The Outlook for Retail Islamic Banking and Finance in UAE

Islamic banking and finance is bound to grow at a higher pace than their conventional counterparts; however, there are systematic and unsystematic risks which will become apparent as the local market continues on a slow yet steady growth for next couple of years in the United Arab Emirates. The Economist Intelligence Unit's Country Report for the United Arab Emirates has revised down the real GDP growth rates for 2010 and 2011 to 2.1% (from 2.6%) and 3.1% (from 3.5%) respectively. Real GDP growth in the UAE is forecast to average 4.9% in 2011-15 slightly lower than the estimated 5.2% in 2006-2010.

With a population reaching 8.19 million as per the National Bureau of Statistic, some experts estimate the local population to be not more than 15%. The exponential population growth during 2002-2008 has been mainly due to the construction related activities and Emirates of Dubai's earlier policy to extend 3-year residence visas to expatriates buying properties in the Emirate. The estimated bankable population UAE is roughly 4.3 million of which a huge chunk can be categorized as "mass retail". This population growth is expected to slow down considerably during the immediate term unless new residency laws are introduced for expatriates. The real challenge to be faced in coming months and years will be "how to fill-up the newly constructed properties" especially the commercial offices and apartment buildings. The main driver for construction boom in the Emirates of Dubai and rest of the Emirates was the perception of getting 3 year renewable residency rights which were shattered back in 2008. The federation will need to carefully think its long term strategy toward providing long term residency to expatriate living and working here in case it want to continue to pursue building its cities and modernize infrastructure.

There are 51 Local and Foreign banks operating in the UAE with an aggregate branch network of 849 as per Central Bank of UAE figures as at 31-10-2010. Of these banks, there are 8 fully licenses Islamic banks with 238 Islamic branches. Additionally, 18 local and foreign banks offer one of more Islamic products & services through their Islamic window operations which represent additional 478 branches. Furthermore there are also 24 Finance Companies of which 11 are pure Islamic in nature. Between the banks and finance companies the market has reached a saturation point and UAE is one of few countries which is overbanked and perhaps under served. Banks whether conventional or Islamic continue to purse same valets with similar products. There is no differentiation and at time the only differentiating factor is price. Such tactics leads to a price war which is good for consumer but at times they tend not to read the fine prints and find themselves locked in an unfavorable position. A stronger push is required from the Central Bank towards looking seriously at the need of recapitalization of the banks and encouraging them to merge and attain not only size but also gain efficiencies.

As there are fewer Islamic players, it is not at all difficult to comprehend that their growth will outpace conventional banks. However, Islamic banks return on average assets relative to conventional banks in 2009 has been lower. Profitability has also declined by 49.8% between 2008 and 2009. The falling of profitability of Islamic banks to conventional banks was slightly higher compared to other markets where this ratio was far greater. Islamic bank's market share on the other hand has increased from the perspective of growth in Islamic assets (CAGR) to 38% between the years 2003-2009. While the growth may not be the issue but the most critical factor for Islamic bank were there inability to bring down their operational costs which was further aggravated due to their having higher exposure to real estate based transactions that resulted in an increased in Non Performing Loans (NPL) and hence higher provisioning / write offs.

Besides higher operational inefficiencies, Islamic banks across Gulf Cooperative Council countries and particularly in the UAE also need to reassess their risk management and liquidity management capabilities. Islamic banks and finance companies being relatively new as compared to their local counter parts have been caught in the growth trap where they did not focus much on risk diversification improving their service standards and efficiencies. They were busy making hay when the sun was shining. Hence, their weaknesses become more evident in the financial downturn. They have been found to be more prone to weaker risk assessment tools, policies and guidelines, lax internal compliance mechanism which has caused them to discover less prudent if not more fraudulent practices deployed by their management at all levels. However, a change is seen in last few quarters where new management has been inducted in few of the Islamic banks.

