IFN Islamic Finance *news*

The World's Leading Islamic Finance News Provider

DUBAI ISLAMIC ECONOMIC ROUNDTABLE

SERIES 2014 – 4

Building Bridges to Create a Trade Finance Network on a Global Scale

Panelists

AIMS

Moinuddin Malim
Managing Partner, AIMS

DLA PIPER

Paul McViety
Head of Islamic Finance, DLA Piper Middle East

DFSA

Prasanna Seshachellam
Director & Head of Islamic Finance, Dubai Financial Services Authority

TEMENOS
The Banking Software Company

Fadi Yazbeck
Product Manager, Islamic Banking, Temenos

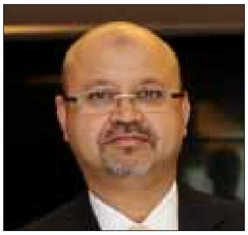
In partnership with

حكومة دبي
GOVERNMENT OF DUBAI

مجلس دبي الاقتصادي
Dubai Economic Council

DIFC
Dubai International Financial Centre

Panelists:



Moinuddin Malim,
Managing partner, AIMS

Paul McViety,
Head of Islamic Finance, DLA Piper Middle East

Prasanna Seshachellam,
Director & Head of Islamic Finance, Dubai Financial Services Authority (DFSA)

Fadi Yazbeck,
Product Manager, Islamic Banking, Temenos

Moinuddin Malim is the founder and managing partner of Alternative International Management Services (AIMS), a boutique Islamic advisory partnership. As the former CEO of Mashreq Al-Islami and head of the Islamic banking division of Mashreq Bank, Moinuddin has over 25 years experience in the Islamic finance industry and has held senior positions in some of the sector's most influential institutions including Albaraka Banking Group, The International Investor and Dubai Islamic Bank.

Paul McViety is a lawyer with over 10 years' experience of advising on Islamic finance transactions, acting for both Islamic and conventional clients - including financial institutions, corporates, funds, regulators and government entities. Paul provides legal advice on a broad range of Islamic transactions: including bilateral and syndicated Islamic financings, co-financings, project finance transactions (including complex multi-sourced financings), the financing of real estate development, asset finance, trade finance, debt restructurings and debt capital markets (Sukuk).

Prasanna Seshachellam is the director and head of Islamic finance for the DFSA, and is responsible for the supervision of prudential risks faced by all authorized firms operating in the Dubai International DIFC, with specific emphasis on the banking and insurance sectors and including the supervision of credit rating agencies and registered auditors in the DIFC. He leads the Islamic Finance Initiative of the DFSA, and represents the DFSA in the Technical Committee of the Islamic Financial Services Board. Prasanna was formerly with the Office of the Superintendent of Financial Institutions in Canada.

Fadi Yazbeck is the product manager for T24 for Islamic banking at Temenos. He has over a decade of experience in all aspects of Islamic banking, including implementations and product designs he managed in the Middle East Asia Pacific and Africa.

[Disclaimer: The views expressed in this publication are those of the above and do not represent the views of and should not be attributed to the Dubai Financial Services Authority]

Building Bridges to Create a Trade Finance Network on a Global Scale

A group of leading industry experts recently gathered at the Dubai International Financial Center (DIFC) under the aegis of IFN and the Dubai financial authorities to discuss the challenges and opportunities of building a global Shariah compliant trade finance network and the possibility inherent in creating a suite of products to service this goal.

Trade finance currently supports 90% of the world trade but emerging economies have seen the highest volumes of trade globally. Where does Islamic trade finance sit in this equation: what are the challenges that we're encountering when proposing Islamic trade finance, and how can we bridge that gap?

Islamic Finance *news* was delighted to bring together the experience and expertise of leading industry stalwarts including Moinuddin Malim, Prasanna Seshachellam, Paul McViety and Fadi Yazbeck. Representing multiple different backgrounds, sectors and fields of expertise from the regulatory, technological and legal arenas, the panel achieved a rewarding and challenging discussion.

IFN: Let's start off by just discussing why trade finance is such an attractive opportunity for Islamic finance - and how big the potential market for that actually is. Perhaps we can ask Moinuddin to get the ball rolling?

Moinuddin: Well first of all, Islamic banking has really not penetrated trade finance well. Let me put this as an overall umbrella statement, and then let me put forward the points of consideration. If one were to look at Islamic economies in the region, then these economies are valued at roughly US$4.1 trillion and if you see the trade that happens between GCC countries - between OIC countries into Europe and elsewhere, most of it is importing goods and or exports, which are mainly oil-related. But how much of this trade is captured by Islamic finance? That is the question - I don't think anybody has a figure for that. But if you look at the balance sheet of Islamic banks, you'll find them doing more structured finance term loans than trade finance. The volume of wholesale banking that goes to trade finance will be hardly more than 15-20% at best - so what this tells me is that Islamic banks have really not penetrated or captured trade finance to any meaningful extent so far.

IFN: Does anyone have anything to add? Would anybody care to hazard a guess at how big the potential market is?

Paul: I think today's session is really about the opportunity that trade finance presents for Islamic finance because, as Moinuddin was saying, to-date it has not captured its real potential. If you look back over the last 15-20 years in terms of the Islamic finance industry's growth: trade finance has been a component of that growth, but not a significant component in the way that you would have expected it to be. To hazard a guess at a percentage of the figure that Moinuddin just referred to: Islamic trade finance represents, I think I read somewhere, less than 1% of that figure - which is really quite surprising. But the encouraging thing is that you have AAOIFI and other key industry bodies who are talking about the potential for growth of Islamic trade finance over the next 5-10 years, and they're expecting that growth to reach up to US$800 billion by the end of 2015. When you consider that the most recent estimates about the size of Islamic finance industry put it at around US$1.8 to 2 trillion dollars, then clearly trade finance has a huge role to play within the wider Islamic finance industry. But it's all about capturing that potential. I think the risk, from where we currently stand, is that the industry will fall short of that US$800 billion figure.

