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London Roundtable

Driving sustainable growth in the UK Islamic finance market

Panelists

King & Spalding
Jawad Ali
Managing partner, King & Spalding Middle East offices and global deputy leader of Islamic finance

TheCityUK
partnering prosperity
Richard Adler
Director financial & professional services, The City UK

BLME
BANK ON OUR PRINCIPLES
Massoud Janekeh
Director and head of Islamic capital markets, Bank of London and The Middle East

K&L GATES
Jonathan Lawrence
Partner, K&L Gates

Moderator

Nazneen Halim
Editor, Islamic Finance news

Nazneen Halim Jawad Ali Jonathan Lawrence Dr Massoud Janekeh Richard Adler

Jawad Ali is the managing partner of King & Spalding's Middle East offices, and the global deputy leader of the firm's award-winning Islamic finance practice group, based in its Dubai office. His practice covers a broad range of Shariah compliant and conventional finance and investment transactions. He is especially recognized for his knowledge of Shariah issues and his skills in developing innovative Shariah compliant investment and financing structures. His practice has involved investment and financing transactions throughout the Middle East, Europe, the US, Southeast Asia and Africa.

Jonathan Lawrence is a finance partner in the London office of global law firm K&L Gates. He has a broad finance practice with specific experience of advising financial institutions, lenders, funds, investors, trust companies, securitization vehicles and concession companies.

Massoud Janekeh joined Bank of London and The Middle East (BLME) in April 2007. He has many years of experience gained across a number of industries in the advisory and financial service businesses. He spent 10 years managing investments for global products at ICI/Zeneca, before moving to strategy consultancy with AT Kearney and Integrum. He then moved to financial services when he joined BDIC as a corporate finance advisor and later on becoming involved in structured debt with European American Capital.

Richard Adler is currently the director of financial and professional services at TheCityUK, an independent membership body promoting the UK financial services industry. More specifically, Richard is the relationship director of the UK Islamic Finance Secretariat (UKIFS), which brings together the government and industry to jointly promote the UK as a global gateway for Islamic finance and to act as the primary contact point for UK government bodies including UK Trade & Investment, HM Treasury and the regulator.

Driving sustainable growth in the UK Islamic finance market

On the 29th May, four market experts: Jawad Ali, Massoud Janekeh, Jonathan Lawrence and Richard Adler, gathered to discuss the current appetite for Islamic finance in one of Europe's most established financial centers, London. The UK, with its growing Muslim population and increasing governmental support towards Islamic finance, from a bird's eye perspective, is on the right track to growing its Islamic finance ambitions.

However, there still exist fundamental issues that need to be addressed such as a sound understanding of Islamic finance products across all levels of the market — from consumers to providers to policy makers, and effective dissemination of information, before any real strides can be made and any significant growth is observed.

The sectors to watch, according to these experts, are real estate, SME financing and infrastructure. The following is the distilled conversation, in which Islamic Finance *news* was fortunate to be a fly on the wall to; between two legal experts, one very experienced capital markets player, and a government body representative. What transpired were sound recommendations and a candid perspective on the progress and setbacks in what has been touted to be the breakout market for this year — the UK.

NAZNEEN HALIM: Jawad, what have you been hearing from your clients in the Middle East, in terms of what they want when they think of the UK market as a Shariah compliant investment destination?

JAWAD ALI: Like all investors, they want a return, and when they look at London and the UK market, they view it to be a very developed market with a robust legal system. It is important to them that there is certainty of the outcome should there be any dispute, more importantly they are looking for a variety of assets. Whether they are Saudi, Kuwaiti, Qatari or from anywhere else in the GCC, they are always looking to

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diversify some of the risk. Perhaps sometimes going for lower returns, when they come to the UK compared to developing or undeveloped markets; but they are looking for a stable environment that will produce either a current yield, or a growth opportunity, or a combination of both.

The UK has what we call the sterling-effect. It is not a euro or dollar-denominated economy, and I can see a correlation between the value of the sterling and the investments that are coming into the UK.