The competition for Islamic banks during next decade will come from Islamic windows of conventional banks. The total share of Islamic windows of the total Islamic banking assets has reached 10.9% by 2009 as compared to 7.3% in 2007. The growth in Islamic windows between 2008 and 2009 despite the financial downturn was 17% with the total size estimated to be US$7.7 billion. Unless the Central Bank of UAE follows what its neighbor in Qatar has, i.e., restrict issuance of Islamic branches and cap their growth, UAE based Islamic banks will need to put their act together quickly. The key challenge will be in retail segment as large corporate and sovereign / sub-sovereign deals will become very price sensitive and local banks will find them difficult to compete with foreign banks.

Transparency, disclosure, compliance and risk management will be the key for health of banking and finance industry in UAE and rest of the G.C.C. counties. While delaying and rationalizing project have helped banks engineer soft lending especially in case of real estate segment, greater transparency and disclosures in retail segment to start with due to recent approval by the President of UAE to set up the credit bureau - a personal credit rating agency will be a welcome change by bank. It may cause some quarters to raise their brows; however, on a longer run, such bureau will make banking and finance industry much safer and will assist the regulator to effectively monitor and keep checks on its lending policy implementation. It will also bring some discipline in a particle retail segment of the market that used to take advantage of lack of clarity with banks and finance companies and over extend itself. Global credit crunch has also exposed UAE to have accesses in borrowing in all fronts including retail. With the introduction of the credit bureau, the relative easy access to credit is bound to decline; however, banks need to play their part in investing in people, products and promotion to bring up the awareness and benefit of savings.

Recent survey by National Bonds for its GCC Saving Index reviled that UAE residents are amongst the worst savers in GCC countries compared to the rest. Key reasons for this behavior may be the relatively high propensity to spend and avenues to spend or even lack of planning or availability of information on products. The key element here is to understand the importance of saving for future and planning. While UAE may have one of the most dynamic consumer culture compared to other GCC countries, people are much more geared towards spending. If retail segment is to grow and be healthy, the key message for the banking & finance institutions will be to educate this segment through innovative products which induce saving behavior and the ideal breeding ground for that to start with youngsters.

One of the key tests of Islamic bank will come from retail customers. Islamic banks have been heavily involved in providing home financing under Forward Ijarah and Ijarah structures for under developed and developed properties, respectively. As the Emirates of Dubai shied away from giving 3-year residency visa to foreigners buying properties in the Emirate, the state owned and private developers became less successful in selling their off plan projects which used to sell completely in hours post launch. To further aggravate the issue, the financial downturn saw a bigger exodus of expatriate population out of Dubai compared to the rest of Emirates or the GCC countries. This affected an increase in cancelation, defaults and delays in payment from the investors to the developer and hence caused a funding shortage which the developers are finding very hard to meet. To top it up, banks started freezing, limited and even decreasing their real estate exposures which further enhance the situation. How does it affect Islamic banking more than conventional? Simple reason, lack of clarity in the law of the land. With conventional mortgage the bank lends money against the real estate, takes a mortgage over property and at time take a Power of Attorney to evict the owner, with Islamic finance, the Islamic entity is the owner and the investor the tenant or the lessee. The local Lands Department put an Ijarah mark on the title deed which means that to evict the lessee in case of a default, the financier needs to go through a longish court proceedings. This gives conventional finance a slight edge over Islamic home financing product. With both products providing the same economical means i.e., financing a property for the buyers, the legal treatment and process should be identical in case of a situation of default otherwise; Islamic entities will start building up a huge inventory of non-performing loans.

Retail banking represent 50% of banking revenues in the Middle East and this share is expected to grow further. Retail segment remain a high growth area for Islamic banking and finance. With operational efficiencies, penetration into new segment and developing human resources, Islamic bank and finance industry around the world is expected to double its profit over next 5-year. In retail banking and finance, greater focus needs to come on the affluent retail segment and Takaful. There has been very little emphasis given on Islamic retail market and except plain vanilla products, one does not get to see any invocation in product and services being introduced. Islamic banks will need to be creative and enhance their existing product offering such as saving schemes, remittances, cards, mortgages, personal loans.

Market analysts are expecting future growth to be result of operation improvements and capturing of new pockets of growth. However, market share of existing fully licensed Islamic banks and finance companies will be challenged by Islamic windows. It is critical for Islamic banks to develop a compelling value proposition in order to keep on attracting all segments of retail customers. This will require defining core elements including the relationship model, branding, service model, professional sales team and product offering.