

# **Long-term challenges and risks in the banking industry: the position of Islamic banks**

## **Scope of the presentation**

The banking industry in developed markets is undergoing a steady and profound transformation. The areas in which banks have historically generated most of their profits are being squeezed, eliminated by technology and appropriated by new players. To compensate, banks are pursuing growth in sectors which previously fell within the domain of other financial institutions such as insurance companies and investment funds. The balance sheet and income profile of a sophisticated bank is today very different from what it was 50 or even 25 years ago. And in 50 years time, “banks” will be scarcely recognisable as the institutions which currently bear that name. As a result, one can confidently say that over the long term the greatest risks facing banks will be strategic, and will derive from the changing face of financial markets, from banking technology and from greater customer sophistication, rather than from the well-rehearsed perils of bad-lending, loss of liquidity and inadequate capitalisation.

The purpose of this paper is to describe some of these long-term strategic risks facing the banking industry as a whole, and then to ask how well placed Islamic banks are, as a group, to confront them. Much has already been written on the risk profile of Islamic banks, and whether Islamic banks are inherently more risky than conventional banks. I contributed to that debate myself in a paper to the 1999 Harvard conference on Islamic Finance and concluded that there is no reason to believe that Islamic banks are inherently more risky than conventional banks. Elsewhere, many Islamic financiers have argued that the presence of profit-and-loss sharing deposits results in Islamic banks being inherently overcapitalised in relation to their conventional peers, while others would say that the fact that Islamic credit is extended against real assets enhances the strength of their balance sheets, in comparison to conventional banks which extend large amounts of unsecured loans.

In this paper I want to move beyond this focus on balance sheet instruments and take a strategic perspective which examines whether Islamic banks are now and will in future be well-positioned to accommodate the future needs of consumers of financial services. I am undertaking this task as a credit analyst who currently follows the performance of major banking groups in Western Europe and who until recently followed financial institutions in the Middle East, including several Islamic banks. My perspective is not that of a Muslim – for I am not a Muslim – nor is it the purpose of this paper to prescribe what Islamic banks ought to do to ensure that they are well-positioned for the future. The direction which Islamic banks should take is a matter for Islamic bankers and the Muslim community to decide. But perhaps I could be so bold as to hope that the perspective which I can give, as a neutral observer, can be of some service in that deliberation.

A discussion of the long term challenges facing the banking industry could fill a book and occupy a whole seminar in itself, so I apologise that my treatment will necessarily be rather cursory. Nonetheless, I hope that I will have identified some of the most salient issues.

### **The decline of intermediation**

The historical role of banks was to act as intermediaries between those with excess funds (savers) and others who lacked funds (borrowers). This business of intermediation was profitable, and it was the fulcrum on which capital markets rested – banks monopolised financial intermediation, and they enjoyed the pricing power which monopolies confer.

But new financial instruments and new types of financial institutions have been disintermediating the banks, either by giving savers and borrowers direct access to each other, or because new players have been able to perform more efficiently some of the processes previously undertaken by banks. The clearest example has been the rapid growth of international bond markets, which give large borrowers direct access to savers. But disintermediation has more recently become a factor in retail financial markets. Money market funds in the US give savers the liquidity which they expect from a bank account, while providing the higher long-term returns associated with stock and bond markets.

Equally important has been the emergence of new players, often focusing on niche activities where their particular competitive advantage or business strategy is able to offer a financial service at terms which the banks are unwilling to match. In the United Kingdom, supermarkets now offer personal loans. Even one of the most basic banking functions, the provision of cash, is being assumed by other providers – if I pay for my groceries by credit card I am asked by the checkout clerk if I would like “cash-back” – Sainsbury’s Supermarket now provides me with cash – there is no need for me even to visit one of my own bank’s cash machines.

The examples may be anecdotal but the effect on bank profitability is concrete. The spread which banks make on what they pay depositors and what they can charge borrowers has been declining. The old business model whereby banking was based on intermediation will be diminishingly viable in the decades to come. Already, insurance and asset management are key features in the business mix of any progressive bank.

