

Islamic Finance Intelligence Summit

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Good morning, ladies and gentlemen. It's a pleasure to be here. I've spent much of the past two decades working in the Middle East, so today's conference has a particular resonance for me; I've watched Islamic finance grow from its nascent phase to an industry that now represents a substantial market. While the industry's in its fourth decade, it's really come into its own in the past few years, and I thought I'd highlight just a few numbers to put it in perspective:

The rise of Islamic finance

The Islamic finance industry consists of 500-plus institutions managing assets estimated in value around US\$500 billion, and is growing at almost twice the rate of interest-related financial services – 29.7 per cent over the past year. And a recent study of projected growth rates estimated that Islamic finance would maintain that nearly twofold increase over conventional wholesale banking.

The global Sukuk market has maintained growth, showing total issuance aggregating US\$37.7 billion in the 2007 third quarter – a growth of 110.7 percent over the previous year. Seven years ago, the total yearly number was just \$336 million.

The impetus behind its growth

The discussion of Islamic finance begins, of course, with identifying the impetus for its growth. The obvious explanation is that there are 1.6 billion Muslims in the world, and a continued economic and construction boom in the Middle East is providing more capital to invest, which, in turn, is generating interest from financial institutions who are eager to cater to the market. This is all true, no question, but I think there are several layers to the industry's expansion and the recent rise in its profile.

To some extent, the industry's growth reflects the legitimacy of Sharia-compliant products. Consumers are much more confident in banks' offers, as the industry has established its credentials through work with, and endorsement from, distinguished religious scholars. This leads to another deceptively simple factor in the rise in Islamic financial services: there is more on offer. As confidence in the sector increases, the industry expands its presence and develops more products; as more products are offered, and more trust is put into them, more are taken up, creating a self-perpetuating cycle.

But it's also important to look at where demand originates, and in my personal experience, there's a growing drive from younger generations to actively seek out financial services that conform to Islamic principles. This is a global trend, by the way, something I've found from Riyadh to Reading.

While the industry's expansion is clearly propelled by demographics, availability and public perception, the growth in Islamic finance is also being stimulated by a strong interest from younger Muslims, which has a major impact on the future trajectory of the industry.

Voltaire said that 'when it comes to money, everybody is of the same religion'. Well, if that were strictly true, this would be quite a pointless conference. But I mention it because his message – and he is not alone in thinking this – is that the financial sector is sometimes considered to lack sufficient social, let alone religious, responsibility. Principles are somehow seen as anathema to a profit-driven industry, which I think is an unfair assessment. Finance is also a service-driven industry, and any financial professional will tell you that the way to succeed is to meet the demands of your customer. And that increasingly means providing for the moral and ethical needs of our clientele. This ethos is evident on the provider side as well – I think everyone in this room has recognised the growing culture of corporate social responsibility, and that financial institutions are making concerted efforts to consider positive social impact as a factor in new product offers.

more Islamic
financial services
on offer

So I would say the drive behind the growth of Islamic financial services is plain old supply and demand on the one hand, and a shift in cultural trends and attitudes – both of customer and provider – on the other. We have a large population for whom these services are attractive, more products to offer, an increasing trust in the sector, younger generations' interest propelling the momentum, and an industry interested in both filling a market need and offering a product with inherent social value.

Benefits of Islamic finance

And there *is* inherent social value, as well as a positive business dimension.

The industry creates working conditions that by necessity transcend national borders and bring us into contact with colleagues the world over. It also strengthens social ties – ignorance is usually the author of social tension, and educating the non-Muslim public about Islamic principles helps create community bonds, especially in Western countries with large Muslim populations – The UK, France, Germany and the US, for instance. Providing banking services in conformity with Sharia law also enfranchises Muslim citizens of all countries, providing fair and equal access to the financial system.