IFN: There is obviously this huge opportunity that has been identified. Are there any specific areas within that where Islamic trade finance is specifically well-suited? Just throwing out words here but supply chain financing or asset-based lending… are there any specific structures or products that Islamic finance is a suitable match for within trade finance?

Moinuddin: If you look at the trade finance, what is trade finance? Trade finance is basically issuing Letters of Credit (LCs) whether its an import LC or export LC: and then basically discounting the LCs. These are the key trade financing products you see. There are banks that have put together those products but the use of those products is very

Moinuddin Malim

limited. Because when it comes to cross-border risk, unless it's a bank that you are comfortable with, you will not discount their LC. Then a lot of times, these bigger buyers are no longer using LCs, they are doing it all on open account. That means that banks will have to take a credit risk on buyers. Are the banks ready for that? Bill discounting is something they understand. But now the larger trade volumes we are seeing, the large product houses or trade houses, are all doing things on open account. That's where I think the challenge comes in: because first of all, banks - especially Islamic banks - are not willing to take the risk. At times when they open their LCs, unless it's a customer that they know very well, the LCs are not clean, they are on margin. At times, they'll have 100% margins and then reduce this as the level of confidence grows. So those aspects have to be looked at and that's where I think the question is. Is Islamic finance connected to the real economy? Are we really supporting the real economy - which is Halal tourism, the Halal industries, the Halal trade - how are you going to label that? I don't see that happening yet.

IFN: Is there a regulatory aspect that we can bring to that?

Prasanna: Speaking from a regulatory perspective, the issues only relate to the ultimate issues of how well it is managed and how well the risk is supported by capital. Going by our experience, the DIFC has really developed the way we base our trade finance in the GCC and in fact wider region. Trade finance is one of the booming areas right now. So we have a lot of experience and fundamentally speaking there are certain areas of Islamic finance which are naturally suited to supporting some areas of trade finance - whether its asset-based, equities, etc. And some people do go down that road and use Islamic finance in contracts and structures to do asset-based lending, which fits in perfectly, but the problem is the Islamic banks have to end up taking the risk on the underlying security, which is something which is not a new concept - but its new to Islamic banks all over the world. There are another group of banks that have done that - where they actually take the commodity risk while securing trade finance transactions on top of that. That is something that could be an opportunity for an Islamic bank that wants to really expand in trade finance and do a really good job. Leveraging on that is really an opportunity that I don't think anybody has been brave enough to try yet.

"Even though the past couple of years have seen some relaxation made for trade finance in general, it doesn't help any bank to be more aggressive or be more liberal – and the current trends in terms of risk weighting and capital requirements are making that even more difficult"

But there is also an entire area about risks, creditors, underlying creditors that is becoming more complicated and the appetite for bankers in general, including Islamic bankers, to take that risk is going down. And simply because of that, all kinds of regulations are moving in a direction which is discouraging to a bank that might want to take risk in those areas. Even though the past couple of years have seen some relaxation made for trade finance in general, it doesn't help any bank to be more aggressive or be more liberal – and the current trends in terms of risk weighting and capital requirements are making that even more difficult. There is going to be a bit of a challenge in this area. However, I do think there are some areas like supply chain financing that are asset-based, or inventory financing – in areas like that corporate can use Islamic finance structures in a very natural way.

I think going back to what are the main Islamic finance problems, what Islamic banks should look at is how to best serve their customers' and economic needs. Based on what we see at banks and looking at the different implementations, we see that there are many banks that have problems meeting the same level of service that a conventional bank can give for trade finance. For example, in terms of first on the knowledge side, most of the Islamic banks are quite new - and then on the financing structure side, there are many banks or many scholars who wouldn't allow pre-shipment financing before the goods are available – issues like that make Islamic banks less competitive. Actually financing manufacturing whenever imports are received - or even later the discounting financing - the types of financing being offered are slightly different. The conventional banks have really customized financing for trade finance. Islamic bankers on the other hand will try to use the same Islamic contracts and just bring them to trade finance, so sometimes we have gaps within the financing process. Another issue comes when, let's say, they look at Murabahah financing. The banks are taking the risk on the commodities. They are taking the full risk and full exposure on this - they can take some collateral but if the goods are not accepted or if they make any mistake then they end up with the goods themselves. And then if you talk about supply chain financing this is where we face again the issue of standardization in trade finance. Since the supply chain is working across two countries, with two separate clients, then what's acceptable for the first regarding types of contract might not be acceptable for the second: and for all those parties that work together in the supply chain financing. This is one of the things that is developing now in conventional banks but for Islamic banks we still don't see the requirements coming to us as a vendor.

IFN: Perhaps we can get Paul to step in there, to talk about the differences in contract documentation – is this a stumbling block to trade transactions?

Paul: It is. Islamic trade finance has been trying to use the conventional products that are available as sort of a benchmark - and as my fellow panelist was mentioning, there are obvious restrictions or limitations in terms of what you can and can't do under Shariah principles. You also have a fundamental drive within trade finance towards risk mitigation (certainly on the conventional side of trade financing), and risk mitigation is exactly how the wider trade finance industry has developed from a legal and structural point of view. The basis of the documentation and processes that are typically put in place have all been developed off the back of ensuring that risk is mitigated wherever possible. When you try to interpose a 'traditional' Islamic financing structure in there, such as a Murabahah based structure, you would be taking ownership risk. You can try to analyze the supply arrangements for that, and you can look at Incoterms, bills of exchange and bills of lading etc., and try and work out how to mitigate that risk as best as possible - but ownership does not make this an easy task, and often the only way is to mitigate in terms of cutting down the amount of 'ownership' time. Ultimately you're talking about something that doesn't necessarily match up to the same objectives as you would see with a conventional trade financing product. And that's before you even get into the issue of the fees that are charged on the back of letters of credit and letters of guarantee; which of course are not permissible in the Islamic context.

