Towers of strength: Malaysia and Saudi Arabia are leading the way in global Islamic finance

THE ISLAMIC ASSET MANAGEMENT BOOM

Islamic finance

Islamic finance asset management is booming globally, with countries in south-east Asia and the Gulf spearheading growth, thanks in part to improved investor confidence, regulations and infrastructure.

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THE SHARIA-COMPLIANT ASSET MANAGEMENT INDUSTRY is on the cusp of a boom. Following a difficult couple of years, in which the poor performance of regional equity markets limited the sector's growth, the stage is set for a longer term resurgence of Islamic funds. This positive momentum has emerged as global equity markets have rallied and improving investor sentiment has spurred fresh demand for asset management services.

Yet, this outlook is also being shaped by longer term dynamics, including a more progressive regulatory environment, the prospects for enhanced cross-border distribution of funds, as well as the development of sharia-compliant pension programmes. Collectively, these trends are feeding into the growing confidence of a sector that is relatively nascent, even in the context of the Islamic finance space.

RAPID GROWTH

According to research from the Malaysia International Islamic Financial Centre (MIFC), in 2004 total assets under management amounted to $29.2bn. By December 2013, this figure had reached $73.7bn. Over the same period, the number of funds has also increased from 285 to about 1065, of which close to 800 are mutual funds.

"Broadly speaking, the Islamic asset management industry continues to be characterised by rapid innovation and growth. The industry experienced a brief but material restructuring around 2012 as a lot of smaller, inefficient and underperforming funds were squeezed out of the market in the wake of the financial crisis," says Mohieddine Kronfol, chief investment officer for global sukuk at Franklin Templeton Investments.

The south-east Asian markets, in conjunction with the countries of the Gulf Co-operation Council (GCC), are at the forefront of this growth. Within these geographies, Malaysia and Saudi Arabia collectively account for close to 63% of the industry's total assets under management. Nevertheless, the sector's growth fundamentals vary greatly between these two dominant hubs of Islamic asset management.

ASIAN EXPLOSION

As a capital-surplus region with many high-net-worth individuals, the Gulf is playing an increasingly important role in Islamic finance. Yet, it is the Asian markets that have been responsible for most of the growth, as well as the innovation, until now.

"The compound annual growth rate in terms of assets under management over the past five years for south-east Asia has been about 27% per annum," says Datin Maznah Mahbob, chief executive of AmInvest, a Malaysia-based asset manager. "Indonesia has led this growth from a low base, with 37% per annum, with Malaysia registering 26% growth and Thailand 18%."

For most of the larger fund managers in the region, these figures have meant that the past 18 months in particular have been highly rewarding. "CIMB-Principal Islamic has more than $2.5bn in assets under management," says Ramlie Kamsari, chief executive of CIMB-Principal Islamic Asset Management. "Following our incorporation in 2008, it took four years to raise the first $1bn, while the second billion was raised in just 11 months. This is a good indicator of the direction in which the industry is heading."

Partly, this success is due to the size of the south-east Asian market. Yet, it also reflects a highly progressive approach to the regulation of the sector, especially in Malaysia. Government authorities, in conjunction with the MIFC, have been quick to develop a world-beating framework for sharia-compliant fund management, particularly in the areas of fund distribution and asset allocation.

"In Malaysia's Islamic finance marketplace, there are no impediments in terms of asset allocation," says Ms Datin from AmInvest. "Fund managers are free to engage with equities, the sukuk and money markets as they see fit. This allows Malaysian funds to be tailored to specific risk and volatility profiles in a way that other emerging markets, where the regulations for funds are typically more prescriptive, are not."

GEOGRAPHICAL CENTRE

Alongside the encouraging regulatory environment, two other factors have pushed south-east Asia to the forefront of the industry. First, Indonesia is emerging as a significant location not only for new fund launches but also as the geographical focus of globally launched funds. According to figures from Thomson Reuters, 18% of total funds launched by September 2013 had an Indonesian focus, compared with just 6% in 2010.

This shift can be attributed to asset managers' renewed confidence in emerging markets, as well as the massive opportunities presented by the country's infrastructure development, favourable demographics and strong economic growth prospects. But Indonesia's rapidly improving regulatory environment, with respect to both conventional and Islamic finance, has also played a role.

"The regulatory and investment environment has improved dramatically over the past three years. Indonesia has studied the Malaysian copybook and the authorities there realise they don't have to reinvent the wheel; progress is being modelled on the Malaysian example," says Mr Ramlie from CIMB-Principal Islamic.