An important qualification to this argument is to note that banks themselves have the opportunity to own the new players which are establishing themselves. In the UK, one of the fastest growing car insurance companies is Direct Line, which is able to offer cheap rates because it distributes its products only by phone – so avoiding the need for a costly branch network. But Direct Line is owned by Abbey National, one of the biggest British banks. Abbey National has realised that a reasonable proportion of car drivers are prepared to buy their insurance over the phone (rather than visiting their bank or an insurance company branch) and they have acted to make sure that they are able to benefit from this trend -- by owning one of the new entrants – rather than being victims of it.

## **The growing importance of banking technology**

Technology is revolutionising the banking industry just as it is revolutionising many other aspects of our lives. The effect on banks is multifaceted and, inevitably, presents both threats and opportunities. Key aspects of way technology is changing banking include:

Greater and cheaper access to customers: The internet, but also phone banking and ATM services, enable banks to interact with customers outside the confines of a branch network. For example, the Dutch bank ING is trying to expand its retail business in France through its ING Direct internet service, rather than by setting up an expensive chain of physical branches. As a result of new technology, it is easier for new entrants to establish themselves than before. A company which has an attractive product can distribute it to customers through remote channels rather than through high street branches.

Separation of manufacturing and distribution: The increased distribution power which technology brings is enabling companies and banks to separate the manufacture of financial products from their distribution. In other sectors, this separation is obvious – when you go to a grocery store in Pasadena you do not expect all the products on the shelves to have been manufactured by the store owners themselves ! But historically, banks have only sold financial products which they have manufactured. And, to look at it the other way around, customers have only been able to buy products from the banks which have manufactured them. This is changing. In the UK you can now get a personal loan or a mortgage from Tesco, a national supermarket chain. Of course, Tesco does not actually lend the money – it is distributing products which in this case are manufactured by Royal Bank of Scotland. The separation of manufacturing and distribution is a threat to banks in the sense that they are no longer the only source from which customers may buy financial products. But the opportunity lies in their ability to sell a far greater range of products, through a greater variety of channels than before. In the future, the successful banks will be those like Royal Bank of Scotland who use technology to package their products in different ways and to distribute their products through a variety of channels.

Using computing power to design more complex products: There are many examples of how computing power is enabling banks to offer products which would not have been possible only a few years ago. On line brokerage and on line business-to-business purchasing are examples. In less developed banking markets, the linking of branches to the head office on line in real time is improving risk management and making banks safer – as well as benefiting customers by accelerating loan approval processes. At the most basic level, customers are no longer prepared to wait in line to withdraw cash from their accounts – we expect to be able to withdraw cash from a machine, at any time of day, all over the country.

Drawing all these factors together, we can say that technology is driving down the cost of banking while offering the opportunity for higher standards of service and risk management. Banks which fall behind their peers in their understanding and use of technology will be marginalised over the long term and will see their profitability and strength decline. At Moody's, assessing the technological sophistication of a bank is becoming an increasingly important element in our bank rating methodology.

### **New financing techniques**

I said that I would not be addressing specific balance sheet risks, but no description of long term banking trends can ignore the rise of structured finance, securitisation and subordination. All these financial techniques enable banks to increase the leverage on their balance sheet: in simple terms to conduct greater volumes of business – and so make more profits – than the level of their capital funds would ordinarily imply. They also enable banks to attract cheaper funding, and to do business with a wider range of customers – an asset which may not be attractive to the bank under a conventional financing, could become attractive through innovative structuring. This is not the place to enter into a detailed description of how these financing techniques work. Suffice it to say that we are observing them being used in greater and greater volumes and they are enabling banks to enhance some of their profitability ratios. I am going to return to this point later in the presentation.