Then there are the purely pragmatic benefits: Sharia-compliant products provide stability. Islamic finance's emphasis on ethical premises and rigorous self-regulation combats weak corporate governance systems and ineffective internal controls – significant causes of financial instability and the failure of institutions.

I'd like to interject here that I'm fully supportive of the example this sets; there is *definitely* an element of the banking community that could do with a bit of discipline...

Islamic finance also enhances the efficiency of resource allocation, by putting a greater emphasis on the feasibility of projects and real economic activities, as opposed to focusing primarily on the creditworthiness of clients.

These factors combine to make Islamic financial vehicles attractive to clients of all faiths, and there's already evidence to that extent – investors buying Sukuks, for instance, have been overwhelming non-Muslim customers. And in our experience, the interest extends to all offers – 63 per cent of HSBC's total Amanah customers in Malaysia, for example, are non-Muslim. Investment comes from around the globe, as well – 66 per cent of DIFC Sukuk investment comes from Europe and Asia, as does 92 per cent of Kazanah's Sukuk.

What still needs to be done – hurdles facing the industry

While we have made tremendous strides in the industry, we have not yet achieved 'intercontinental Islamic banking perfection', as it were. Though the industry is expanding – remarkably so – we must remember that this is still an evolutionary process and a decisive landscape is not yet set out before us. Islamic finance still represents only 1 per cent of global banking assets – and how we proceed from this point will dictate the ultimate shape of the industry.

There's been a lot of talk, for instance, about innovation and creativity in the market. Many believe that the sector needs more innovation to create bespoke provisions, rather than mirroring the conventional industry and its products. Adjusting Islamic products to other models could restrict the industry, or slow the pace of its growth.

Then there is what Harold Macmillan feared most – 'events, dear boy, events'. Islamic finance has proven its resilience to the recent downturns in the GCC equity markets, and the Islamic Finance Intelligence Service's figures, released last week, show a strong Sukuk market in spite of this summer's credit crisis. But the recent challenges in the conventional credit markets should still serve as a reminder that understanding of risk and return can sometimes be limited. These lessons highlight the need for exhaustive risk assessments for Islamic offerings, to gird them against unforeseeable circumstances.

There are also practical considerations regarding religious intricacies and subtleties. Sharia is, and is likely to continue to be, interpreted locally, as reading varies across areas and cultures. At Amanah, we established both a Global Sharia

Advisory Board *and* Regional Sharia Committees, to ensure the reading of Sharia is concordant with local beliefs. Most banks have a Sharia Advisory Board operating in some capacity, but this creates an added issue of supply – there are a limited number of qualified religious scholars available for instruction. It may be that in areas where the industry's expansion is particularly rapid, the Malaysian model will be adopted, where a single national Sharia board is overseen by the government. This, however, will create different situations for different banks, depending on their geographical location and the extent of their global reach. We're standing at a crossroads at the moment, and whichever path the industry takes will affect us all, and likely in different ways.

And there's the issue highlighted by The Banker's comprehensive analysis of the industry, underreporting. Benchmarking and a thorough assessment of Islamic financial assets are more difficult when the level of disclosure is not what it is in conventional markets.

Which leads me to the biggest hurdle the industry faces: getting everyone to work together. Finance is a competitive business, sure. But there are entrenched reservations that have so far hindered the industry's ability to act as a single community, and these need to be overcome in order to clearly shape the sector. I don't think there's any doubt that competition will be maintained if we work collaboratively. But there can't be healthy competition if the field remains undefined.

Integration of the Islamic financial services industry into the international financial system will largely depend on the credibility of the work done by the Islamic Financial Services Board, Accounting and Auditing Organisation for Islamic Financial Institutions and other standard-setting organizations. It will also depend on the response of the industry to the rapidly changing regulatory, technological and market environments. We will need to manage the industry's progression across markets; in a sound financial services industry, most financial institutions – Islamic or otherwise – will be efficient and stable. But in developing countries there are serious gaps in overall financial infrastructures, which again are shared by both Islamic and conventional financial services. Failure to collaborate could damage the industry as it advances within both developed and emerging markets.

