Going West, Again - The New Offshore Opportunity in the Arab World

By Veit Etzold and Philipp Wackerbeck

While more and more assets of High Net Worth Individuals in the GCC is invested on-shore, not only the disruptions of the Arab spring, but also the need to diversify portfolios makes Middle Eastern money going abroad again. At the same time, Islamic Banking, banking business according to the Holy Qur'an and the Shari'ah, becomes more and more important for GCC investors. While typical offshore locations for GCC money like the UK already strongly embrace Islamic Banking, others like Germany, famous for its mid sized hidden champion businesses, so far have failed to do so. With GCC money going west (again), Islamic Banking could not only help to merge investments between East and West but could also turn out to be a rewarding business case.

- High Net Worth Individuals from the Middle East used to have a high exposure to offshore investments with 50 to 60% of all assets invested offshore; with the GCC keeping up with banking infrastructure and services, the trend reversed to onshore investment
- With increasing risk appetite of Middle Eastern wealth investors and the need to diversify, assets are again relocated offshore. Also, due to the uncertainty in the wake of the Arab spring, the UK, Switzerland and Singapore, but also Germany have become new investment destinations
- Islamic Banking plays a more and more important role as a vehicle for Middle Eastern cross border investments
- Whereas the UK, a prime investment hub, has already embraced Islamic Banking, Germany, which is very attractive due to its undervalued "Mittelstand" medium sized companies, so far failed to do so
- Islamic commercial banking, merging east and west, could turn out to be a rewarding business case

The share of GCC investable assets that resides offshore is among the highest in the world, estimated at between 50 percent and 60 percent. GCC investors go offshore for various reasons: geopolitical risk in the larger MENA region, access to better investment opportunities, interest in professional services abroad, and the desire to preserve privacy. Anecdotal evidence suggests that Switzerland is still the most popular destination for Middle Eastern assets, especially for Saudi investors. Other favored offshore destinations include London, the Channel Islands (Jersey, Guernsey), the Isle of Man, and, to a lesser extent, Singapore.

The long-term trend, however, is towards more assets staying onshore. Although geopolitical risk is still a factor, most of the GCC countries are increasingly becoming an island of stability in the MENA region. Also, the local market, both for wealth services and for actual investments, is becoming more competitive. Finally, the privacy that some offshore locations once offered and many HNWIs hold dear has been eroded as economies become more interconnected and international pressure on places like Switzerland and Liechtenstein has almost vaporized its once holy bank secrecy frameworks.

That said, there will be short-term fluctuations in this long-term trend driven by specific economic and political events. In the near term we expect the share of offshore assets to increase for several reasons. First, offshore deposits will swing up as the financial crisis abates and investors reallocate their portfolios from a very defensive, low-risk onshore- to a more aggressive offshore position. Second, local markets, although developing quickly, are still relatively immature; they have fewer products and services than offshore markets and a less established regulatory environment. Finally, although the GCC is politically widely stable, there is still a threat to stability in the greater MENA region; thus, offshore accounts remain an important safe haven. The trend back to off-shore investment started already with the almost-default of Dubai world in December 2009, but was accelerated by an event, starting in early 2011, which is now known as The Arab Spring. The Arab rebellions, mainly taking part in Egypt, Libya, Syria, Tunesia and

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partly also in Bahrain, have affected demand for offshore investments again, especially among wealthy families. While the Arab spring was greeted by many Westeners as the "wind of change" now also blowing in the Arab world, it has certainly also added a great amount of political risk in the respective countries, mainly Libya and Egypt, but also Bahrain. So the trend for on-shore investments is not only stopped due to the recent political development, but offshore investment seems to emerge stronger than ever from a short- to mid-term perspective.