There are clearly a number of structural and documentary challenges but I think - taking a step back from all of that - Islamic finance needs to approach trade finance in a different way and look at how it can support the real economy, but to do so in a way that doesn't necessarily look to replicate or rely upon the principles that have been established through conventional trade finance products. The challenge there however, is your typical customer base and what they're looking to see - and of course their benchmark will often end up being price and what they can get from conventional trade finance, unfortunately.

Prasanna: That has been a problem earlier, with other segments in Islamic finance. Take Sukuk for example, it took quite a long time for them to evolve. Today we are seeing Sukuk as a very vibrant market, there are big issues coming out, we are seeing a lot of volume - but look back and we see that it had to go through years of evolution. People were trying out new things, and some things failed and some succeeded. There's pressure on Shariah scholars to push boundaries and get different views. And not all of that is happening on the asset side. They are playing it very cool. They are just using some few contracts here and there. I think that there need to be further efforts to get products or Islamic structures that can meet the financing needs of a difficult industry: such as SME requirements or like big banks which need money to finance inventory or make purchases. That process I don't think has even started - its still at the very early stages, so it has to go through a process of innovation and evolution. There is scope and I can see that there is scope as to how they can do it because similar things have been achieved in other parts of the Islamic finance industry.

IFN: So what areas are there where innovation could be applied?

Moinuddin: Just to add to what Prasanna and Paul have said: the way that Islamic banks have been mimicking the trade, in a commercial bank a typical trade cross-border transaction happens through the LC and the TR. The LCs finance to term finance and the way the term of TR works is like an overdraft wherever the ability to the pay is settled. Whereas in Islamic finance the mode used is Murabahah so there have a number of modes of finance depending on the margin you require for the LC and wherever the LC is negotiated you give a Murabahah - and that itself has led to a problem. Because Murabahah gives a fixed number of days, whereas TR is open credit – they can settle in 90 days, in 10 days, in 120 days. But if you fix a Murabahah this is fixed for 90 days - but regarding what happens beyond that you're not allowed to take additional profit. So what do you do is you give it to charity. That itself limits the banks' ability to really look at trade finance. One of the key points that I take from Prasanna is that trade finance lends itself very well to Islamic finance. And this may be true, but the problem comes in when it crosses borders. As soon as it crosses border you want to safeguard yourself. How do you safeguard yourself? By taking a letter of credit from a bank that you accept the deal from. And as soon as the letter of credit is negotiated you are bound to a short-term loan. But looking at the few countries where trade finance is really done well, that's more about deals done within that jurisdiction than cross border. People have looked at advanced acquisition of products. These lend very well themselves to trade finance but the problem is that the bank has to take the commodity risk, they have to take the ownership risk. For example, in Pakistan a few of the banks actually have bonded warehouses where they take the hypotication on the goods and /or take the ownership of the goods and release them as the sale happens. So they don't do it as a Murabahah, they use the Mudarabah structure.

Paul McViety

IFN: But surely the foundation of Islamic finance is profit and risk sharing? So you can't expect to mitigate risk entirely?

Moinuddin: Yes but unfortunately it doesn't happen right. That's the problem, that's the key. Why doesn't it happen is because the way each bank wants to limit the risk that they take. Any bank - and I challenge that openly, if you can show me any bank which will put more than 20%, which itself is a big number, into asset deals such as Mudarabah, Musharakah – they will not. At least 60-70% of the book is in Murabahah alone, which is nothing but an IOU loan, and then the balance is in Ijarah.

If you look at financing, in a typical bank its role is intermediation. We should remove the word 'banking' really, because in Islamic financing, perfectly speaking, you should be sharing the risk. The core problem lies on the liability side, where you have taken the funds from somebody. Are you in the position to turn around and tell that person that you share the same risk? So analogically speaking, I'm talking more about something like a fund structure, in which case, the bank on a fiduciary role takes funds from you as from an investor, stating that whatever income is generated from investing these funds will be shared with you in the form of profit/loss and that the bank is free to invest it anywhere.

But the problem is that there are these so-called Islamic investment institutions that coexist along with the conventional banks that make matters worse. They are called Islamic banks; however, they behave more like a "conventional bank", which means for a regulator like me there are other issues such as micro prudential issues and stability concerns. So the effect on the economy is the same as any other bank. Hence the regulators tend to start asking questions about exactly what type of business these Islamic banks are running and they will tell you no, you cannot take commodity risk because if this goes down, you will be risking the depositors funds; so there are limits and rules on everything on the prudential side that limits Islamic trade finance.

Prasanna: The latest trend in this area is the emergence of what we call what we regulators call 'shadow banks', which are basically not banks but there are a lot of them appearing – and more in this area than in others because of the lesser regulation. They can do all these things because there is no one to regulate them and say no, you cannot take exposure on this commodity risk. If an Islamic bank goes into that space however, they can move in only on the liability side – getting investors to put money in on that basis – otherwise it would be very difficult.

So another point is the Salam contract, which is a classic example. In fact I think the origins of Salam - I'm not an expert but I believe that the origins of Salam actually comes from trade finance. It's a classic instrument that came up only for trade finance in the 'olden days'. So we're not doing anything particularly new - it's a risk return thing that has to be adapted and broadened to what we now need it to do.

> *"The conventional banks have really customized financing for trade finance. Islamic bankers on the other hand will try to use the same Islamic contracts and just bring them to trade finance, so sometimes we have gaps within the financing process"*

Moinuddin: But the whole thing comes back to the maturity of the industry - whether it's the GCC or the wider Islamic industry. The GCC is an oil rich economy but tell me: outside one or two local banks, does anyone actually have an oil and gas expert within their bank? I think I can name just one bank in the UAE with an oil and gas expert – and that bank has expertise in perhaps five or six sectors. In the Islamic banks there's zero. Once you have that expertise however, that is when you can really take the asset risk and say now we can play around with that commodity. It is when they don't have expertise that the regulator should not allow them to take that risk - and that's unfortunately where Islamic banks are right now.

IFN: Paul, you seem to want to say something?

