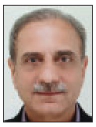
Scaling for growth – the challenge for Islamic banks

In recent years, both conventional and Islamic banks in the GCC countries have faced increased competition amid a challenging economic environment; this has been against a backdrop of liquidity pressures (especially in the relatively smaller banks), increasing operating costs and asset quality that is not improving. ASAD AHMED delves further.



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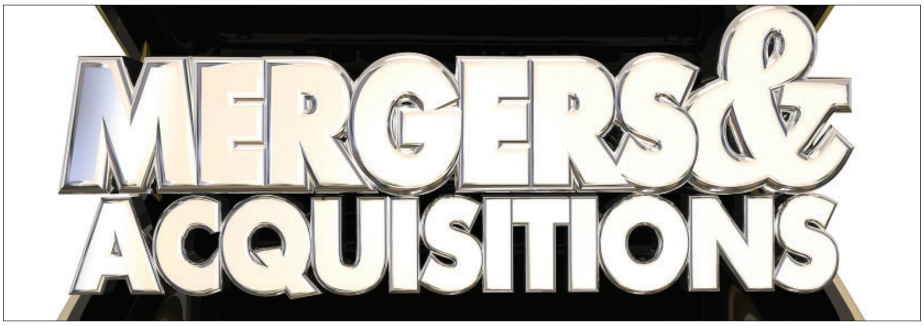

Currently, the GCC is overbanked for the current population as both retail and commercial banking customers across the region have a wealth of choice of both international and local lenders; and, in light of the aforementioned factors, there has been an acceleration of mergers and acquisitions activity in the region. This is a logical outcome leading to a more efficient and more robust financial services sector.

The outlook for the Shariah compliant banks is perhaps more of a challenge. While, on the one hand, the global Islamic economy is increasing its share of the total, the opportunities for consolidation do not always keep pace. According to the recent State of the Global Islamic Economy Report 2018–19 by Thomson Reuters, with Muslim spending estimated at US$2.1 trillion in 2017, the Islamic economy continues its steady growth driven by an expanding, young Muslim population which is expected to reach three billion in 2060, up from 1.8 billion in 2017.

It is generally agreed that banking consolidation in an overbanked and challenging economic environment is a beneficial outcome not only for operational and financial efficiency but also for providing regulatory ease given the strong emphasis on compliance in today's world. However, we have seen limited activity by independent Islamic banks in the UAE which seem unlikely to merge among themselves. In the meantime, conventional banks continue to grow their Islamic windows, limiting the organic growth of Islamic banks. There have been some recent consolidations in the UAE where there was commonality in the ownership structure, namely Dubai Islamic Bank (DIB)'s acquisition of Noor Bank and Abu Dhabi Commercial Bank's acquisition of Al Hilal Bank which has given a boost to the sector by virtue of the creation of larger, more sustainable entities.

Some of the larger Islamic banks in the region have realized that organic growth needs to be supplemented and several UAE banks have gone down this route. DIB, for example, has — in addition to rapid growth in the UAE — set up shop in Kenya with a view to participating in the growing Islamic banking market in East Africa, in addition to taking a significant minority stake in an Islamic bank in Indonesia. Abu Dhabi Islamic Bank has also built an international business in several geographies, notably a sizeable franchise in Egypt.

A point to note with regards to inorganic growth is with respect to purchases of portfolios; there have been instances in both the UAE and the Far East where conventional banks — seeking to reduce their exposure to the asset class or specific market — have sold their portfolios to Islamic banks seeking to grow.

Scaling up, however, still requires surmounting important legal, regulatory and institutional challenges, such as adequate standardization of contracts and managing the cost of structuring and executing Islamic infrastructure financing. This is highlighted because I strongly believe that infrastructure finance is ideal for Islamic finance — a view held by most industry participants. This has implications not only for corporate lenders but, if properly structured, can provide a suitable investment vehicle for retail investors.

Scaling up through organic and inorganic growth is certainly important, but it should not take away from the fundamental premise of the focus on the customer. It remains absolutely crucial for the Islamic banking industry to focus on the development and innovation of products that anticipate, focus and deliver on customer needs without compromising Shariah compliance. There has been very little innovation in either asset or liability products, and the alternatives available to retail investors are extremely limited.

It is also time for Islamic banks to commit to digitalization. Islamic banks cannot practically expect to grow if they are behind their conventional peers in digital services. Given that millennials have a clear preference for conducting their banking services on digital platforms, digital banking is becoming a significant client segment. While many Islamic banks, much like their conventional peers, are adopting digitalization, they are still not "thinking digital". They must adopt next-generation technologies as there will be challenger Shariah compliant banks at some point, and the fight for Gen Z customers will begin in earnest.