Islamic Finance *forum*

Are we likely to witness consolidation within the Islamic Banking Industry as we have seen with the conventional banks?

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Consolidation is an inevitable consequence of the over-riding imperative within Western enterprise models to "cut costs" and "maximize shareholder value". In the case of the Islamic banking industry certain bottlenecks strengthen this trend, principally a shortage of Western-based legal expertise and of Islamic scholars both versed in modern financial techniques and sophisticated enough to bridge the fundamental divide between an asset-based economy and a deficit-based financial system.

The foci of Islamic Banking consolidation appear likely to be the developing "Centers of excellence" in London and Dubai. The sources of funds will be the sea of petrodollars which - unlike after the first oil shock - are not destined for US assets but probably rather for investment in the developing economies of the Middle East, India and China.

However, I believe that a tsunami is about to overwhelm any wave of consolidation, embodied in the trend towards disintermediation and decentralization of the financial system inherent in the pervasive spread of the Internet: i.e. the "Napsterization" of financial markets.

We already see in the emergence of a direct "peer to peer" connection between lender and borrower without credit intermediation by Banks. Alternatively, new partnership-based "Clearing Unions" offer bilateral interest-free credit subject to a multilateral guarantee.

In the future Banks will no longer create credit – the unquestioned but deeply questionable "Deficit-based" financing at the heart of monetary markets as currently practiced – but may instead manage the creation of credit and introduce investors to investments possibly using new trust and partnership legal "wrappers".

Central Banks will cease to issue deficit-based money and instead become monetary authorities managing the issue of "asset-based" money by national treasuries.

Timescale? At most five years, precipitated by a dollar crisis itself founded upon peaking energy supplies and the reluctance of oil producing nations to fund profligate US energy use.

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Consolidation within the Islamic banking industry is likely in the long term but in the next two or three years we are unlikely to see any mergers. Whereas the multinational conventional banks operate in liberal economic environments, where major institutions such as HSBC have been able to buy up local banks, acquisitions within most Muslim countries by foreign banks are likely to counter resistance. The Dubai Islamic Bank has an office in Tehran for example, as trade between Dubai and Iran is increasing in significance, but it is doubtful if it would want to acquire one of Iran's state owned Islamic banks even if it had the opportunity, and it is unlikely that the government or Central Bank in Iran would want to let this happen anyway.

In the case of Saudi Arabia although some new international banks are establishing offices, no foreign takeovers of existing banks are being allowed, and none of the new entrants are Islamic banks. There is perhaps a reluctance to challenge large Islamic retail banks such as the Al Rajhi Corporation for Banking and Investment on its own home turf.

In Malaysia foreign Islamic banks such as the Kuwait Finance House are establishing offices, but they are not interested in establishing or acquiring retail networks, their role being to identify investment opportunities for the funds they have raised in the oil rich Gulf, not to harness deposits from Malaysians. They are more likely to work in partnership with local banks, but not to take them over, partly because they do not know the market well, and are likely to proceed with extreme caution.

The most likely mergers would be in the UAE where the banking system is very fragmented. Islamic financial institutions such as the Dubai Islamic Bank, the Abu Dhabi Islamic Bank and the National Bank of Sharjah have strong affiliations with particular emirates as their names imply, and although they have branches throughout the UAE, the identification with a particular home base is viewed as a strength that would be lost after a merger. Nevertheless as the UAE increasingly functions as a single market, and as eventually this is also the case with the wider Gulf Cooperation Council, cross emirate and cross border mergers seem inevitable.

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Islamic Finance forum (continued…)

AIAK GROUP

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I do believe there must be consolidation in the Islamic Banking industry, because currently bank capital is too low to support significant transaction sizes. A relevant case in point is HSBC recent landmark asset-backed bridge financing to support Etisalat's US$2.6 billion bid for Pakistan's PTCL.

This was not only managed by HSBC, but every other participant in the syndicate is a commercial bank (including global banks like Citi, Deutche and Barclays). Why? Because Islamic banks don't have the balance sheet to bid for these transactions. So consolidation is a must, else the Islamic banking industry, as we call it, will remain an oddity on the fringe of the banking community, or more likely will be little more than one amongst many specialized product lines offered by the global banks.

Sadly, I don't think the consolidation will happen soon enough, and that the latter scenario is very likely to materialize, but that is a separate matter for discussion.

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Despite an impressive growth record, Islamic banking remains only a small segment of the global finance industry. In order to compete with the mainstream banks, Islamic banks must grow in size and resources. However, Islamic banks have so far been insignificant players in their respective markets, barring few exceptions. The largest Islamic bank, Bank Melli in Iran, has total assets of about $22 billion, compared with total assets of $1.28 trillion of the largest bank in the world, namely, Mizuho Financial Group of Japan. In fact, there are only 6 Islamic banks with total assets of $10 billion or more (only 2 if the state-owned Iranian Islamic banks are excluded); and there are only 4 Islamic banks with market capitalisation of $1 billion or more (only 2 excluding Iranian banks). This compares poorly with the conventional banks: top 6 conventional banks have their individual total assets exceeding $1 trillion; 3 top conventional banks each have market capitalisation of $100 billion or more. Given this huge size differential, Islamic banks are bound to go through a similar consolidation as their conventional counterparts did in the past. There is now a trend emerging in favour of establishing "mega" Islamic banks; but an active process of mergers and acquisition (M&A) will serve as a real impetus to growth of size of Islamic banks. The conversion of conventional banks into Islamic ones in a number of Muslim countries will pave way for M&A. The process of conversion is witnessing growth at present and it may take a while before a wave of M&A may emerge in Islamic banking.