**So how well placed are Islamic banks to confront these challenges and exploit the opportunities ? Let us start by looking at how disintermediation may affect them.**

**Disintermediation is a real threat, but one which Islamic banks are well placed to counter**

Disintermediation is indeed a big threat to the future of Islamic banks because they currently benefit from large amounts of unremunerated deposits or deposits which earn low returns. As the Islamic mutual fund industry grows, more and more of these deposits will migrate to those mutual funds in search of higher returns. As the opportunities to invest in Islamic funds grows, and the transparency of those funds increases, customers will simply not be willing to accept zero returns on bank deposits. In my opinion, the growth of the investment fund market has been one of the most exciting developments in Islamic finance over the last few years, both from the perspective of the amount of money invested, but also in terms of the sophistication of the sector – there is far more information about performance and investment styles now than in the recent past.

But of course Islamic banks already offer fund management products. *Mudarabah* is well established as a product offered by banks, not just by specialised investment funds. In the coming decades, the successful Islamic banks will be the ones which offer a broad range of well-performing investment funds, either manufactured by the bank itself, or distributed on behalf of another institution – remember what I said earlier about technology separating the functions of manufacturing and distribution. In the Gulf we have seen the example of commercial banks offering their customers mutual funds

designed by the Institutional Investor, a Kuwait-based Islamic investment bank. Those commercial banks are earning commission income by distributing the funds, and they are deepening the relationship with their clients, and perhaps attracting new clients who previously did not have a relationship with the bank.

Management expertise is a key determinant of any bank's ability cope with the challenges such as disintermediation and new entrants, and this is no less true for Islamic banks. A management team which is content to rely on conventional deposits and, on the asset side, *murabahah* and a few *mudarabah* funds will over time be marginalised as customers switch part of their money to investment funds. It is my observation that many Islamic investors – both retail and corporate – are quite conservative in their risk appetite and expectations. As they become more financially sophisticated their expectations will rise, and if the banks cannot fulfill them, someone else will fill the gap.

**Islamic banks should be able to exploit the opportunities of technology – providing their access to the internet is not restricted**

As for the issue of technology, I can see no reason in principle why Islamic banks cannot exploit the opportunities of banking technology – as a distribution channel -- to the same extent as conventional banks. There have been various attempts by Muslim groups to forestall technological innovation but as far as I can see they have all eventually failed. Scholars objected to the introduction of the telegraph in Saudi Arabia, but telegraph wires were nonetheless laid, and in the 1960s, again in Saudi Arabia, certain groups mounted violent opposition to the introduction of television, but their efforts came to nought. We can all observe that Islamic banks do in practice provide ATM facilities and phone banking for their clients just like conventional banks.

As for technology as an aid to product design, again, I can see no reason why Islamic banks cannot use modern computing power to create more sophisticated products. Take, for example, “sweeper facilities”, whereby any balances in a customer's current account over a pre-set amount are automatically swept into a higher-paying savings account, and, vice versa -- balances being swept automatically from the savings account if the current account is liable to go overdrawn. Is there any reason why this type of product cannot be offered by an Islamic bank, in order to sweep customers' funds from *qard hassan* into an investment account ?

There is one very obvious qualification that I have to make at this stage, and that concerns attitudes to the internet. The internet is a powerful banking tool and it will become more powerful. Yet in some Muslim countries access to the internet has been restricted due to concerns that users will have access to material of which the government disapproves – essentially we are talking about pornography or material posted by the political opponents of the government. But this would not seem to be an insurmountable problem. I was talking recently to a major international bank which had entered into a joint venture agreement with an internet portal – with a view to marketing the bank's services through the portal – and the bank had insisted that a firewall be put in place to

ensure that no one looking at the bank's material could go from there to access pornography.

Certainly, if Islamic banks find themselves unable to use the internet they will be at a serious disadvantage vis-à-vis their conventional rivals – internet technology offers huge opportunities to distribute products more cheaply and to reach new customers. In many countries, the constraint is more likely to originate from the government rather than the Islamic banks themselves.

### **The design and implementation of innovative financing techniques is one of the greatest challenges facing Islamic banks**

I referred earlier to the benefits which conventional banks are able to get from structured finance, securitisation and subordination – benefits which include greater volumes of business, a wider client base, and greater leverage of capital. It's not clear to me how far current Islamic financial theory enables Islamic banks to use these instruments – although I have seen that mortgage securitisation has begun here in the US – but I would predict that there is considerable untapped potential. Anyone involved in Islamic finance knows that the industry lacks the range and sophistication of asset and liability classes which are routinely used by conventional banks.