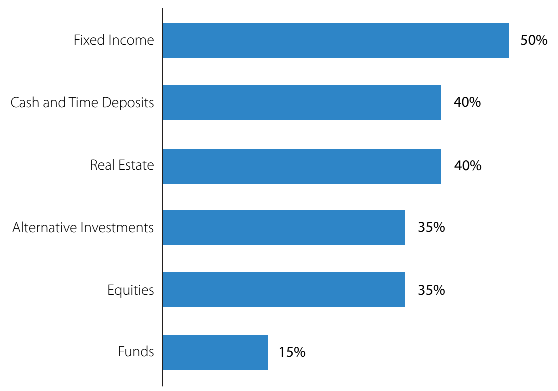
To capture this offshore share of wallet, local banks should consider forging partnerships with offshore banks or establishing a presence of their own in an offshore market. For offshore players, there is a window of opportunity to benefit from a temporary halt of the long-term trend towards greater onshoring and thus to either ensure that existing offshore assets are not repatriated or even new assets can be generated in the short-term.

Investment targets of Middle Eastern investors

Investment preferences of Muslim and Arab investors are quite similar to those of western investors, especially after the credit crisis and during the ongoing sovereign debt crisis. As a private banking survey among Middle East investors, conducted by Booz & Company shows, fixed income is now the most attractive investment class as investors try to strike a balance between security and performance (see Exhibit 1). [1]

Post-crisis, the Most Preferred Investments Are Relatively Conservative

SURVEY QUESTION: WHAT ARE THE MOST PREFERRED ASSET CLASSES POST-CRISIS? (PERCENTAGE OF RESPONSES)



Note: Multiple answers possible; percentage figures rounded.
Source: Booz & Company

Exhibit 1: Investment Preferences of Middle Eastern wealthy investors after the financial crisis

As can be seen, cash and time deposits remain an attractive asset class. Real estate, despite seeing stark declines during the crisis, is also popular mainly as a direct investment due to a perceived low correlation with financial markets and expected price increases in many GCC countries. Finally, most private bankers say that alternative investments—such as regional private equity, private equity in Asia and Africa, and hedge funds—are gaining momentum again in attracting capital.

Private bankers were almost evenly divided on another question: Has the crisis permanently changed investor behavior? Sixty percent said the product mix will remain more conservative than pre-crisis, which will crimp revenue at private banks as complex instruments generate higher fees. However, forty percent said that "greed will come back" and that many aggressive investors will return to their pre-crisis investment style. Complex, highly leveraged, and high-margin products will regain popularity as these investors once again seek double-digit returns.

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Concerning Middle Eastern investors, risk and return are not the only variables to discuss when investing on- or offshore. In addition, there is an important cultural phenomenon to discuss, which is already more than 1000 years old, but has really gained momentum since the 1990s of the last century and has grown with double digit rates ever since: Islamic Banking.

Islamic Banking as the cornerstone of Middle Eastern investment

As we have shown in our article "Soul Searching after the Crisis"[2], Islamic Banking is a nascent industry. Even though several Islamic financial contracts have already been in existence during the age of the Prophet Muhammad, Islamic Banking is almost wholly an invention of modern times, with the first seeds sown in Egypt in the 1960s. The first genuine Islamic private commercial bank, Dubai Islamic Bank, was founded in 1975. Also in the 70s of the 20th century, Pakistan (1977), Iran (1983) and Sudan (1989) transformed their conventional banks into Islamic Banks.[3]

Nowadays, there are more than 500 Islamic banking institutions worldwide, and their numbers are rapidly growing, with the highest growth potential in Muslim hubs like India, Pakistan and Indonesia.

If asked, what sets Islamic Banking apart from conventional banking, most bankers would answer, that it is the prohibition of interest, as it is written in the Holy Qur'an and the Shari'ah, the body of Islamic law: For instance, a Muslim has to respect that receiving or paying interest rates, as it is common practice in the western world, is forbidden according to the Qur'an. Shari'ah requires that all contracts and transactions need to be free of "Riba". Literally translated, "Riba" means usury and is condemned by Allah. The Qur'an forbids a Muslim to practice "Riba."

