification and characterisation of underlying assets	Integrating conventional and Islamic tranches
Governing law	Inter-creditor issues
Taxation	Absence of standard Islamic finance documentation
Sharing collateral	Shariah approval process

3. It is prohibited in certain countries. For example, the Sultanate of Oman has taken a significant leap in this regard by prohibiting the use of Commodity Murabaha or Tawarruq altogether (except in very limited circumstances for specified periods).

4. This was reinforced by the case of Shamil Bank of Bahrain v Beximco Pharmaceuticals (2004) in which the court held that Shari'ah principles did not apply to the contract and that the financing was enforceable under English law.

Lack of suitable alternatives for structures

Commodity Murabaha or Tawarruq remains the most popular choice for Islamic syndications for general corporate financings and for those obligors who do not possess sufficient unencumbered assets to be able to obtain financing based on other Shariah compliant structures. Although Commodity Murabaha or Tawarruq is easy to implement and it is relatively cost effective, a number of Shari'ah Scholars are becoming increasing uncomfortable with the use of Commodity Murabaha and many are urging their institutions to explore other options which have better Shari'ah acceptance and higher exposure to asset and ownership risk[3]. On the other hand, there is a lack of suitable alternatives to Commodity Murabaha. Wakala and Mudaraba may be viewed as alternatives but local tax laws and laws governing agency relationship, may make these structures unsuitable for Islamic financings.

It is possible to blend Shariah-compliant and conventional tranches into a single syndication, although when this happens there are a few additional factors to consider. For example, it is necessary to ensure that Shari'ah-compliant and conventional institutions will be treated equally in the event of default or the exercise of remedies; and that both are paid pari passu from the project's cash flows. Another factor relates to the sharing of security granted by the project company, which needs to be available on an equitable basis both to the conventional institutions and to the IFIs.

No recourse to specific assets

In many cases, IFIs have no recourse to specific assets such as on concession based infrastructure projects (where a concession is granted on the basis of build operate and transfer for a specific tenor) for the financing of roads, bridges and tunnels. On these projects, traditional Istisna' procurement or Wakala structures with a lease cannot work because Shari'ah scholars typically do not allow a sale and leaseback of concession rights which are not specific or tangible. Most of these projects are multi-sourced and it is not possible to specify which part of the project would be financed by the IFIs (other than in percentage terms reflecting the proportionate share of the IFIs in the overall financing corresponding to their contribution). Developing partnership, agency or management based structures without a lease to circumvent these and other issues is very costly and time consuming, which generally drives sponsors behind these projects away from utilising Islamic finance.

Choice of governing law

The choice of governing law is important. Although contracts are governed by the law chosen by the parties to the contract, courts interpret this as a choice of the law of a particular country and exclude the possibility of choosing an international system of law, such as the Shari'ah [4].

Absence of standard documentation

There remains a fundamental issue in Islamic syndicated financing with respect to the absence of standard documentation and the Shari'ah approval process. The absence of a universally agreed form of documentation means that there is a time consuming process to ensure that the transactions are Shari'ah compliant. Different interpretations in the Shari'ah approval process of each arranger may also inhibit syndication, particularly if it involves cross-border syndication. The different treatment of debt trading in Middle East and Malaysia is an example of this. In some cases, the documents typically refer to LSTA (Loan Syndication and Trading Association) and LMA (Loan Market Association) forms, which enable conventional lenders to participate in an Islamic syndication.

Home bias and capacity

Most syndicated deals take place predominantly in the Middle East and Malaysia, while deals from the remaining Muslim and non-Muslim countries are still small. There is also a presence of the so-called "home bias" whereby most Islamic financers prefer to provide syndicated financing to the borrowers from their respective regions, which implies a lack of participation in syndications across regions. In addition, most of the mandated lead arrangers of the Islamic syndications in the Middle East have been major international banks[5] . While some of the GCC-based Islamic banks are acquiring experience as arrangers, most are too small to manage major syndications. There is nevertheless opportunity for Islamic banks to serve as co-arrangers, perhaps providing Shari'ah compliance skills as an incentive for international banks to partner with them.

5. For example, HSBC, Barclay Capital, Standard Chartered, Citi, Sumitomo Mitsui Financial group

Case Study

Some of the issues highlighted above were dealt with on a recent concession based multi-sourced financing (which included an Islamic syndicated tranche), where the concession granted to the grantee was to develop a toll road on the basis of build operate and transfer. Significant time was spent in bridging the views of the Shari'a scholars from various financial institutions and meeting the concerns of the conventional lenders.

