Keeping pace

GROWTH PROSPECTS FOR THE ISLAMIC FINANCE INDUSTRY ARE GOOD, BUT NOT ALL PLAYERS ARE EQUIPPED TO BENEFIT, AS **GRAHAM BUCK** DISCOVERS.

The Islamic finance industry would face a challenging economic scenario during 2011, predicted Ernst & Young in its annual forecast at the start of this year. Given the unrest that has swept the Middle East and North Africa since January, the region faces challenging political conditions too.

Yet despite the uncertainties, the firm is confident that Islamic financial institutions have reached a crossroads, and will continue to show resilience to setbacks. The industry's annual growth levels managed a rate in excess of 20% for several successive years until slowing as a result of "tremendous pressure" in 2010.

Nonetheless, as an industry with assets of around $1 trillion, Islamic finance has achieved critical mass, says Ashar Nazim, an executive director of Ernst & Young and Middle East North Africa (MENA) head of Islamic financial services. Having traditionally been focused only on Sharia-compliant institutions, Islamic banks are now seeking to penetrate the mass market.

Nazim adds: "The question reverberating across boardrooms, and among users of Islamic financial services, is about differentiation, or lack thereof, that Islamic financial institutions have on offer. The effectiveness of the existing Sharia governance framework, as well as synthetic product structures commonly in use, is especially under discussion."

There is concern that too many Islamic financial institutions are not truly Sharia-compliant. Regulatory authorities are now looking closely at the issue, as it threatens to undermine the industry's credibility.

Future growth rates could show more variation. The mass protests in countries such as Egypt, Libya and Syria have affected both the conventional and Islamic finance industries, with planned projects being put on hold. By contrast, the economic basics in the Gulf Cooperation Council (GCC) states remain very strong.

The resurgent price of oil is the main driver, particularly in Saudi Arabia. Other contributory factors include massive levels of public spending across the region and significant government support for Islamic finance. Nazim cites Bahrain as a recent example of the latter, with the country's central bank issuing a five-year maturity Islamic leasing sukuk in April valued around $530m.

"Valuations have become more reasonable and investors are more ready to make decisions," says Nazim. "Meanwhile many institutions are reconsidering their domicile and looking at alternative locations."

While there are many positive drivers, Ernst & Young cautions that the industry's growth prospects are hampered by scarcity of data and underinvestment in analytical tools. This limits the focus of Islamic banks to a handful of asset classes while, in many cases, their operating costs exceed those of their conventional peers. The report notes that as future opportunities may cease coming from traditional captive clientele, Islamic financial institutions will "urgently need" to upgrade their business models to tap mainstream segments.

Nazim says the Islamic finance market has too many uncompetitive players, which must diversify and introduce new products to survive. Although customer demand is consistently strong, it has attracted a number of global players, which are seeking to infiltrate the market.

But diversification may not happen as the necessary funding is often unavailable. Ernst & Young says that more than half of all Islamic fund managers may operate with less than the minimum level of assets under management needed to remain viable. It concludes that this provides an opportunity for global fund managers, as well as for consolidation within the industry.

A key emerging sector highlighted is Islamic endowment, or waqf, with a $105bn "wealth pool", that has the potential both to stimulate strong liability generation for Islamic banks and also revive the Islamic fund management industry. Currently this sector is between 60% and 70% invested in real estate, with the remainder in the money market. Nazim says that its rapid growth from a very small base has created a need for proper investment management, particularly as the potential for further expansion in 2011 and 2012 is "tremendous".

He adds: "Decision-makers at Islamic financial institutions need research and tools to assist in making informed decisions on the future growth trajectory of their businesses. Implications of Sharia rulings on governance, product structures and markets need to be

appropriately incorporated at the planning phase itself."

In April, Ernst & Young released the fourth edition of its World Takaful Report, Transforming Operating Performance, to coincide with the sixth annual World Takaful Conference. The latest version underlines how growth is booming; total global takaful contributions grew by 31% in 2009 to $6.9bn, hit $9.15bn last year and are on course to reach $12bn during 2011.

The takaful industry is concentrated in the MENA and South-East Asia regions. In 2009 the top three markets globally were Saudi Arabia (with total contributions of $3.86bn), Malaysia ($1.15bn) and the UAE ($640m). Sudan is the most significant country outside this trio, at $340m, while Egypt, Bangladesh and Pakistan are growing rapidly. Otherwise, most GCC states have seen takaful growth slowing – with the exception of Saudi Arabia, which has been bolstered by the continuing roll-out of compulsory medical insurance.

The fastest-growing region worldwide for takaful contributions is the Indian subcontinent, with an impressive annual rate of 85%, followed by the Levant with 40%, GCC (31%), South-East Asia (29%) and Africa (26%). Broken down by country, Indonesia has the best growth rate at 67%, followed by Bangladesh (58%) and Saudi Arabia (34%).

Nazim says that because the MENA takaful market is much younger than the Malaysian market, it has yet to achieve the same level of scale. "Within MENA, the GCC is a more competitive market with a larger number of players and will drive growth for the industry," he forecasts. "Key takaful markets are characterised by low insurance penetration rates and comparatively high rates of economic growth, leading to a positive outlook for the sector as a whole."

The report identifies the top strategic issues facing takaful as competition for growth, diversification and specialisation, and the cultural and religious acceptability of insurance. In key markets, an increasing number of takaful players have intensified competition as small local players battle established conventional players. Those competing for commercial business have to offer further capacity, underwriting expertise and better broker relationships.

Overconcentration in particular business lines and failure to diversify has encouraged takaful growth to be mainly driven by personal lines so that a number of commercial lines suffer a shortage or even absence of capacity. Takaful operators consequently enjoy lower return on equity (RoE) than conventional insurers, which is aggravated during an economic downturn.

Another big influence is the traditional social systems of protection and reliance on family ties dominant in the Middle East and South Asia, where "awareness of risks, implications and Sharia-permissible takaful solutions is still limited". In the GCC countries, growth is driven by compulsory insurance rather than voluntary policies.

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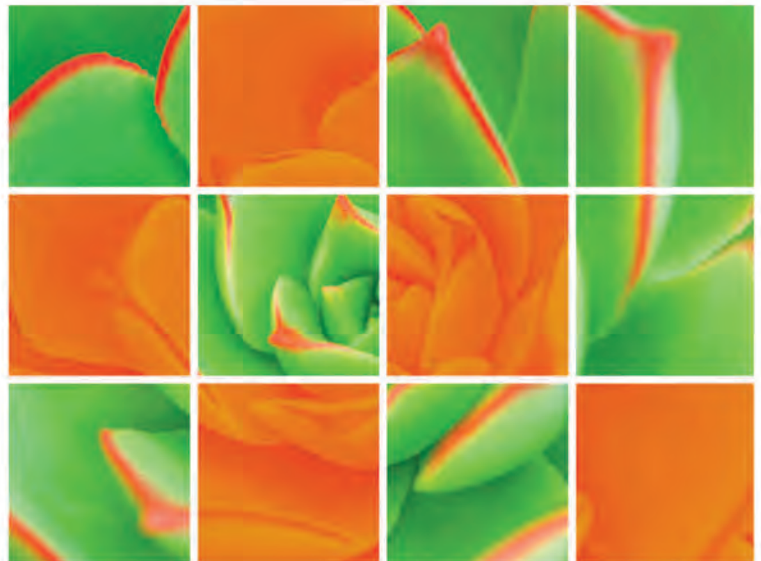

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