[Surah Al-Baquarah, 276]
"Those who swallow usury cannot arise except as he arises whom the devil prostrates by (his) touch. That is because they say, trading is only like usury. And Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, and he desists, he shall have what has already passed. And his affair is in the hands of Allah. And whoever returns (to it) – these are the companions of the Fire: therein they will abide."

The understanding of the prohibition of Riba is of utmost importance for the construction of Islamic financial products and the implementation of Islamic banking services. A classical savings account where you get interest or a common credit for which you pay a monthly or yearly interest rate is not permissible in Islamic banking. Islamic banks face the challenge to create financial products for faithful Muslims that acknowledge the absence of interest rates but are attractive enough at the same time to compete with western banking products.

For ensuring Shari'ah compliance within the Islamic Bank, every Islamic Finance institution, be it a bank, an insurance or an investment company, has a Shari'ah Board and its members need long years of education for turning them into Shari'ah Scholars, being a special kind of Islamic jurisconsult. There are only a few scholars in the world that are experts both in the teaching of the Qur'an as well as in economic and financial topics. So in fact a Shari'ah Scholar must be an expert in two very different worlds: The worlds of Religion and Money. By giving a Financial Services Provider the certificate that its products are Shari'ah conform, Shari'ah Scholars guarantee – with their good name – for the Shari'ah compliance of the respective product.

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However, the challenge remains, that currently there is no worldwide standard that defines, which products are Shari'ah-conform and which ones are not. An exception is the banking system of Malaysia. While Malaysia allows both conventional and Islamic Banking, the specialty of Malaysia is that the Bank Negara, the central bank of Malaysia, is not only the central governance body of banks, but also the country's Shari'ah Board.

Another trait of Islamic Banking is the Profit and Loss sharing practice, for example in loans. As it is forbidden in Islam that "money creates money", cash and wealth need

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always be invested into business and activity and should not be left idle to be accumulated via interest. Thus, in a *Mudarabah* contract, which could be compared to a business loan, the bank invests money in the business, whereas the company or the entrepreneur invests his or her own working power. If the company should default, the loss is solely paid by the bank, as the business owner already contributed his human capital, comparable to a start up financing via venture capital.

A *Murabahah* contract can be compared to a consumer loan. Instead of paying a sum of money to the client and charging principal cost and interest rates, the Islamic Bank buys the good and sells it to the client with a profit. As the client cannot pay the combined lump sum in one go, it will be stretched over several months or years. This practice, of course, causes the Islamic Bank to transfer much more assets to its balance sheet.

A *Diminishing Musharakah* is another version of real estate finance, where the bank, for example, buys 80% of a house, the client buys 20% and the ownership is slowly transferred to the client, who is buying more and more shares of the house back from the bank. Also, according to Shari'ah law, investment in alcohol, pig meat, entertainment, media and pornography are strictly forbidden.

Within the Muslim world, there is a hot debate, how the "right" Islamic Finance System should look like and how much governments should consider the teachings of the Qur'an in the economy. Also, there is ongoing debate on Shari'ah compliance of capital market products, especially, when they are issued by Western banks, who are not fully fledged Shari'ah compliant, but only operate so called 'Islamic Windows' or are just issuing Islamic products on top of their conventional offerings. Lately, there was a lot of debate among Shari'ah scholars on Goldman Sachs' planned $2b Sukuk, which was ruled by Shari'ah Scholar Mohammed Khnifer as not Shari'ah compliant.[4] Another example would be Islamic derivative products based on the so-called Wa'ad structure, which is some form of a unilateral promise and has been introduced and marketed actively by various Western banks. The most famous criticism came from one of the leading Shari'ah scholars, Sheikh Taqui Usmani who also chairs the Shari'ah Board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, a standard setting body in the Islamic financial industry. Usmani had claimed a few years ago that actually the vast majority of all Islamic bonds (Sukuk) issued at that time where not Shari'ah-compliant from his perspective, as they were contradicting some basic Islamic principles.