The key issues identified include:

- Traditional Istisna'a/Wakala/Procurement structures were not possible due to the nature of the concession
- Shari'ah concerns about a variable floating return in the absence of a lease for amortisation and return on principal
- Public policy issues
- No access to physical assets underlying the concession
- Restriction on disposal of interest (i.e. transfer or assignment) in the concession
- Shari'ah scholars uncomfortable with sale and leaseback of concession rights
- Conventional senior creditors concerned about structural superiority of IFIs
- Difficulties in providing precise description and identification of specific assets to be financed by the IFIs
- Tax issues
- Characterisation of Islamic tranches

As to a solution, the above issues led to the development of a combined procurement and agency based structure, which was a variation of the traditional parallel Istisna'a structure. Under this structure, the project company was appointed by the IFIs to procure the design, construction, engineering and delivery of a specific percentage of the project. The IFIs through their agent subcontracted these obligations back to the project company pursuant to an agency agreement. Disbursements were made to the project company pursuant to an agency agreement. Repayment of principal and fixed profit was made by the project company in line with the procurement agreement as deferred consideration. Acceleration occurred through a termination right under the procurement agreement.

2. Islamic trade finance

The promising opportunities for Islamic trade financing have been driven by the global outlook of the trade sector in Muslim countries. While the global trade of OIC countries keeps increasing, the Islamic Centre for Development of Trade (ICDT) predicts that the growth rate of intra-OIC trade will be higher than that for the OIC global trade as a whole. This further implies substantial untapped opportunities for Islamic trade financing to strengthen the global real-sector linkages, which is in line with the new Ten-Year Programme of Action of the OIC for the period of 2016 – 2025. This huge potential may come primarily from rapid-growth markets, including Turkey, Indonesia, Malaysia, Qatar, Saudi Arabia, and the UAE.

Trade finance is therefore another route that IFIs can take to internationalise their business. As with syndicated financing, benefits accrue to the individual IFI in the form of diversification, improved customer offerings, and revenues; and benefits also accrue to the wider Muslim community, as the number of IFIs offering financing in a wider range of countries increases.

2.1. The role of MDBs

Trade finance also plays an important role in promoting economic growth and prosperity, particularly in less developed economies, which is the reason why multilateral development banks (MDBs) are heavily involved in facilitating the growth of trade finance. For example, the Asian Development Bank has estimated that a 5% increase in the availability of trade finance can lead to a 2% increase in economic production and a 2% increase in jobs. However, it is clear that there is a big gap between the global demand for trade finance and its availability. Forty five per cent of respondents to the International Chamber of Commerce's 2014 Global Survey of Trade Finance reported a shortfall in the global availability of trade finance. Banks surveyed reported a rejection rate of 21% on proposed trade finance transactions. In this environment, MDBs generally have three methods to facilitate trade finance as follows:

Risk sharing or risk participation agreements	The MDB shares the risk of a transaction with commercial banks that provide the financing.
Lines of financing	This enables financial institutions to make financing even when they have limited resources. Such lines are frequently used to get credit to small and medium sized enterprises, for example in the form of pre and post shipment finance, factoring or import financing.
Commodity finance	This type of financing targets commodity aggregators and export marketing agencies, or funds that are involved in agricultural products.

When the availability of international trade finance shrank as a result of the global financial crisis, the G20 group of nations asked MDBs to increase their trade finance resources to fill the gap. One result of this was the creation by the Islamic Development Bank of the Islamic Trade Finance Corporation (ITFC).

The ITFC focuses primarily on encouraging more trade between members of the OIC. As a leader in Shari'ah-compliant trade finance, the Corporation uses its expertise and its financial resources to fund businesses and governments in OIC states. ITFC uses four modes of financing:

Import financing	Structured with murabaha
Pre-export financing	Structured with murabaha and istisna'
Export financing	Structured with murabaha
Structured financing	Based on strength of cash flow rather than strength of the borrower.

The dominant form of financing is Murabaha, and the following chart indicates the main commodities that ITFC has financed.