Paul: Just a couple of points here I think to illustrate the challenges around risk. I have seen some financial institutions developing trade finance platforms which do use Murabahah but which have moved away from taking any Murabahah-based risk on the underlying goods or assets that are being traded. Those institutions have instead chosen to move more towards platforms relying upon synthesized commodity Murabahah trades and going through a Tawarruq format, using LME-based metals or commodities.

IFN: Which surely brings a compliance issue in itself in certain jurisdictions?

Paul: Well, yes and no. I suppose it illustrates the point that there is a risk too far in some of these structures given how the banks are regulated and ultimately what their responsibilities are towards their customer base. As I say, that has led some institutions to go down the route of having commodity Murabahah-based platforms to provide their own trade finance solutions. Then it perhaps becomes even more focused on replicating the economics of what you see in a conventional trade finance product. And just to pick up the point that Moinuddin was making, in terms of a breakdown of intra-OIC trade by-products or sectors: based on a survey done in 2011, petroleum was at 29%, miscellaneous manufactured products were 29%, food products 17%, machinery and transport equipment 13% and chemical products 9%. So you're talking about a wide variety different underlying products and sectors, and to understand all of the risks associated with each of those sectors requires a dedicated team of experts - and unfortunately you won't find a bank in the region, conventional or Islamic, that has experts who can cover everything.

IFN: Let's look at briefly at where the actual opportunities are and who are the end customers - because we touched on it earlier and I just want to return to it before you get too involved in the conversation. We have seen suggestions that one reason Islamic trade finance is picking up is because the conventional banks that were big players, such as ING, have pulled back: so there's a gap now to be filled that Islamic banks can step into. So are these banks directing their products or their offerings to Islamic customers or to conventional customers that are now lacking service from their former providers? What target market is Islamic trade finance trying to capture?

Moinuddin: Well I can share from my experience, that Islamic banking is not only for Muslim customers. It is about how you approach the customer and who approaches them first. It's a relationship that has to be built over time. There used to be a time when Islamic finance was more expensive than conventional but over the last five or six years they have been at par. The first question is the required services platform, the local expertise to understand the product lifecycle. Unfortunately most of these banks don't have this. They don't understand the client and product lifecycle. Why would any client look at trade finance? Because he needs more working capital finance to release his receivables so he can get more production done. We need to understand the product lifecycle and from that perspective, Islamic banks do not specialize, they are not in a place to understand the trade or trade function. There may be a few who have it but it's not available generally speaking. And then second, as you mention intra-OIC trade, who's capturing that? You'll see that it's mostly done by major international banks - not even commercial local banks are taking a chunk of it. Why? Firstly because of their inability to understand the costing of the risk; and secondly, as you have mentioned, the standardization of documentation. And when you bring in Islamic finance its further complicated as even the Murabahah contract varies from bank to bank.

IFN: What about the technology platform that it's based on? From a provider perspective, is it an inhibitor or that something that could be improved on?

Fadi: So, I think the technology platform can be used especially when we talk about supply chain financing across all those countries. You need to link the suppliers to the buyer in a way that is going through the bank in terms of purchasing and selling. Again doing direct links - for example I've seen some reports that say that some of the researchers are trying to create some Islamic trade finance derivate network that will have direct access between the different Islamic banks where they can guarantee the risk of other banks, the intermarket risk. Technology can play a big role at this level to create links between the two banks and show what's available on the market in terms of products, goods and contracts that can be financed through Islamic trade finance. Now when it comes to let's say the big player and who's filling the gaps, I don't think that Islamic trade finance will necessarily fill the gap left by ING or any other big bank leaving the market. It all depends on how attractive the product is for the bank in terms of profitability and for the clients in terms of knowledge and how simple it is to apply or issue an Islamic LC – or an LC Murabahah, compared to a regular conventional LC. So it all comes down to accessibility and ease of use of the product.

Moinuddin: Just to add, LCs and others are all governed and standardized. It's actually what happens after the LC that's the issue - how do you enter into a finance mode?

Fadi: Yes. So one of the banks that we've seen has started using a Musharakah LC, because then they are sharing the risk, they share the charges, they share whatever is the outcome of the LC, which brings them closer to something that is both convenient to the customer and convenient to the bank in terms of profitability on the bank's side. The challenge that arises in Musharakah is dependent on the scholars and how flexible they are. The bank focus is on a turnover of profit. The scholar needs to be flexible enough to say yes, we have an expected rate, and you can collect fees on it. So I can see that Musharakah could be a good product.

Moinuddin: There are three forms of LCs that an Islamic bank is allowed to open. Broadly speaking. One is where the bank requires some margin; one is where the client wants financing; and one is where the client doesn't want financing. In general trade this is how it happens as well. So in Islamic finance the way the LC structures are used under the Khalafa model where the bank becomes a sponsor. When you issue a Murabahah LC where the client wants 100% financing - then the LC is opened in a joint name of the client and the bank. Because the bank should own the goods, they must arrive because showing the bank as the ownership, then the banks negotiate and then enter into a TR or an Islamic Murabahah. And then you have Musharakah where the goods have


Prasanna Seshachellam

to land in the name of the customer because of customer requirements, because of registration requirements: that's when they do the Musharakah - which could be 1%-99%, i.e., a 1% contribution toward purchase by the customer and 99% by the bank. But then the exit to a Musharakah could be anything – it could be equipment, it could be Ijarah - if it was commodity it could be Murabahah. A Wakalah LC is when the client doesn't really need financing. So you open a Wakalah LC and when the LC documents are negotiated, clients settle in cash. These three forms are generally readily available across the board.

IFN: Taking it in a slightly different direction, we talk a lot about the challenges and the difficulties and the barriers to Islamic finance: what about the advantages? Are there specific advantages that Islamic banks can offer, or that Islamic products can offer, in terms of features or liquidity or services?

Paul: I think the main opportunity for Islamic trade finance is as an alternative source of liquidity. If you are a customer who needs to finance an underlying trade transaction, then you will naturally want to find a competitive source for that funding. Islamic trade financing can be (and has proven to be) an alternative to conventional trade financing, particularly where liquidity in conventional banking markets has dried up for certain types of customer; it just needs to be in the right place at the right time. I guess that is what we are talking about today, regarding this opportunity.