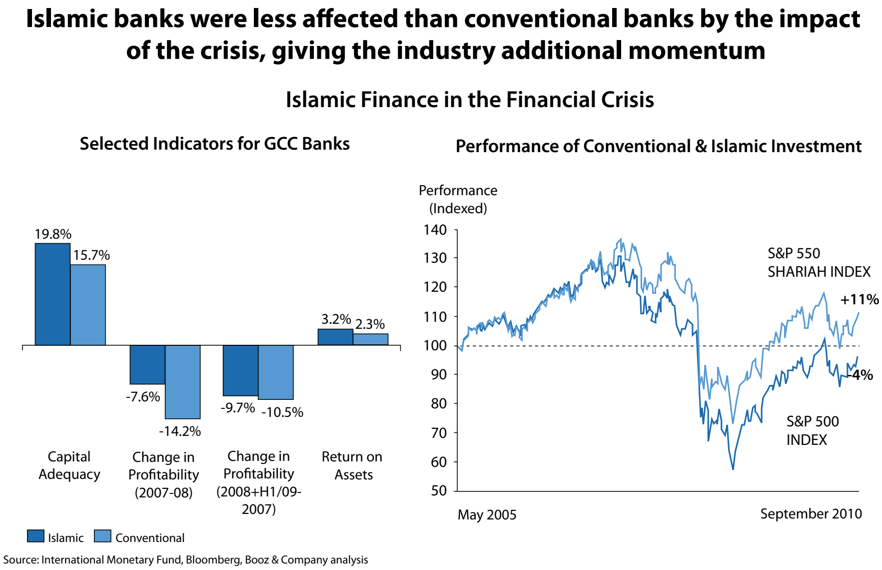


Exhibit 2: Comparison between the S&P 500 and the S&P 500 Sharia-Index during the financial crisis

Most of those Sukuk have been issued by regional banks in the GCC.

The struggle, what is Islamic and what not, does of course not stop at banking. Quite recently, Ali-Akbar Velayati, senior advisor to Ayatollah Ali Khamenei of Iran, accused Turkey that it was too much, following a rather "secular Islam", "…a version of western liberal democracy and unacceptable for countries going through an 'Islamic Awakening'."[5]

Turkey's finance minister argued, that the problems of the financial crisis could have been prevented, if the financial world had implied more the governance of Islamic Finance.[6] One might argue, if Islamic Banking would have prevented the financial crisis entirely, but Interestingly, it were *those* banking practices that caused the crisis, that are also disallowed in Shari'ah law, like financing worthless assets, derivatives, speculation and short selling. There have been various analysis performed in recent times analyzing the performance of Islamic financial institutions during the financial crisis. As one IMF report indicates, Islamic banks of most of the GCC countries, apart from Kuwait, have performed better than their conventional peers during the crisis. However, it needs to be further analyzed if this better performance was driven by structural advantages such as stricter limitations on leverage. Comparing the S&P 500 Index and the S&P 500 Shari'ah index shows that at the end of 2010 the S&P 500 Shari'ah was outperforming the conventional S&P by 11% (see Exhibit 2).

Despite the better performance, there remain several challenges for Islamic Banking, the main issue being how to conduct Islamic governance in countries, which are not Islamic, like Europe, the U.S., Australia, South Africa, etc. Capital management is another issue, as Islamic banks are not allowed to tap the interbanking market, as this market and its cost of capital like LIBOR and EURIBOR[7] are interest based. Also in Islam there are several schools of thought and thus no clear global guidance to judge, what is Islamic and what not. There have already been several regulatory agencies been set up in the Muslim world, like the IFSB in Kuala Lumpur/Malaysia[8], the AAOIFI[9] already mentioned above, the IIRA[10] and the IIFM[11], the latter three being in Bahrain. Capital adequacy according to Basel II and III is also an issue, as these regulations put Islamic banks at a disadvantage, as they, for example, are not allowed to include hybrid capital instruments or subordinated debts as tier 2 capital, as these instruments involve interest, which are in contradiction to Shari'ah principles.[12]