Main Commodities Financed

Source: Islamic Trade Financing : Driving the industry, Mr. Nazeem Noordali, ITFC

ITFC is able to circumvent the constraints of balance sheet size and strength to work with local partners in providing Shari'ah-compliant financing that will bring benefits to local companies and consumers. As such, it presents an enormous opportunity for IFIs that are seeking to internationalise their operations but do not have much international experience. Such IFIs cannot afford to take a lot of risk during the first stages of the internationalisation efforts, which is why the risk sharing provided by programmes such as ITFC is so significant. Furthermore, work with an MDB programme gives an IFI access to experience and knowledge of international markets that it would take years to acquire.

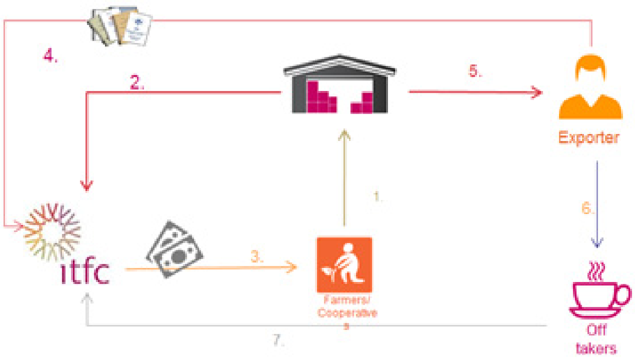
2.2. Impediments to trade finance

The trend in trade finance shows that open account, short-term credit insurance, factoring and technology driven supply chain finance is fast becoming the norm. Nonetheless, some of the key impediments were identified as particularly significant based on an ADB survey. The three issues identified as most significant were: requirements relating to anti-money laundering and "Know Your Customer"; low credit ratings of issuing banks; and previous disputes or unsatisfactory performance.

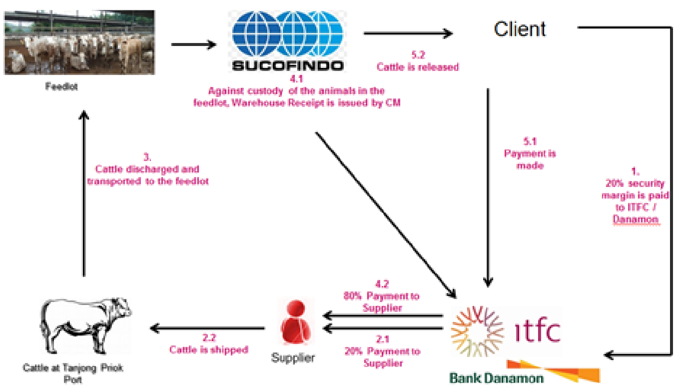
All of these impediments relate to banks that are trying to issue facilities for their customers. Simply put, in most cases, banks in larger and more established economies are not willing to take the risk of doing business with banks in less established and more opaque economies. Specific to Islamic trade finance, the challenges also include the competitive cost of Islamic trade financing, the availability of Shari'ah-compliant products to meet the demand, prudential standards (such as Basel III), and the level of awareness with regard to Islamic finance in the countries' trading partners. The availability of Shari'ah-compliant hedging instruments is also considered necessary to mitigate currency, market, counterparty and political risks. Some of the Islamic trade financing mechanisms such as syndicated trade financing and Islamic trade finance funds need to be promoted further in order to enhance the volume.

Case Study

The meeting considered a case study from the ITFC that referred to coffee financing in Indonesia and its developmental impact. The mechanism was direct payment to farmers and cooperatives, representing 2.2k farmers. The payment was against delivery of coffee beans to warehouse, with no more selling on deferred basis. This has overcome the issue of lack of financing in local markets.



Another case study was an innovative structure for a non-classical commodity related to cattle financing. The mechanism financed the live cattle imports and aided Indonesia in fulfilling its beef requirements. This kind of structure required a higher level of monitoring and risk mitigation, as well as involved partnership with a local bank.



Source: Islamic Trade Financing : Driving the industry, Mr. Nazeem Noordali, ITFC

Concluding remarks and takeaway points

The case for the greater internationalisation of IFIs is compelling. Internationalisation offers opportunities for IFIs to expand and diversify their businesses, generate greater revenues and reduce their dependence on their home markets. It also brings great benefits to Muslims (and non-Muslims who are committed to ethical forms of finance) by increasing the availability of Shari'ah-compliant financial services across the globe.