Take the example of subordination. Conventional banks routinely issue deeply subordinated preference shares. For the non-bankers among you, these are securities which central banks are prepared to consider as capital, so benefiting the bank's regulatory capital ratios; yet they do not count as issued share capital, so they do not dilute the investment of existing shareholders; and they are a cheaper form of funding than issued share capital, which benefits the bank. So by issuing these securities, the bank pleases regulators, shareholders and secures a relatively cheap form of funding. The key point is that although they are a cheaper form of funding than equity, preferred shares pay a higher return than conventional debt, because in the event that the bank gets into trouble, it must pay holders of conventional debt ("senior debt") before paying anything to the holders of preferred shares – that's where the "subordination" comes in – the rights of the holders of preferred stock are subordinated to the rights of other claimants.

The advantages of such instruments are clear, but they depend on investors accepting that their claims rank behind those of other asset holders, and on the bank being able to enforce this priority of claim in a court. I would be very interested to know whether Islamic finance could accept that one class of investor should receive a higher return than other classes as compensation for the risk which they are taking that if the investment goes bad, they will likely receive a lower payout.

I am not going to spend time running through other examples. Suffice it to say that the development of new instruments would enable Islamic banks to build more diverse balance sheets which should therefore be inherently stronger and display an more efficient risk-return profile.

## **Islamic banks are not focussed primarily on profit maximisation**

In assessing the future strategic direction of Islamic banks it is important to recognise one fundamental difference between Islamic and conventional banks. The purpose of Islamic banks is not simply to provide banking services to customers, it is also to enable the Muslim community to conduct its financial affairs in accordance with the *sharia*. The business model for Islamic banks is not one of pure “profit maximisation”. An Islamic bank which is unprofitable and steadily going out of business is still an Islamic bank providing that it adheres to its overriding strategic objective of conducting all its operations in accordance with the *sharia* – it may not be a very good bank, but its credentials as an *Islamic* bank remain undiminished.

The significance of this lies in the danger that managers and shareholders will be prepared to accept lower performance from their Islamic banks – the attitude might be that financial performance is secondary to the importance of adhering to the *sharia*. I would argue that the two are not contradictory. And I believe that Muslim scholars would go further and argue that because Islam is a holistic system in which ethics and economics are not distinct (as they are in western economic theory) then an Islamic bank’s most direct route to superlative financial performance will necessarily lie along the path of most pious adherence to the *sharia*.

Since I am not a Muslim, I do not wish to express an opinion on the validity of the last point. I would simply make a practical observation. If you believe, as I do, that Islamic financial markets in all their forms will grow in the coming decades, then investors are going to have more choice in where they place their capital. Islamic banks will have to compete for that capital and if they are inefficient and display poor returns they will lose out to other Islamic institutions which are able to use it more profitably. If Islamic banks do not perform, they will be starved of capital and will be marginalised. You can interpret that marginalisation as a consequence of inadequate piety (in a holistic Islamic system) or as a consequence solely of economic factors (according to western economic theory), but the result will be the same.

## **Conclusion: whether you are an Islamic bank or an conventional bank: adapt or die!**

Banks whose business continues to be based on taking deposits on one side and lending them out on the other side will go the way of the dinosaurs – they will become extinct, with the exception of a few pockets in obscure corners of the world where they will live on a curious anachronisms who have opted out of the evolutionary process – rather like those giant lizards in the Galapagos Islands which are believed to be the closest living descendants of dinosaurs. That will be the case whether a bank is Islamic or conventional.

The successful banks will be those which are able to retain customer loyalty and current profitability by distributing new financial products which meet customers’ needs for the future. Management dynamism and expertise, and an appreciation of the opportunities offered by technology will be key determinants of success. There is no reason why

Islamic banks cannot be successful in this brave new world of banking. Indeed, the exceptional position which they command within the Islamic Umma gives them many advantages which are denied to conventional banks.