Islamic Investment in the GCC

In the Gulf Cooperation Council (GCC), which consists of Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates, Shari'ah compliance enjoys a growing importance. According to a Booz & Company study, 10% of investors in the HNWI segment ask for 100 percent Islamic products and up to 30% prefer Islamic products to conventional ones. Kuwait, Saudia Arabia and the UAE are considered the markets with the highest demand for Shari'ah compliant investments.

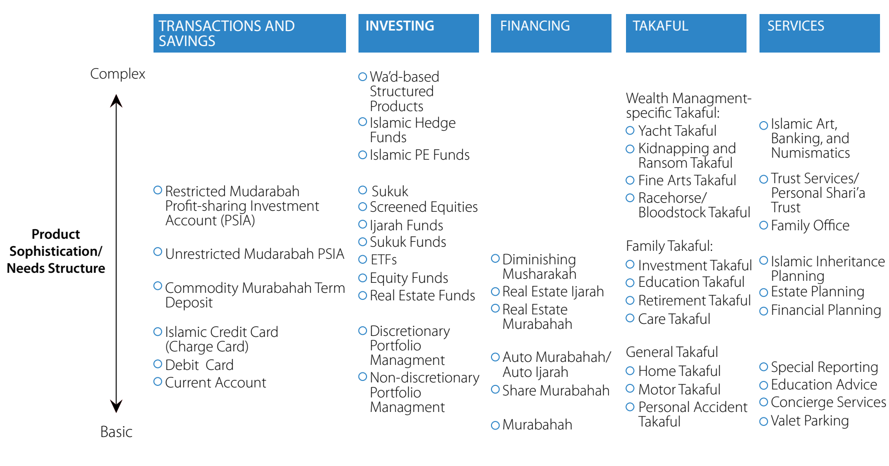
As outlined above, one of the challenges remaining is, that Islamic banks lack liquidity in the secondary market, as this market on a global scale is interest based and thus not Shari'ah compliant. Also, due to the smaller size of the Islamic Banking market, these banks cannot provide the diversification of a conventional portfolio. Finally, Islamic banks face uncertainty due to the independent judgment of decentralized Shari'ah boards. Nevertheless, Islamic Banks are addressing these issues and Islamic wealth management products enjoy an ever higher popularity with Middle Eastern investors.

What is to do? To attract Middle Eastern (Ultra) High Net Worth

The banking practices that are disallowed in Shari'ah law are the same ones that caused the financial crisis. However, it needs to be further analyzed if the better performance of Islamic Banks was driven by structural advantages such as stricter limitations on leverage.

Exhibit 3: Typical client needs in Islamic Banking

Overview of Client Needs in Islamic Private Banking



Source: Booz & Company

Individuals with Shari'ah-compliant wealth management offerings, banks need to provide a full-fledged product and service suite comparable to the most recent conventional offerings. Such offerings need to include products from transactions and savings, investment and financing solutions as well as Islamic insurance (Takaful) products (see Exhibit 3).

Shari'ah Islamic offerings also need to cater for the desire to invest in fixed income products among Islamic investors. However, given the prohibition of interest rates, such products need to be structured differently. Islamic bonds (Sukuk) have for many years been seen as the perfect solutions, but markets are developing more slowly than expected. Also, due to the limited size of the Sukuk market compared to the global "plain vanilla" bond market, there is not sufficient supply to meet investor's demand. To provide investors with an investment vehicle that also pays annual or semi-annual payments, like a bond, but is Shari'ah compliant, an alternative are Shari'ah-compliant recurring income products based, for example on real estate or equipment leasing. Such products, like the Wafra products of National Bank of Kuwait (NBK), have gained strong popularity among institutional and wealth management clients. We believe there is an immediate market potential of up to 13bn USD in such products, as the next exhibit shows (see Exhibit 4).

