Islamic finance: Growing beyond

By Mustafa Adil

According to Ernst & Young's *World Islamic Banking Competitiveness Report 2013*, global Islamic banking assets held by commercial banks are set to cross US$1.8 trillion in 2013, up from the US$1.55 trillion of assets held in 2012.This is significantly higher than some of the earlier industry estimates. Globally, the Islamic banking industry continues to record robust growth, with the leading top 20 Islamic banks registering a growth of 16% in the last three years and Saudi Arabia emerging as the largest international market for Islamic assets (excluding Iran's banking industry which has major limitations for international participants).

Top 20 Islamic banks hold over 50% of global Islamic banking assets

The top 20 Islamic banks hold 57% of the total global Islamic banking assets (excluding banks in Iran) and are concentrated in the seven core markets for Islamic banking which include Saudi Arabia, Malaysia, Kuwait, UAE, Bahrain, Qatar and Turkey.

The Islamic banking industry in Saudi Arabia with an estimated US$207 billion of Islamic assets was ranked first. Malaysia ranked second with total assets of US$106 billion in 2011 and UAE ranked third with total assets of US$75 billion.

New markets on the horizon – Indonesia, Egypt, Iraq and Libya

Egypt has been actively investigating issuing sovereign Sukuks as well as the development of new regulatory framework for Islamic banks, as several banks in Egypt are expected to launch Shari'a compliant products. Iraq is mulling Islamic banking legislation while Libya prepares to implement its Islamic banking framework.

A number of both established and new banks are considering introducing Islamic banking operations in these markets - highlighting the continued growth and development of Islamic banking throughout the Middle East North Africa (MENA) region.

Ten of the world's 25 Rapid Growth Markets (RGMs) have large Muslim populations and present significant growth prospects for Islamic banking. The fast-growth economies now form almost half of the global GDP and remain the main contributors to overall global growth. The outlook for Islamic banking in these markets is bright.

Profitability still an issue

Despite the projected asset growth and the introduction of new Islamic initiatives in a number of countries, the profitability of Islamic banking continues to lag behind that of conventional banking in the same markets. Over the period of 2008-2011, the leading ROE for Islamic banking was only 11.6% against 15.3% for conventional banking. Islamic banks continue to face a number of issues affecting the profitability of the industry. These include sub-scale operations, very basic risk culture, incomplete market segmentation, low engagement with clients, and absence of technologically oriented value propositions.

In several markets, Islamic banks are significantly over-exposed to the real estate sector. On average, almost one fourth of their balance sheet is concentrated in real estate compared to 16% for conventional banks in the same markets.

During the years prior to the global financial crisis, Islamic banks were able to ride the boom in the real estate sector to generate high profitability. This performance hid many of the operating inefficiencies in those institutions, especially with regard to their core business.

The severity of performance challenge has prompted a wide-ranging transformation of business practices at several Islamic financial institutions, which is a welcomed development. We believe this will see the industry take the next step in its evolution from being a niche market to a profitable, service- orientated industry attracting customers with its product innovation and value-added services. Discussions with management and boards of leading Islamic banks suggest that major transformation is happening around Regulations, Risk and Retail Banking (the 3 Rs).

These 3 Rs of transformation are geared towards capital planning, risk modeling, mitigating Shari'a risk and building customer-centric organizations. There are also meaningful developments on the regulatory front although a lot more needs to be done to create the right enabling environment for Islamic banks to implement the reform agenda.

Outlook

A well-executed transformation programme could take two to three years to be implemented, and could improve Islamic banks' profitability by approximately 25%. Ernst & Young's estimate suggests that this would potentially improve returns to Islamic banks equity holders by an additional $9 billion by 2015. But at the same time, there is also a general consensus that a partial implementation will lead to complete failure.

Critics argue that no Islamic bank today can claim to have a truly international brand either in terms of market coverage or service excellence. However, there are 13 Islamic banks that have built up significant financial muscle, each with equity of more than $1 billion, and they will decisively influence the future trajectory of the industry. High potential international markets – each at different stages of development and therefore requiring different penetration strategies – include Saudi Arabia, Malaysia, Qatar, Turkey and Indonesia.

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