Yet internationalisation is not a step to be taken lightly. As the contributors to CIBAFI's Roundtable explained, internationalisation needs to be built on a foundation of strong domestic business; it needs to be carefully considered using objective criteria; and governance risk and compliance functions need to be upgraded to take account of the greater complexity that internationalisation entails. An IFI's brand is a crucial asset that can be used to penetrate new markets, yet the brand needs to encompass a wide range of non-financial factors if it is to successfully appeal across national borders.

Larger IFIs have several strategies open to them as they consider how to structure their internationalisation: building a new operation from scratch, buying an existing operation, or partnering with a local firm. Such initiatives are often beyond the capabilities of smaller IFIs, but there are still ways in which smaller IFIs can extend their exposure overseas, for example by participating in Shari'ah-compliant syndications or by participating in financing schemes developed by multi-lateral development banks.

The opportunities for IFIs to internationalise their operations are great, but they could be even greater. Many factors continue to impede internationalisation by IFIs: banking regulations, accounting standards, and Shari'ah interpretations that differ from country to country; national regulators that are protective of domestic banks and financial systems; and the fact that internationalisation has not, until now, been given the prominence that it deserves within the Islamic finance industry.

The following paragraphs summarise some of the key points that were identified during the CIBAFI Roundtable that could lead to greater internationalisation of IFIs.

Regulators and Islamic finance standard setters have a role in promoting a cross-border level playing field that enables IFIs to internationalise, as well as facilitating an increase in the volume of cross-border Islamic investment flows and transactions.

The regulator of each Muslim-majority country, and those with significant Muslim minorities, needs to implement Islamic finance regulations that can provide a level playing field for IFIs to operate vis-à-vis conventional counterparts. Countries also need to be open to new entrants, including through mergers or partnerships with domestic players.

Islamic finance standard setters need to strengthen their engagement with (conventional) standard setters, such as the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), etc., in order to ensure that Islamic finance regulations can be adopted in a timely manner.

IFIs need to take a rigorous approach to market selection and also to their mode of entry into new markets. If entry is to be profitable it requires achieving significant size rather than mere flag-planting. It is also likely to involve reforms to governance and risk management.

In addition to adopting a rigorous and structured approach to market selection, IFIs need to consider how entry into each market is to be achieved. The principal options are to create a new operation from scratch, merger or acquisition, or partnership with an existing player. The last of these has considerable merits from the point of view of flexibility and sustainability of the new operation.

Internationalisation will place new demands on IFIs' risk management and compliance functions because of the need to meet diverse regulatory regimes and Shari'ah interpretations in different jurisdictions. This is likely to require an integrated approach to governance, risk and compliance at group level.

IFIs need to reconsider their branding and business models in the light of the needs and values of customers, both Muslim and non-Muslim and to shift from models based purely on shareholders' values to a broader concept of stakeholders' values.

If an IFI is trying to enter a new market, it will be difficult to distinguish itself purely in terms of Shari'ah compliance. It is also likely to need to attract both Muslim and non-Muslim customers. It will need to define coherent branding across its operations, based on consistent values which connect with those of its customers and other stakeholders. More broadly, IFIs need to strengthen relationships and enhance engagement with different groups of stakeholders and to move from satisfying shareholders' to satisfying stakeholders' values and well-being.\

There is a need to enhance the volume of co-financing among IFIs and trade financing across regions, aligned with the emerging trend of increasing economic growth and trade flows of Muslim-majority countries

Co-financing and trade finance offer opportunities for IFIs to participate in international business without establishing operations in new jurisdictions. Trade financing opportunities in particular are supported by the continuing growth in the trade activity of the OIC countries.

In respect of syndications, there are numerous structural and technical impediments such as the absence of standard documentation, governing law, etc. There is a need to increase awareness of the work of Shari'ah standard setters and urge these standard setters to make greater efforts to harmonize Shari'ah opinions across borders and regions with respect to co-financing; and where harmonization is difficult, to identify areas of agreement (or potential agreement) that could facilitate increased financial flows between regions. There may also be scope to develop standard documentation. In addition, IFIs need to improve their capacities, relating to their skills and experiences, to be mandated lead arrangers of the Islamic syndications.

In respect of trade finance, participation in an MDB-led programme can give an IFI access to international experience and knowledge, and allow it to limit its risks in the early years. IFIs do, however, need to develop their performance and compliance (particularly with AML/KYC requirements) if they are to be regarded as trustworthy partners by banks in more developed economies.