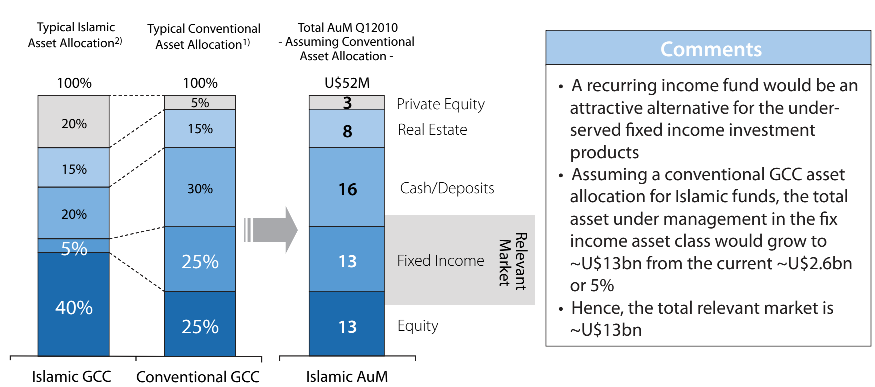
Going West: Investing in Real Estate in Europe

As shown in the Booz&Company study, real estate investments enjoy ongoing popularity with Middle Eastern investors. And despite lower yields and the current uncertainty concerning the future of the Euro, European markets are still attractive as they are less volatile. Concerning investments outside the GCC, the UK draws most attention. This is not only because London is a very popular place among global real estate investors, mainly because of its strong ties to the Middle East and the English language, but also due to the fact, that the UK hosts five Islamic Banks (BLME, IBB, EIIB, QIB and Gatehouse[13]) thus being the only European country that so far has introduced Islamic Banking. As can be seen in Exhibit 5, Middle East investments in British Real Estate were growing with a CAGR (Compound annual growth rate) of 11 percent until 2010, and even in the aftermath of the financial crisis and in the wake of the European debt crisis, is expected to remain constant at about 7 percent p.a.

Whereas the combined real estate investment market in 2011 was nearly £38b, about a third of it could be used by Shari'ah compliant investors, as £19.6b worth of real estate were out of scope for a typical Middle Eastern investor and £4.6b were not Shari'ah compliant; this could be because gambling or drinking activities or even pornography or prostitution were carried out in the relevant properties. As can be seen, London was by far the most important region for Shari'ah compliant real estate investment with £6.6 bn worth of

Assuming conventional asset allocation of Islamic funds, the relevant market for recurring income products would be ~U$13bn

Relevant Market for Recurring Income Products

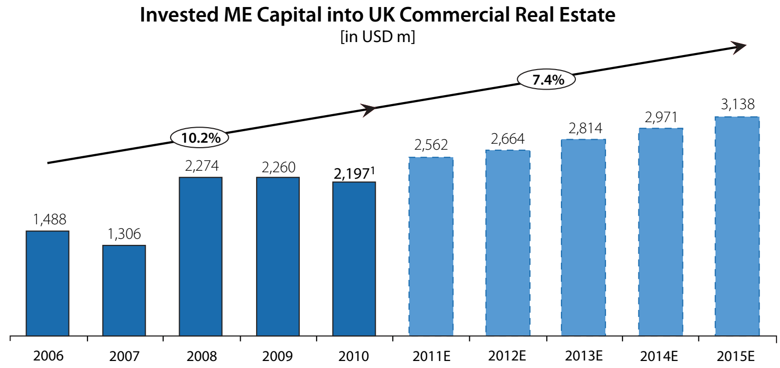


1) Mutual Funds and Offshore investments in typical conventional asset allocation for GCC have been incorporated into five core asset classes
2) Figures adjusted to better reflect assets re-allocations from equity to cash
Sources: IPSOS; Encore; E&Y Islamic Funds Report 2010, Booz & Company analysis

Exhibit 4: Recurring real estate or equipment leading funds as an alternative to traditional bonds

relevant investments in London in 2011, compared to a mere £3.6 bn for the rest of the UK outside London.