Global reach – current situation

And more markets are showing interest by the day. The current titans of Islamic finance are, of course, Malaysia, Bahrain and Dubai and, increasingly, the UK in the West. And Iran leads all countries with the highest level of Sharia-compliant assets – \$154.6 billion, to be exact. But there are also emerging markets to watch, many of them in East Asia.

I have to say that I don't like making predictions. Banking is a constantly changing industry, and if each of us had a crystal ball, well...a lot of us would own our own islands by now. But while we don't make predictions, we do look at emerging trends to gauge the market's direction, and in that capacity,

the need for collaborative work

we estimate that in Malaysia and the Gulf Cooperation Council region growth will be different yet complementary – vertical in Malaysia, versus lateral in the GCC.

The establishment of the Malaysia International Islamic Financial Centre in September 2006 underlines a concerted effort by the government to consolidate the existing 12 Islamic banks in the country. New legislation on foreign exchange and capital control regulations are intended to encourage new market ventures and to attract investors to the area. The Malaysian emphasis is fivefold: capacity-building, investment in human capital, enhancing the financial soundness and compliance of IFIs, strengthening Sharia compliance and governance, and the expansion of the sector beyond Muslim countries.

By contrast, the GCC states should see expansion of the market through new banks and companies and more product offers. This is partly because the huge liquidity in the market more directly impacts on demand for financial products. It is also because Islamic finance in most regions does not yet have the structure, regulation and legislation that Malaysia enjoys.

Global situation – emerging players and opportunities ahead

While Malaysia and the GCC countries will continue to lead the growth, Europe and large parts of Asia are playing an increasingly important role.

Some areas are natural destinations for Islamic finance, such as Indonesia, home to the world’s largest Muslim population. But despite its demographic predisposition, just 1 per cent of the bonds issued this year were based on Islamic principles. The Indonesian economy, however, is growing by 5 % a year, which is expected to stimulate major development of the banking sector, and Sharia-compliant banking in particular. Coupled with the Government-led initiatives to accelerate the growth and use of Sharia-compliant financial instruments, Indonesia offers one of the fastest growing new markets for Islamic finance. HSBC Amanah recently opened a branch in Indonesia, becoming the first foreign bank to launch a Sharia Retail Operation.

Other countries with lower consumer demand for Islamic finance are looking to encourage growth of the industry by creating favourable regulatory environments. Singapore, for instance, has aspirations of being the international Islamic capital markets centre. The central bank is encouraging private lenders and wealth-management companies to create products that comply with Islamic principles, and the Singapore Stock Exchange is working with others to issue the first exchange-traded fund off the SGX/FTSE Asia 100 Sharia Index.

Hong Kong is hoping to become a launching pad for investors from the Middle East who are interested in tapping the Chinese market. It has taken steps to develop a local Islamic bond market and the Financial Secretary recently said

that “For Hong Kong to be a major international financial centre...Islamic finance must be among our portfolio of products and services”.

Japan's second largest securities house, Daiwa, recently announced that it plans to list an exchange-traded fund based on Japanese equities and screened by Islamic investment principles on the Singapore Exchange.

And London, of course, is vying to be the Western capital of Islamic finance. The Government started adapting tax and regulatory frameworks to allow for the development of Islamic finance products back in 2003. Of course, we’ll be hearing more about this later, after you get me off the stage, which I’m looking forward to – the speeches, I mean, not getting off the stage.

Conclusion

So there is much to come. The future of Islamic finance is set to be a bright one, and I’m sure we’re all looking forward to being a part of it. There are some hurdles along the way, as there are in any business, but these are no more insurmountable than in any other sector. There is a strong force propelling the industry forward and there are opportunities around the world. This is a pivotal time in the history of an important sector, and I’m delighted that we at HSBC can be a part of it. Thank you.

**structure,
regulation,
legislation**