Jonathan, what, in your opinion is the most developed market in the UK for Islamic finance at the moment?

JONATHAN LAWRENCE: The most developed market is probably real estate, and clients are investing directly into this sector using Islamic compliant and investment financing techniques. For example, the combination of conventional and Islamic finance tranches has been very successful in the real estate market in the UK; which has given exposure for such techniques via Islamic funds, Islamic banks and conventional banks here in the UK. What I'm hopeful may happen is that this model will be taken further, whether it is through additional infrastructure or corporate activities. And I think the UK real estate market has been very grateful for the Islamic compliant funding that has come into deals. Frankly, there are deals that would not have been executed had it not been for that extra funding.

Richard, with UKIFS being part of the government-led initiative to make Islamic finance a viable business model in the UK, what have you been tasked to do?

RICHARD ADLER: The government through the task force is looking at infrastructure Sukuk, and the likes of banks such as Gatehouse Bank are currently involved in infrastructure. We also recently saw the sale of a prominent London building to the sovereign wealth pension fund of Malaysia.

What we are not good at as an industry in the UK is publicizing the fact. So apart from the Shard, which the public is aware of being funded in a Shariah compliant manner, and unusual ones like Southend Airport, which was funded through BLME, there is little knowledge by the general public of other Islamic finance deals that have been done.

So what we are trying to get the groups to do now is to let UKIFS know about the many deals being transacted so we can publicize that through our PR channels. Even if you do not want to disclose the client, it is just a matter of publicizing the fact that another Islamic finance deal has been completed. Islamic finance in this country really does struggle particularly from a profile point of view. If you go right back to the consumer, especially the Muslim consumer, they do not in the main understand what you mean by Islamic finance or Shariah compliant products. They would rather bank with conventional banks such as Lloyds or Barclays. So it is really awareness that we are trying to raise now.

> ***"I am always surprised as to the lack of appreciation of the size of the Shariah compliant investor market in the UK"***

JAWAD ALI: I agree with Richard wholeheartedly. I am always surprised as to the lack of appreciation of the size of the Shariah compliant investor market in the UK. The issue is with the investors who most of the time, choose not to publicize their deals. They don't want to be on anybody's radar screen.

Oftentimes we close a deal which is really very newsworthy and go back to the client and say we want to issue a press release, put it on our transactional list, etc., and 70% of the time, the answer would be 'no'. They do not want any mention of their name, assets and the like. I do feel that this is an issue, and the reason Sukuk gets almost disproportionate attention is because by their nature, they are public deals — no matter how small.

Is this lack of publicity affecting other areas within the sector as well?

RICHARD ADLER: There is a charity foundation, which approached me recently, and they represent Muslim investors who shy away from Islamic banking, because they don't think the City takes it seriously. So they actually don't know about The Shard and other Islamic real estate financing which I found astounding. We need to show that these deals are being done, and it will then filter back to the retail market.

JAWAD ALI: : I worked on the initial acquisition of The Shard by the first Qatari consortium, who were all Shariah compliant Qatar-based financial institutions with the exception of the developer. When the crisis hit, it became clear that the development would need much more funding. That is when the government of Qatar stepped in. Securing the new equity and refinancing the debt at that time was difficult. Having the government step in was crucial for the success of the development of the Shard.

Like the Shard, there are a number of success stories and iconic buildings in London which have been financed on a Shariah compliant manner. However, most of these properties, especially in light of recent event in London, will do their best

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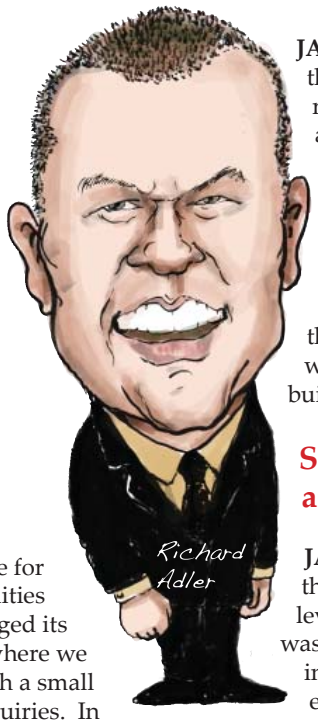
to avoid the use of the term 'Islamic finance'. Islamic finance and investment have nothing to do with politics — these are just ambitious investors who want to protect and maximize their wealth, who are bringing money to the jurisdiction, and who are choosing to invest ethically and also leveraging on a non-interest bearing basis, but that message is lost. In terms of awareness, a lot of us are preaching to the choir, and not the people who actually need to be converted.