Middle East investments into UK CRE are expected to grow by ~7% over the next few years, offering further growth potential



Note: 2010 ME capital flow is estimated based on the CRE transaction volume (£33bn) multiplied by proportion of overseas investors (25% - CBRE estimate). Then applied a proportion of ME investors within the total overseas investment (17.4% - breakdown at Europe level, CBRE interview result).
Same methodologies where used for the 2011 and 2012 but with different assumptions. In 2011, a proportion of overseas investors is 26%. Of which, the proportion of ME investors were assumed to equal 2010 level (i.e. 17.4%)
Sources: Trowers & Hamlins/DTZ Research, Property Data, Capital IQ, CBRE, Booz & Company Analysis

Exhibit 5: Middle East investments into Commercial Real Estate (CER)

Diversifying the portfolio – Hidden treasures in Germany

However, Middle Eastern investors do not stop at the UK, as other European markets, namely those on the continents, seem to get more attractive for Middle Eastern and also for Shari'ah-compliant investors as well. Especially Germany gets more and more in the focus of GCC investors, not only because of its high manufacturing skills and products that are especially admired in the Middle East, but also because of its position as Europe's biggest and strongest economy. Several real estate transactions with Middle Eastern investors involved have taken place during the last years in Germany. Some sample transactions are outlined below:

- In 2006, HDG Mansur purchased for HSBC Amanah five office real estate objects in Frankfurt and Munich for a combined price of €190m
- In 2006, Gulf Finance House bought a real estate portfolio from Lone Star for €600m
- In 2007 Qatar Islamic Bank also bought a real estate portfolio from Lone Star for €430m
- In 2008, Pramerica Real Estate Investors purchased the Munich Mall "Das Einstein" for €160 m
- In January 2010, Arab Investments purchased several retail- and office objects in Berlin for €260 m

Apart from real estate, Germany has something, other countries within Europe do not have: a number of highly successful international mid-sized companies (Mittelstand) which are also often referred to as "Hidden Champions". These are, for example, Kaercher, a market leader for cleaning technology; Krones, a company specialized on bottling beverages; Wuerth, a privately owned producer and seller of power tools as well as Recaro, the world's #1 producer of jet chairs. While the above companies are only named as examples, it is obvious, that these hidden champions get more and more on the radar screen of GCC investors, who want to diversify their portfolio and participate on the market expansion of German top notch manufacturing firms. Also, many German mid-sized "Mittelstand" companies are in need of capital for financing expansion, but lack traditional banking loans, as German banks after the credit crisis cut down their balance sheets and thus decrease loans. So the long term investment strategy of Middle Eastern investors and the prudent and long term corporate strategy of German "Mittelstand" companies would make for a perfect fit and win-win situation. The numbers are nothing but impressive: In a recent interview, Fahad el Attijah, the deputy minister of economy of Qatar, said, that during the next years, Qatar alone plans to invest € 25 b in the German industry.[14] While Qatar already has invested in large German corporations like the construction firm Hochtief or the carmaker Volkswagen, Qatar now aims to shift its investment focus to mid-sized companies. A recent example for this trend is the take-over of at 29% stake in German Airline Air Berlin by the fast growing Gulf airline Etihad Airways.[15] Smart money investors from the Middle East, like Nazem Fawwaz Al Kudsi, head of the Abu Dhabi investment Company, have a prudent approach to evaluate investment opportunities in the West. "A multiple, we often use, is the market capitalization of all listed companies compared to the gross national product of the relevant country", Al Kudsi said in a recent interview with a major German newspaper.[16] "We are looking for countries, with this multiple being less than one. Here, we invest. Germany is one of those countries."