There are also geographical 'hotspots'. I've worked in the region 10 years or so and I have seen a reasonable amount of trade finance activity, particularly in the Islamic trade finance sphere but focused on certain countries. With Turkey for example, the likes of HSBC and Citibank, in particular, used to do a lot of Islamic trade finance Murabahah deals with

Turkish counterparties, and with this came an established way of doing deals. You would have guys on the ground here in Dubai (on a Turkish 'desk') executing these trades with support from their counterparts based in their respective branches in Istanbul. So there is something of a lesson there, which is that it's very important to have a broad geographical network or coverage. I think this is one of the areas where Islamic banks struggle in trade finance (and more generally); because if you look outside of OIC countries, and in particular outside of the GCC and Southeast Asia, their coverage isn't particularly great. There simply aren't branches in all of the major cities across the globe in the same way competing conventional institutions do have. This is a challenge that needs to be overcome.

But going back to what I was saying before, I have seen a real shift in terms of the focus of trade finance activity. The focus at the moment is very much on trade with Africa. Over the course of the last 10 years, the level of trade between the GCC and Africa has gone through the roof. I'm not sure what the exact figures are, but it's impressive. As a result, a lot of banks based in the GCC region - international, regional and also some local banks - are focusing on capitalizing, in some way, on that tradeflow - and Islamic trade finance is one of the areas that could benefit from this.

Moinuddin: That's an excellent point that Paul mentioned but, unfortunately, not even in an OIC country - if you look at Islamic banks I don't recall any Islamic bank which has presence in a majority of the Islamic countries as well. If you look at the core Islamic Muslim countries where the population bases are, they are not there. That's one area that trade finance has not really taken up. Why? Because you don't have the distribution reach, and if you don't have distribution reach you don't take comfort in the supply chain. If you talk about HSBC, Standard Chartered, Citi, they have that network and distribution reach where they can assess the risk of both the supplier as well as the user, and that's when they take the risk on the supply chain and say OK, let's do a trade deal - like an actual commodity trade deal - which is something that Islamic banks don't, because in size and distribution reach, they're not there yet.

IFN: Speaking about intra-OIC trade, how can this be promoted or encouraged? And I know, that Moinuddin, we were discussing this recently and perhaps I can ask you to just quickly recap what you were saying.

Moinuddin: Sure. We touched base that the IDB as a supranational institution has its own currency called the Islamic dinar, which is a basket of currencies by all the Islamic countries. Unfortunately within the OIC countries, they don't use their own Islamic dinar for trade. If you use that then perhaps that would encourage more trade finance because it could be IDB-issued currency on which LCs can happen and open trade can happen and banks can discount it- and the IDB itself can discount.

IFN: But even without using a different currency, is there a role that the IDB could play because it does have that geographical reach?

Fadi: I think they can play a role in terms of assessing risk for other countries and banks in other countries so they can provide more information and knowledge to Islamic banks; or maybe they can provide a supporting channel or a guarantee on the actual payments, based on their own assessment; since they have the reach they can get this calculation based own their own risk assessment. This way maybe what we speaking about as the disadvantage of Islamic banks of not being present and not knowing what is the cross-border risk can be resolved at this level.

"The market is growing at such a pace that anybody can take advantage of it as long as they are prepared to take advantage. The point is that Islamic banks are not prepared: in terms of distribution reach, in terms of risk management capabilities, more importantly in terms of developing and evolving products to meet those specific needs"

Paul: The IDB does already play a role, through the International Islamic Trade Finance Corporation (ITFC).

Prasanna: The trade is growing … there's no question about need to promote the trade. Intra-OIC trade as well as GCC, South-south trade, is booming - China, Asia, Africa trade, any access you are talking about is really booming. The market is growing at such a pace that anybody can take advantage of it as long as they are prepared to take advantage. The point is that Islamic banks are not prepared: in terms of distribution reach, in terms of risk management capabilities, more importantly in terms of developing and evolving products to meet those specific needs. Like if I were to give a pre-shipment financing, do I have a product? If I were to give like a LC, a clean LC, how do I do that? I think that not much focus has been spent on that. Probably somebody like IDB can do that. In many cases, these things are ideally driven by customer demand. But otherwise in many cases they can be driven by institutions like the IDB because they have deep pockets, so they can spend on R&D, they can put people to work doing research.

So that way, I think definitely institutions like the IDB can play a facilitator role in coming up with a solution.

Moinuddin: The key issue again is whether Islamic banks have the ability to take a position, number one. And if they take a position and charge a higher rate of return, will the customer pay it or will he not go away to a commercial bank saying well, you are opening my LC and you're giving me my TR at Libor +2%.

Prasanna: But there have been instances – in DIFC we have banks, not Islamic banks but commercial banks, who have specific expertise in areas like this, in commodity trade financing. That's why I'm saying there are people who are doing that. And I've seen that this is something that is natural and it fits the portfolio of Islamic banks easily. So as I said, on the contrary, we have banks opening in the DIFC where I just don't see that happening. So it's also a question of Islamic scale, a question of Islamic bank liabilities, so they go in search of assets to fill that gap – and they are subject to competition to earn a return. So then they start thinking about all these things. But so far I don't think that such pressures are working on them yet. Because this market is booming – there is business where we want it.

IFN: So what I'm interesting in, just to touch back on a point that you made earlier: if there is a growing demand for Shariah compliant trade finance that Islamic banks aren't meeting, are we going to see conventional banks stepping into this space and taking over the sector, because Islamic banks aren't providing what the customers are asking for?

Prasanna: I think that there is demand for trade financing. It's up to Islamic banks to go and grab as big a share as possible.

IFN: But you mentioned that you've seen conventional banks go into some Islamic products and Islamic trade?

Moinuddin: Every conventional bank, whether it's international or local, has an Islamic window now – except in Qatar, which has banned Islamic windows. And those Islamic windows are actually challenging the pure, fully fledged Islamic banks, and they are taking that trade away from them. Why? Because they're used to trade finance, they have a specialist desk, and if the customer wants Islamic, they will give them Islamic.