> ***"For now, property financing is not as plentiful in London as we would have thought. Principally because the historic lenders, the Irish and the Scots have been rather quiet"***

JONATHAN LAWRENCE: I think we need to give the Islamic investment and finance message to the real estate market and other markets directly, rather than speaking solely to other financiers. So perhaps it would be better for us to speak at real estate conferences and aviation industry conferences. That's what the pitch will be — to people who want to do deals, but don't have all the financial resources — consider these new sources of financing.

RICHARD ADLER: When I speak to a lot of Islamic finance practitioners now, they talk about using the term ethical funding instead of Islamic finance so as to widen the appeal and not stigmatize. At this moment, more than 90% of these funds' investors are non-Muslim because of the funds' good performance. These fund managers want to attract Muslim investors as well because of the ethical screening the fund undertakes to attain Shariah compliant status.



Massoud, from a capital market/ banking perspective, what is the demand like on the ground?

MASSOUD JANEKEH: BLME does not offer long-term project finance, the financing profile for large projects don't match the funding capabilities of a bank of our size. Instead BLME has arranged its team to offer property development finance where we see no shortage of demand. The challenge with a small bank like us is coping with the number of enquiries. In fact we don't need to advertize our offering; otherwise we could not manage the demand. For now, property financing is not as plentiful in London as we would have thought, because the historic lenders, the Irish and the Scottish banks, have been rather quiet recently. And what we find, especially in trickier areas like development finance — and London does need a lot of development finance—is that many highstreet banks are not financing development schemes because their focus is on investment assets, or corporate funding large house builders.

The second practical point is that Islamic finance is still a fairly young industry and a lot of banks in the sector are still mid-sized or relatively small-sized. So that means that it is very difficult to finance a large project on a bilateral basis — you immediately go above your large exposure limits. At the same time the market for syndication is not such that you have easy syndication deals.

From our experience in property finance syndication we know: many Islamic banks in the early days have burned their fingers in the property market, in fact there are lots of gravestones around Dubai of former bad property deals, a legacy that remains a factor in hesitation in investing in real estate; second property still accounts for majority large proportion of the assets of an Islamic banking book and there is a limit issue in taking more property assets. And third, property investment has become fairly international and there is competing investment opportunities across the world; not just the UK.

But syndications in real estate are still a challenge. Southbank Tower is one of the rare syndication deals that we took part in, and the financing amount involved was quite substantial. The equity was funded by a group of Saudi investors that put their money behind it, and a group of Islamic lenders led by ABC Bank who came into a syndicate together. But I don't see one of these every month. That's for sure.

JAWAD ALI: We had the pleasure of working on the acquisition of the King's Reach property as we represented the investors who brought in equity and a mezzanine facility, and I agree with Massoud wholeheartedly that we don't see this every month, but in my career, during the time I was in London from 2002-07, we did one of those deals every quarter if not twice a quarter… And I thought the momentum would continue forever. And like any real estate investor community, the crash did affect the Islamic investors. They were affected because they were investing in the same streets, same corners, same buildings as everyone else.

So, how badly were real estate investors affected during the crisis?

JAWAD ALI: Perhaps they had leveraged more than they should have. At the time, they had around 70-85% levels of debt, and when the market moved — even if it was by 20% — it really affected them considerably. The investments were made by Shariah compliant closed-ended investment funds which did not leave any equity

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in reserve. So, when they came back to their investors in 2009-10, asking for money, there was none left to be given. If this was done by a private individual where there is less gearing, or an open-ended fund; these issues could have been dealt with more easily.