On the other hand, south-east Asia's role as an Islamic asset management hub is set to expand significantly with the implementation of a passport regime focused on countries from the Association of Southeast Asian Nations (Asean). Under this system, known as the Asean collective investment schemes, fund managers will be able to offer locally originated and authorised funds to retail investors in other member countries. This development will ameliorate the distribution and allocation of funds, greatly enhancing the market potential for fund managers operating in a region of 600 million people.

At the time of writing, only Malaysia, Thailand and Singapore were signatories to the agreement, although Indonesia is expected to follow shortly. "This will be a game-changer for Islamic fund managers in Malaysia. This will put forward a strong value proposition for Malaysia's Islamic finance marketplace to be the dominant domicile for Islamic funds when that passport regime comes into place as it will provide fund managers easy access to the wider Asean region," says Mr Ramlie.

SAUDI STEPS UP

While developments in Asia may be driving regulation and innovation in the sector, markets in the GCC are shaping the sector in different ways. Notably, the total volume of funds in the region is growing exponentially. Of the top 20 Islamic funds by asset size, as of December 2013, 10 were domiciled in Saudi Arabia, according to the MIFC.

"Although Asia has been the principal driver of this growth on a global level, we are beginning to see some important and credible developments from the GCC. Now that

> THE ISLAMIC ASSET MANAGEMENT INDUSTRY CONTINUES TO BE CHARACTERISED BY RAPID INNOVATION AND GROWTH
> ***Mohieddine Kronfol***

the region has emerged from the financial crisis, there has been a material change in the amount of liquidity and credit available, as well as the economic growth of the constituent countries," says Mr Kronfol from Franklin Templeton.

Yet, the market dynamics in the Gulf differ noticeably from Asia. Unlike Asia, high-net-worth individuals and regional family offices are the focus for most fund managers, particularly in the larger markets.

"In the Saudi market, the assets under management for mutual funds have, over the past seven years, remained largely stagnant," says Zaheeruddin Khalid, managing director and chief investment officer for Jadwa Investment. "So the retail market, although sizeable, hasn't really grown and we expect limited growth in this area over the medium term. Most asset managers in the region continue to focus on high-net-worth individuals and established family groups for their growth."

Crucially, these groups' investment preferences tend to discount mutual funds. "Many of the high net worth individuals and wealthy family groups do not invest in mutual funds. They invest through discretionary portfolios or segregated accounts managed by asset management entities," says Mr Khalid.

Regulatory developments in the GCC are also beginning to gather pace. Member countries are in the embryonic stages of considering a European-style passport directive, modelled on the EU's Undertakings for the Collective Investment in Transferrable Securities Directive. Moreover, discussions are under way between financial centres in the Gulf and fund management centres in Europe, exploring the prospects for improved cross-border distribution. While both initiatives have a long way to go, they point to the kind of longer term thinking needed to push the industry forward.

LAGGING BEHIND

Nevertheless, immediate regulatory challenges for the region remain and the environment as a whole lags behind that of Asia. "In the GCC, asset managers are dealing with regulatory regimes and infrastructure that make the distribution of their products challenging. For example, the United Arab Emirates has introduced a host of new rules, which impede the industry's development due to potentially onerous registration fees and charges," says Mr Kronfol.

At an international level, other challenges exist for the industry as a whole. Achieving greater levels of scale and profitability is one. To remedy this, the dearth of institutional investors in the sector must be addressed. Although ongoing sharia-compliant pension reforms in Malaysia and the GCC may be a catalyst in this instance, larger funds must also be more active in attracting non-retail investors to the market. Moreover, with equity funds accounting for about 54% of all Islamic funds, according to Thomson Reuters, a process of asset diversification, particularly into fixed-income markets, is needed.

Near-term impediments aside, the investment case for sharia-compliant asset management is growing, particularly as demand increases and regulation improves. Much of this growth will come from existing markets. Yet, the prospects for expansion into non-Islamic markets is also encouraging. "There is a level of confidence in the sharia-compliant finance space as a whole and this is because there is a strong investment case, independent of the religious component," says Mr Khalid.

With global sukuk markets deepening as a number of non-Islamic sovereigns enter the market, including the UK and Hong Kong, the potential for a broadening of the market is high. As these developments unfold, the sharia-compliant asset management industry is poised for stratospheric growth. TB