IFN: So what do Islamic banks need to do to capture business? That's the million dollar question!

Moinuddin: It's really very simple. It's the inability to take a position. The main problem comes in because they've taken current accounts and fixed deposits, and they can't switch away from this and take an equity position. Because whenever Islamic bank shifts its mode from Murabahah and Ijarah, which is again more of deferred payment sale and financial lease, it is taking equity risk - which it is not willing to do.

Prasanna: It is a mismatch to the other side. And even if they do the regulators will not support that.

Moinuddin: Unless like he said, you create a dedicated trade finance fund and then play with that. If that happens it will encourage trade.

Fadi Yazbeck

IFN: Are we seeing that happen - or can we expect to see that happen?

Prasanna: I'm not seeing that … maybe it has happened but not in general.

Moinuddin: No, it doesn't

Fadi: I think it depends on how the bank would be able to attract funds for these depositors invested in this fund. So far most of the depositors who go to a bank and invest there, I don't see that for now they would be willing to take that much risk. It all depends on the perception, and how the Islamic bank is offering it at the investor side and then on the product side as well.

Moinuddin: But again, trade can be very risk-free depending on how you structure it. I have been told that Dubai is more export and re-exports. Ninety percent of exports don't even touch the bill of exchange, it is all offshore. That in itself is just traders matching the buyers and sellers, and their margins can be upwards of 150%, because they know how to source it, where to sell it – and this lends itself very well to something like a trade finance fund.

Paul: And when you look for example what the DMCC are trying to do with trading…

IFN: So that was going to be the next question: what role are platforms like DMCC and NASDAQ Dubai playing?

Moinuddin: NASDAQ Dubai is not a commodities platform, it facilitates Islamic finance as a financial market for transaction such as Sukuk; whereas the DMCC has created warehouse receipts – warrants - based on the commodities that are warehoused in Dubai. Those are again used more so to create this paper transaction, Tawarruq. But then they also have actual commodities where banks can finance.

Paul: Well that's broadly what DMCC Tradeflow is intended for. I was at a recent presentation which was focused on the commodity Murabahah platform that they have developed, and it is essentially built off the back of a real trade platform. The Tradeflow platform is designed to facilitate exactly these kind of trade finance transactions, whether it is Shariah compliant or whether it is conventional. And to do so in a manner that gives everyone the kind of safeguards that they would expect: in terms of warehouse warrants, and the ability to take security (over the underlying assets). All of these things are key features of Tradeflow. But as Moinuddin says, the uptake today - I don't think - has been quite as great as was anticipated.

IFN: Why do you think that is?

Moinuddin: Banks' ability to take risk on commodities. Neither Islamic or conventional banks will take the risk, whereas Tradeflow and the warrant that DMCC has created and the commodities they have enlisted -are excellent and at par to LME, in that respect (with smaller volumes at present). But banks should have the ability to actually take the risk on the commodities and say yes we are taking physical positions and as the supplier sells off we will net off and take our profit out wherever it is - it is just not happening yet.

"Islamic windows are actually challenging the pure, fully fledged Islamic banks, and they are taking that trade away from them. Why? Because they're used to trade finance, they have a specialist desk, and if the customer wants Islamic, they will give them Islamic"

Paul: I think that challenge comes back to this point, about how do you go about taking that risk in an increased world of regulation? For example, look at Basel II and Basel III. When Basel III initially came out, and at the initial stage of forming the regulations, people were surprised at how tough a stance they took on trade finance products. I am pleased to say that there was a subsequent consultation process and modifications were made which actually took into account the fact that you're financing, through trade finance, a real economy - and that there are real underlying assets. In other words, it's not a speculative trade and therefore less likely to cause the same kind of ripple effect as seen with the complex / layered products which brought about the 2008 global financial crisis.

Trade finance is short-term, and often uncommitted. It should have a separate category and treatment from a regulatory perspective - and, quite pleasingly, the Basel committee responded by modifying the regulations. If they hadn't taken that step, many people were predicting that the impact (of those regulatory changes) upon GDP growth could have been negative.

Prasanna: Yes, I was trying to say that in a different way – what has happened is that the global regulators, not the individual regulators, which we call the standard-setters – particularly the Basel committee – absolutely went in the opposite direction. They probably didn't even understand the issue very well. The other thing is that the Basel committee even today, you're talking about the top 30 countries in the world. So their thinking is inside the committee. Their thinking is very much driven by a few countries, let's say the US. The US, their trade financing is very much driven by markets, they use heavy share of commercial paper for financing. They are not driven by bank financing. They have problems in the markets and that's what drives a lot of the issues. It is absolutely inappropriate to use the same view to apply to Asia because in most of Asia trade finance is done through banks and there is very little of a commercial paper market here. The outcome of that is that they have gone extremely risk adverse; they've become so strict, it is shocking.

And the general mood has changed even after this 'relaxation', the general mood continues to be that OK, we have to tighten up everything; whether its on the liquidity front or the capital front. So there is no interest from them in being willing to listen to a reasonable perspective. That's what I tried to point out this morning, its not us the individual regulators, it's the standard-setters. This is because it is being driven from the top by the G20. They will just set it down and say: you need to get this done.

Moinuddin: Manipulating the industry, basically.

Prasanna: Yes exactly. And then they come down to IFSB and IFSB tells us what we need to do. We are individual regulators, we have no choice compared to before - if we don't do it then there are assessments which come from the IMF/IFSB and they will pass unfavourable or deficient assessments on the regulators concerned. So the net result is that actually it is not providing a conducive environment for banks to take risks.

Paul: My view is that - in effect - it moves real economy, Islamic trade finance away from being the business of wholesale Islamic banking and more towards specialist funds, or even microfinance initiatives.

Prasanna: Yes, actually a lot of these funds are going to what we called shadow banks, which are not regulated as banks. But those techniques that they use - similar techniques could be used for Islamic banks.