Coming back to what Massoud said; the reason why we are not seeing these deals is because we are still seeing a legacy of real estate assets owned by Shariah compliant individuals and funds that are still problem assets; not because there is something wrong with the assets, it is just the way the leverage was taken at the time.

Compared to the banks in the US, the banks here, led by a mixture of German banks, British banks, etc., decided that they were just going to roll over these facilities — basically kicking the can rather than dealing with the issues at hand. Between 2009-10, we saw a lot of rollovers, and three years later, the same symptoms/same problems still exist. We have a facility coming up in August, September and October of 2013 which are still plagued by the same issues, value dipped below loan amount and are in need of further equity.

So I think we are now going to see a wave of exits — and that's when the publicity is going to come in, where people actually realize the loss; come to this reality, reset the clock and move on.

JONATHAN LAWRENCE: The new dynamics in real estate as far as debt/equity levels are concerned, is 50% of lending on a property by a senior bank, 30% by a mezzanine financier, and 20% by an equity provider. And that 30% mezzanine finance is very important. When we talk about mezzanine financing it encompasses providing financing that gives perhaps a higher return than the conventional senior bank is giving, but also making sure that the investment or development can carry on. And we've seen those types of mezzanine real estate finance deals, in London and outside of London. We need to look beyond London for that market and see the deals that have been done in Scotland or the north of England on different types of real estate assets, for example student accommodation. I wonder if others think that those real estate investment success stories, even after the downturn, could be translated into other areas — be it corporate finance or infrastructure; do people actually see Islamic real estate financing as a springboard into different areas?

JONATHAN LAWRENCE: Richard, on the task force, are they looking to involve conventional banks as well? Or will they be audience to these deals?

RICHARD ADLER: The task force is relatively new and so at this stage is involving the Islamic banks of course. Through UKIFS and TheCityUK we of course have a lot of conventional banks who participate who will watch with interest to see how things evolve.

Outside of real estate, what sectors also deserve equal coverage?

MASSOUD JANEKEH: In fact in the UK, BLME enjoys a much more balanced asset portfolio because we have access to a very strong leasing market where we do a lot of leasing business. Yet it is not just about the big ticket deals but also about a lot of smaller deals as well, such as equipment leasing that makes it attractive. As a mid-sized bank we focus on the UK mid cap market and targeting a segment that remains underserved by many of the larger banks in the current financial climate. Also, it is a niche that fits our business well and provides better returns.

For example, we offer Ijarah leasing as a product in the UK, and we are now one of the established leasing houses. Ijarah suits Islamic finance and the UK tax framework very well. In the UK, there are advantages for a company to take an operating lease or finance lease, rather than own the assets. And it also helps small businesses with their capital expenditure. Capex investment is an issue for many businesses because in the current market, bank funding is limited and businesses don't want to take the whole cost from their cashflow outright. Leasing can smooth the capital outlay requirement.

> ***"When we talk about mezzanine financing it encompasses providing financing that gives perhaps a higher return than the conventional senior bank is giving, but also making sure that the investment or development can carry on"***

Therefore leasing, the way it is developed, is of particular benefit to SMEs. And we know that's where the growth happens. Coming back to Jawad's statement about where the message is, we are now getting recognition for helping the SME sector, and have a reliable leasing product where our customers do not need to face very large documentation. We now have a fairly standard leasing documentation that we can offer our clients, which looks and feels like a market standard leasing document.

JONATHAN LAWRENCE: That's another great story for the market — Islamic investors and financiers helping SMEs. But

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then again, it would be unfair to expect Islamic finance to solve the funding and infrastructure shortfalls. I think it's part of the solution, but not the only one. I think banks do have a role to play in bringing together groups of investors with different types of financing and looking at combining them all. That's something of particular interest to me; to see how you can combine conventional and Shariah compliant structures in one deal, and contribute to the methods of putting that in place.