Annexes

Annexes

Annex 1.

List of Speakers at CIBAFI's Roundtable, "Internationalisation Strategies for IFIs" held on 23 – 24 February 2015 in Manama, Kingdom of Bahrain and contributors of this publication.

Opening Remarks and Keynote Speeches

Mr. Abdelilah Belatik
Secretary General, CIBAFI

Dr. Abdul Aziz AlHinai
Vice President, Islamic Development Bank

Mr. Khalid Hamad Abdulrahman,
Executive Director of Banking Supervision, Central Bank of Bahrain

H. E. Dr Ahmad Mohamed Ali Al Madani
President of the Islamic Development Bank

Session 1: Homogeneity in Islamic finance development, Shari'ah and regulatory frameworks across different jurisdictions

Mr. Carel Oosthuizen
Senior Financial Sector Expert, Former IMF Official
* Speaker and contributor to this publication

Dr. Hatim El-Tahir
Director, Islamic Finance Group, Deloitte & Touche
* Speaker and contributor to this publication

Session 2: Key requirements for internationalisation, modes of entry and strategies to achieve competitive positioning of foreign Islamic financial institutions

Dr. Philipp Wackerbeck,
Partner, Strategy& (formerly Booz and Co)

Session 3: Rebranding as an expansion strategy for Islamic Financial Institutions to go main-stream

Mr. Vaquas Alvi
Regional Director, Ogilvynoor Middle East and North Africa

Mr. Ayman Ahmed Mohamed Abdalla
First Vice President, Strategic Planning, Al Baraka Banking Group
* Speaker and contributor to this publication

Session 4: Cross border Islamic syndicated financing

Mr. Salman Ahmed
Partner, Head of Islamic Finance in the Middle East, Trowers & Hamlins LLP
* Speaker and contributor to this publication

Session 5: Trade financing for IFIs to boost global real-sector linkages

Mr. Nazeem Noordali
General Manager of Corporate and Structured Finance Department (CSF), Islamic Trade Finance Corporation (ITFC)

Repoporteur

Andrew Cunningham
Founder, Darien Analytics Ltd

Dr. Ginanjar Dewandaru
Research Economist, CIBAFI

Annex 2.

Structures Commonly Used to Structure Shari'ah-compliant syndications

Structures Commonly Used to Structure Shari'ah-compliant syndications	
Murabaha	Murabaha entails the sale of commodities to a borrower/obligor with a defined and agreed profit mark-up being added to the purchase price. Amounts paid by the borrower towards the purchase price of the commodities are used to pay the agreed fee to the investment agent and the syndicate banks (including the investment agent, if applicable) and to repay their shares pro-rata to the amounts they advanced.
Commodity Murabaha (Tawarruq)	Under a commodity murabaha, the investment agent (the lead bank) buys a freely tradable asset (except gold or silver) in the spot market using the funds received from the lenders. The investment agent then immediately sells the asset at an agreed marked up price to the borrower/obligor and makes immediate delivery. The borrower's/obligor's obligation to pay the purchase price is deferred (to be paid either in instalments or in a single bullet repayment). The borrower/obligor then immediately sells the asset in the spot market to a third party for immediate payment and delivery.
Ijarah	An Ijara is an Islamic equivalent of a lease, entailing the transfer of the usufruct of an asset by one entity to another entity in exchange for a rental payment. Issues that determine whether an Ijara structure is appropriate include: • The availability to the borrower/obligor of assets of sufficient value so that the borrow/obligor can sell assets to the investment agent to support the amount it wants to borrow • (in the case of a revolving transaction) the ability to sell down assets on the drawdown dates • the absence of any restrictions (such as a lien or a covenant) that would preclude sale of the assets to the investment agent
Istisna'	Istisna' is generally used to raise finance for construction projects and is commonly used in conjunction with an Ijara structure. To be Shari'ah-compliant, a manufacturer must use its own materials to produce an asset and the price and specifications of the asset to be manufactured must be agreed at the outset.

General Council for Islamic Banks
and Financial Institutions (CIBAFI)

Jeera III Tower, Office 51, Building No. 657,
Road No.2811, Block No. 428
Manama, Kingdom of Bahrain.
P.O. Box No. 24456

Email: cibafi@cibafi.org

Telephone No.: +973 1735 7300

Fax No.: +973 1732 4902