IFN: Surely that throws up its own sets of issues: the concept of an unregulated industry of shadow banks getting involved in trade finance…?

Prasanna: They are already involved anyway, what I'm trying

to say is that Islamic banks can just learn from that. I am not saying that Islamic banks should not be regulated, they can be regulated, but they can borrow some of the techniques they use. Not for anything nefarious – I am just pointing out that they have invented some of their own financing techniques and probably you could take that approach and see if they can bring in that technique to Shariah compliant. It's up the Islamic banks to grab a share of the growing pie, they don't do it they'll fall behind. The pie is growing and it will be the commercial banks that keep taking it.

Moinuddin: Where you have the classical example of technique from your shadow banking analogy, is the big trading houses. They have their own trade finance desk and they don't need to look at bank financing, they provide their own supply credit and they are multi-billion dollar agencies operating from either a commodities platform or going into white goods – Glencoe, Trafigura, Nobles etc - they are substantially large, these are multibillion dollar entities.

IFN: So what can be done on a regulatory basis to assist this? You mention that your hands are pretty much tied in terms of Basel III but is there anything further, just bringing this back to a focus on Dubai itself, that the DFSA is looking to do?

Prasanna: At best the regulators role in developing anything can be to the extent of facilitating only. As a regulator what I can do is be risk-focused. I need to be open and focus on risks because my mandate is to focus on risks. If we are focused on the risks, then the regulator can achieve and facilitate innovation. In areas like this an Islamic bank walks in and says okay and you know what I have a new structure, I have this customer need and this is how I propose to do this. I have to approach it with an open mind just to understand the risk involved, and then map it into my existing regulatory structure. In fact not even map it: if I understand the risk and how much risk is involved, then I decide what I can tolerate and what I cannot tolerate.

If I cannot tolerate it then I can see in my rules and regulations as to how I intend to mitigate it. That kind of open attitude will really help. But the DFSA is a really rare organization simply because of the quality of our people. We have taken that approach. And to a certain extent we don't have public policy constraints and things like that. But also, for example, if a bank comes to us and say okay we have this specific instance but this runs against one of your rule: what can we do? We actually have a process by which we can actually understand this, and if we understand it and agree on the rationale then we have process by which we can even waive the rule for that instance or modify it.

Moinuddin: Prasanna hit the nail on the head - if you can quantify and map the risk. That's where the problem lies with Islamic banks. Especially when you look at an industry like trade finance. They don't understand the industry, and they can't quantify the risk at times. That's why they play it very safe, they can discount somebody else's LC or give a TR when their LC is negotiated. But to take actual risk of the commodity they need to understand how the commodity market works, how the spot market changes and how you can keep that risk and be hedged.

IFN: And is that a question of human capital, is that a question of training, is that a question of awareness - how can that be addressed?

Moinuddin: Start from human capital - then technology then a level of understanding, then having market depth. The Islamic trade finance industry does not exist in the UAE. I'm not sure if that's a very broad and generalized statement … but it does not.

IFN: That's a pretty broad statement. Would the rest of the table agree?

Moinuddin: Even smaller countries like Taiwan for example, their GDP is much smaller but they have trade finance because they are supporting their exports. We could do that but we don't.

Paul: I do think we are seeing more activity though. I look at it from a transactional perspective, Islamic and conventional: and we're seeing a lot more trade finance activity, particularly over the last 18-24 months. We've seen international players, in particular, taking collateral management arrangements (as an example of a trend) to safeguard their interests in the underlying asset. As Moinuddin says, they're applying their internationally understood risks to a local context: in turn, they ask us (as lawyers) what are the risks associated from a local law perspective. They want to understand how international best practice maps into a local law context across the different countries in the region where this trade is being carried out.

IFN: Where is that interest coming from - who is that interest coming from?

Paul: I think the vast majority of it is with the traditional trade finance players: international institutions with their wider network available to them.

Prasanna: People who are warehousing their goods. A lot of big suppliers, they have their inventory and they can't just keep it sitting there. They would like to hedge against that, how do they do that?

Paul: It is also institutions following their corporates as well. These are often corporates which have extensive networks for trading across the globe. The existing trade finance relationship with an institution, say in Switzerland, could mean that the institution ends up doing business with exactly the same corporate here in this region.

Moinuddin: That's an excellent point actually. Japanese banks will finance Japanese corporates, Swiss banks will finance Swiss corporates. They support their supply chain. But for local banks, who are they going to support?

> *"Japanese banks will finance Japanese corporates, Swiss banks will finance Swiss corporates. They support their supply chain. But for local banks, who are they going to support?"*

Prasanna: Human capital is very scarce. I've been a player in risk for all my time in banking. Here people are very uninterested in risk. I can pick up the phone and talk to someone about a credit card and he is totally uninterested in my credit risk, he is only interested in my salary. Which is absolutely irrelevant. If you go to any other country – Canada, Malaysia, wherever – they focus on who you are and what you do. Here there is nothing of the sort. They are just following their checklist.

But when I speak to risk management people, right through to the top level, I do think there's a lot more need for development, particularly in the GCC in terms of understanding all these things. Only then you can develop product solutions.

Moinuddin: And that is also more so within Islamic finance than conventional. They should look at the recent survey done by EY – over the next five years in the core Islamic markets they say that if you take the 5% of top leadership of these core markets then you need to train 12,000 people. Where are these people going to come from, who are going to train them?

IFN: Well, this is a conversation for another time, we are not here to discuss human capital in Islamic finance! Let's go back to the ITFC, what role does it play and what is it doing to support Islamic trade finance?

Paul: In a variety of different ways is the honest answer. From a pure finance perspective, they have the resources available to fund or arrange various different trade finance-related initiatives. But they are also active more generally in terms of promoting Islamic trade between OIC countries. If you look at the statistics on what they've been able to achieve - I think they facilitated something like US$3 billion-worth of trade in 2011. Be it quasi-governmental, that's a sizeable commitment to trade. It is clear that ITFC are doing things both practically and also from a more general awareness perspective as well.