MASSOUD JANEKEH: We regularly do that actually, for example in healthcare finance. Healthcare transactions are a growing area of finance. Once again, the absence of traditional funders in this sector has made room for new entrants to take share. So there is a lot of refinancing opportunities and many banks, to be honest, cannot take all of the exposure, so we co-finance through an inter-creditor agreement, which is part of the technology that Jonathan was talking about. That allows our form of financing to sit side by side with the conventional financing and I can see that becoming a commonplace for us in in due course.

JAWAD ALI: I agree that infrastructure, anywhere in the world offers a good opportunity for Shariah compliant investors. It is an easy sector. It is Shariah compliant, ethical and usually — referring back to what Massoud said, it is so large that the need for funding is so acute that the borrower is willing to think outside the box to execute a deal — be it in a conventional or Shariah compliant manner.

However, it hasn't really taken off because usually they turn to Shariah compliant funds when there is no one else — and this is certainly not a criticism of the conventional markets. And usually, it is an act of desperation, and not a long-term plan. So I think from a Middle Eastern investor's point of view, from talking to our clients, they are quite wary and ask us to find out if there is anything wrong with the deal. And I can't be honest if I don't say that it is true — sometimes the deal has been shopped around, no one has come through, and then they bring it to the Middle East.

So are you saying that to some extent, Islamic investors are getting sloppy seconds?

JAWAD ALI: Middle East investors, whether they are conventional or Islamic. There is a bit of apprehension when it comes to infrastructure, although they know that in the long-term is actually going to pay off; it still requires effort. Even among the Gulf states themselves, there are competing programs. All of the countries in the Gulf need major infrastructure projects — be it social infrastructure or hard infrastructure. Social infrastructure has now been adopted by the private sector and Shariah compliant funds are leading the effort.

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Sukuk and the UK environment

Massoud believes that the UK government has been progressive in terms of adapting Sukuk to the UK's financial sector. "The legislation that has been put in place for alternative finance in the UK is probably the leading edge. Had Middle Eastern governments addressed their Sukuk legislation in the same way, we wouldn't have the ownership issues that the Middle East has in addressing foreign ownership rights of Sukuk assets, which became a big problem in some of the early structures," he said. He added that in the UK, the issue of transfer taxes and all other issues that are required to see a property transaction through from the cradle to the grave have been effectively addressed in country's tax legislation framework.

> ***"For instance, Southbank Tower is a large Shariah compliant property transaction; its GDV will be hundreds of millions in pounds to put it mildly"***

However, he also clarified that the current Sukuk conundrum in the UK stems from the fact that Sukuk does not fit with the investment criteria all the time. "For instance, Southbank Tower is a large Shariah compliant property transaction; its GDV will be hundreds of millions in pounds to put it mildly. But it doesn't fit a Sukuk structure as the financing has to retire with sales over a period of time and not an arbitrary bond maturity." Most of the time, this sort of financing, Massoud says, requires the management of a club of banks or a syndication. "A bond or Sukuk is a public issue — if you're lucky, you have a well-diversified pool of investors taking it up. The investors rely on a well-defined cashflow from the investment with a particular return for a period of time. And this sort of investment is not flexible enough from a borrower's perspective and certainly does not suit development finance."

What is needed, Massoud elucidates, is a regular issuer in Europe who issues Sukuk alongside its other issuances. "That would work, because then people are able to benchmark it; they know the behavior, and they know the exact story. On a single asset transaction, people are too apprehensive. It is a private placement, to be honest. And to dress it up as anything else will be difficult. And that is why we do not have enough Sukuk issuances, because we have not convinced the Shells of this world, and the likes of Glaxo Smith Kline to come into the market. GE has done it, but they've only done it once. We were hoping that they would do it every other month; which hasn't happened."