The role of Islamic Banking and the way ahead

With the ongoing insecurity concerning the Arab Spring wealth investors from the Middle East will continue diversifying their portfolios by investing abroad. Here, especially countries with a solid economy and a sufficient amount of undervalued companies, like Germany, are primary targets for long term, strategic investment.

Also, Islamic Banking has increased in importance during the last years. While many of the industry based companies of the German Mittelstand produce goods that are Shari'ah compliant, for example car parts, tools, machinery or chemistry, there is still no comprehensive Islamic Banking offering available for helping investors in these cross border transactions and ensure

Shari'ah compliance of the acquired companies or real estate objects and the financing transaction in itself. This is a bit of a contradiction: Germany, the country with the second highest Muslim population in Europe and a primary target for Middle Eastern investors, so far has no Islamic Bank. A likely model for opening up an Islamic commercial and later retail bank in Germany could be an Islamic Window of an existing major German bank. However, this, we find unlikely to happen, one reason being the necessity of banks to focus on their core business and cut back expenses, due to regulatory demands and, as mentioned above, the damage incurred by the credit crisis. Also, on a global scale, Islamic Windows like HSBC Amanah are scaling down, while pure Islamic specialists and Middle Eastern banks are scaling up. There have been attempts in Germany to set up an Islamic banking branch, with Kuwait Türk being a most recent example. However, these attempts never ended up with a fully licensed bank due to the specific nature of German banking regulations and many other hurdles international investors might face, with language being a major obstacle – most German officials working in government administration prefer German to English. Additionally, most of such attempts to develop Islamic banking have been mainly focused on retail banking which we believe is not a compelling value proposition on its own and not attractive to many investors, as the financial models show that for a pure-play Islamic retail bank there is no attractive business case.

However, there is a clear business case for specialists to capitalize on Islamic commercial banking, especially when it comes to originating investment opportunities for Middle Eastern investors. Major players have struggled to do so and many Western banks have exited the market. So currently, there is a window of opportunity for an Islamic commercial bank, may it be in the way of a greenfield approach or through a joint venture between a Middle Eastern house with local partners. The opportunity is still out there in the market and, as always, someone just needs to take the first step to capture it.

There is a clear business case for specialists to capitalize on Islamic commercial banking, especially in originating investment opportunities for Middle Eastern investors.

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Notes

1.See Booz & Company Viewpoint "GCC Private Banking 2010-2011: Successful Growth Strategies after the Perfect Storm", p. 13
2.IESE Insight, Third Quarter, Issue 10, IESE Business School, Barcelona, 2011
3.With the independence of South Sudan in summer 2011, it looks likely as if northern Sudan will stick to an Islamic Banking system and South Sudan is transforming its banking industry back to conventional banking.
4.See also: "Goldman runs into sukuk hurdle" in *Financial Times*, Dec. 16, 2011, p. 18
5.Daniel Dombey, Najmeh Bozogmehr, "Iran condemns Turkey's ‚secular Islam' system" in *Financial Times*, December 14, 2011
6.http://www.deutsch-tuerkische-nachrichten.de/2011/12/12339/%E2%80%9Eislamisches-bankwesen-ist-gutes-gegenmittel-zur-krise%E2%80%9C/
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11.International Islamic Financial Market
12.For more information, see also Amr Mohamed El Tiby, *Islamic Banking: How to manage risk and improve profitability*, Wiley, 2011
13.Bank of London and the Middle East, Islamic Bank of Britain, European Islamic Investment Bank and Qatar Investment Bank
14.Handelsblatt, December 9, 2011
15.http://www.ft.com/intl/cms/s/0/2a6945f0-2a24-11e1-8f04-00144feabdc0.html#axzz1h9tMcJq8
16.Frankfurter Allgemeine Zeitung, Dec. 16, p. 24, translated into English

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