IFN: Do you think - Fadi for example, do you think that there's a greater role they can play or do you think that there's an area where they could support the sector further?

Fadi: I think they're playing a good role so far especially in terms of having Islamic finance serve the actual economy. Originally it started with the federal government of the OIC countries and this is one of the ways they're doing it. I think however that the biggest role goes back to the central banks of the countries themselves in terms of promoting Islamic finance and trade finance - they need to remove all the barriers. This is what I think would have the biggest influence in promoting the sector.

IFN: That takes us quite neatly to our final question. We've touched on most of the bases we wanted to cover today, so the final question, if I can just take it around the table, is how can countries or even individual banks work together? What channels can they go through, what bridges can they build that will encourage Islamic trade finance flows?

Fadi: The way I see it is that Islamic trade finance should use the existing channels and infrastructure. They don't have to rebuild or reinvent the wheel – what they need in place is good products, which are sellable; and good technology so that they can manage all their operations in an efficient way. As we have repeatedly said, Islamic trade finance is an alternative product to conventional trade finance. They need to offer something competitive and not try to reinvent the whole thing. So it's just facilitating and creating the knowledge and offering a good product.

IFN: And Prasanna, what do you think?

Prasanna: There are so many areas. Human capital is important, and also we need more focus on innovation and building products. The demand is always there, so Islamic banks have to step up to the plate and grab as much of it as they can.

IFN: Paul?

Paul: I have similar thoughts, but the one area that I think really needs to be focused on is that broader geographical network. Whether it is through a series of co-operation arrangements with other financial institutions (that do have that broader network), the key is being able to track and tap into the real economy, the real underlying trade activity - where it's taking place and when it's taking place. At the moment, I think Islamic financial institutions struggle with that. I think to add in to that, exactly the point that Prasanna made about product range: you need products that people know work, but also products that people understand as well - and I don't think the understanding is there unfortunately at the moment. We have a lot of Islamic products that may work for one institution, but they don't necessarily work for another. It is challenging, but we do need some kind of 'think-tank' approach between Islamic institutions to work on models that are acceptable - not necessarily for all, but certainly the majority.

IFN: And is there an agency or institution that you think perform that think-tank role, is that something that the IDB or the ITFC could step in to perform?

Paul: The ITFC certainly has a role to play there, but I think on a broader level we need a greater level of co-operation between banks operating in the relevant countries where the underlying trade activity is happening. As I mentioned earlier, for me, the most important point is the lack of geographical spread and being able to tackle that challenge much more effectively.

IFN: Moinuddin, would you like to finish this off? What are your final thoughts?

Moinuddin: Well, if we leave Islamic trade finance to commercial Islamic banks then it's never going to grow. I would like to see perhaps entities like ITFC taking actual positions rather than just arranging financing for trade. Because of their network - since they have presence through the IDB in all of the OIC countries - they should start taking actual trade risk and trade positions and lead by example. If they do it right, that will encourage Islamic banks to take part of that facilitation. So the funding actually can come from an Islamic bank taking a unit share into what ITFC does.

That's one way of encouraging them - learning starts from ground zero. If you expect that somebody will come and put in place an Islamic trade finance model - that is never going to happen. And these banks will never have the distribution reach in the next 10 years.

So if those things are not going to happen on their own, are we going to let the opportunity pass us by? No, we need to push the ITFC and IDB, and say look, you've done trade facilitation through finance – now move one-step ahead. Set up an actual trade finance fund, take positions into those countries, facilitate the sale of goods, at physical positions, get engaged with the actual buying and selling of goods.

Once you do this well and you do it right, then invite other Islamic banks to take part in this and then connect them together.

IFN: Gentlemen, thank you for your participation.

Protecting and Empowering Islamic Trade Finance through Technology

In today's digital world, having the right technology and protection has never been more important, particularly for Islamic trade finance. This need for security is highlighted by the increasing threat of disruption from activities such as a denial-of-service (DoS) attacks. These attacks can no longer be ignored. If effected, this attempt to make a machine or network resource unavailable to its intended user, could not only result in loss of earnings to corporate customers but have long term effects on their banks including reputational damage, lost trust and attrition.

These risks are known, however, although no fraud related DoS cases are documented, it is possible that these attacks may be designed to "distract" banks while fraud takes place, possibly to gather account details etc. and therefore Trade Finance would be a key target. And with many corporates having multiple internal users with different levels of access, robust protection is essential. Plus let us not forget that if corporates can't reach their bank to move money, they are likely to flood its call center with inquiries.

However, protection is available with the right technology. Systems that use an in-built password authentication system and accommodate a third-party authentication server (to validate users prior to any traffic hitting the servers) offer an effective method to combat these attacks. With these features, banks are able to provide a wide range of authentication options and in turn reduce the likelihood of a denial-of-service attack affecting their servers.

Darryl Proctor, Product Director – Corporate Banking at Temenos says: "The threat of DoS attacks is set to continue and likely to become increasingly sophisticated. Banks cannot afford to be complacent about this.' He adds: Through an agile online authentication solution these threats can be addressed, and in addition, some solutions enable corporate customers to benefit from the convenience of banking from their desktops, enabling access to any authorised accounts with their bank over the Internet. Benefits such as supporting import letters of credit (LC) to make amendments and review drawings, highlight discrepancies and support finance decisions can also be made available with the right system. So not only is the bank's reputation and customer relationship supported but with the right system banks are able to offer additional value, supporting retention and potentially offering new revenue opportunities, giving them the competitive edge."

DLA Piper provides legal services to clients across key industry sectors including banking and financial services, real estate and construction, technology and healthcare. We understand the global importance and impact of Islamic financial services, and remain committed to supporting our clients wherever they do business.

Our international reach and integration means that DLA Piper can handle Islamic finance matters originating in all of the major financial centres. Our lawyers have significant experience in acting for Islamic and conventional clients involved in the Islamic finance industry (including financial institutions, corporates, funds, market regulators and other government entities).

For further information on DLA Piper please visit www.dlapiper.com

DLA PIPER

www.dlapiper.com