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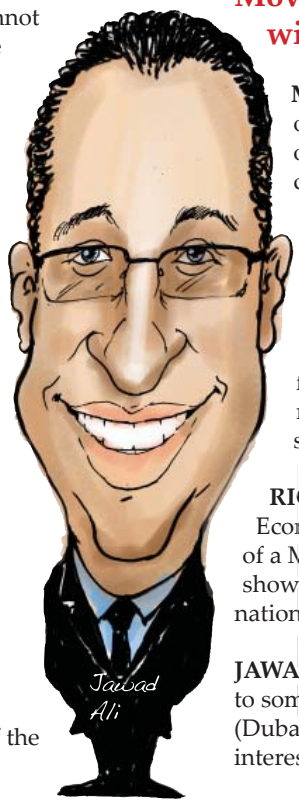
We are also seeing a move to specialty funds that are targeting certain sectors. If the UK persists and tries to build those bridges, now in the bad times, I think you will see the dawn of global infrastructure funds. Because the issue with just a regional infrastructure fund is that you aren't going to win every deal. And there is competition from a number of people. So you may risk not deploying your funds in the appropriate time period. But if you have a global look and focus on a sector, then you can actually come in and deploy your funds at the right time.

> ***"All of the countries in the Gulf need major infrastructure projects — be it social infrastructure or hard infrastructure. Social infrastructure has now been adopted by the private sector and Shariah compliant funds are leading the effort"***

JONATHAN LAWRENCE: That was the issue that has been mentioned before about competition for funds. We're not the only ones. There are Australia, the States and Saudi Arabia. Probably dare to say that London cannot rest on its laurels when it comes to real estate because there has been a move by France for example, to attract Qatari money into investments. 5 billion euro investment gone into France, real estate. Germany and other peripheral countries where people are looking to take more of a risk and looking for more of an upside; even looking to Italy and Greece as well on the real estate side.

Is the future bright then for infrastructure finance in the UK?

MASSOUD JANEKEH: There is one commercial point that I would like to make. This is a young sector, where most of the banks are five-10 years old; of course there are older ones like Dubai Islamic Bank and Kuwait Finance House. But when you look at an infrastructure finance, the economics of an infrastructure project does not lend them to short-term funding and the smaller banks cannot raise liabilities that match the tenor of the infrastructure projects.



We have seen in the Sukuk market when banks raise five year money which can be priced anywhere from 4-6%; if you use this as their cost of funding and on top of that add their margin; then you can see the cost of financing your 10-year project would actually be in excess of 10% and as we know not many governments like to pay such rates . It does not work with the economics of public sector financing to go to a small bank. That's why a lot of these projects really require large bank funding; well-established banks that can go to the market and raise term money cheaply.

And the problem with infrastructure finance is actually that is not that much available in the conventional world either.

JONATHAN LAWRENCE: It used to be that monoline insurers would wrap deals and support them, and then all these issues about Basel III and how they can tie-up all this money and allocate five years, not 25 or 30 years.

MASSOUD JANEKEH: One issue is the economics of the deal and how good a fit it is with the current banking market. The other point is the nature of infrastructure finance which differs in this country to the Middle East and other emerging market countries. In the UK we have quite a well-developed and advanced public private partnership and public finance initiatives financing models that effectively allow an off-take agreement to be in place, such that there is no recourse on government for debt obligations from that particular off-take. In absence of recourse mono lines offered additional protection to the investors. For a long time this non-recourse structure suited the government quite well, although as we know now, the pricing of the off take agreements was not always to the benefit of the taxpayers.

Moving forward, how do you think the UK will fare?

MASSOUD JANEKEH: There are still plenty financing opportunities in the UK and some of the project financing opportunities could lend themselves well to Shariah compliant structures under terms attractive for Islamic investors. But I believe there is a need for packaging these assets as investment products to meet the growing need of Islamic wealth management. Private banking is currently in growth mode in the UK. It really is the hottest thing in the banking world right now. The UK has a good opportunity to regain its position as a leader for wealth management products, because it has global reach and provides globally recognized services which should make it a destination of choice for investors.

RICHARD ADLER: I think with the World Islamic Economic Forum coming to London for the first time outside of a Muslim state in October we have an opportunity to showcase UK Islamic finance and make an announcement as a nation, whether that happens or not remains to be seen.

JAWAD ALI: I feel that Dubai's cost advantage is disappearing to some extent. TheCityUK also has an MoU with the DIFC (Dubai International Financial Center), so that would be interesting to watch. — *NH*